



Can Hollande pull off a Schröder and will it work?

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With the New Year came a new Hollande pledging to build a New France. Still, most of the announcements made in January by the French President merely confirmed a prudent policy inflexion which started last year. Hollande is counting on the solemnity of the speech, putting economic reforms more firmly on the French political agenda, and on the nod to Germany with the shift from “socialist” to “social-democrat” in his self-definition to send a strong message. But to make a serious policy turnaround you need not just vision, you need a capacity to challenge taboos. Schroeder took office *after* a public ideological revision of the centre-left, Hollande did not. In this sense, “pulling off a Schroeder”, i.e. addressing head-on, in one sweep, the structural shortcomings of the French economy is going to be next to impossible for the current French administration. The reforms are likely to be slow, and the transition will be costly in terms of growth. This will weaken France’s reserves of political energy for European reform for many years.

The structural hurdles to reform are more firmly entrenched in France than in Germany 10 years ago as France has chosen to resist globalization paying the price through acute deindustrialization. Some taboos, in particular on labour market issues, still remain. In Germany the Hartz reforms and union-supported wage moderation allowed an underdeveloped services sector to absorb the low-skilled unemployed and ultimately the creation of significantly more stable jobs than in France. In contrast, political and ideological opposition to the German model – perceived as overly dependent on precarious, low-paid jobs and rising inequalities – are prevalent on the French political right and left. They receive further fodder from the latest policy shift on the Eastern side of the Rhine – introduction of a minimum wage, higher spending on pension. This will force Hollande to tread carefully and will impair his capacity to emulate some of the best features of the Schroeder reforms.

Thus the adjustment is likely to be slower to yield any meaningful results on potential growth than in the German experience and a meaningful structural re-convergence of the two countries will be slow. The very limited fiscal room will prevent a transitory rise in public spending that eased the adjustment in Germany. Instead France needs to work hard to downsize its bloated public sector. This will not be an easy feat, given the size of structural entitlements.

The implications of France’s economic relapse reach beyond its borders. As France has already become very dependent on monetary stimulus Germany will have to put up with another reason for the ECB to maintain a very accommodative monetary policy, and Berlin is unlikely to find in Paris a staunch ally in completing the institutional overhaul of the Euro area.



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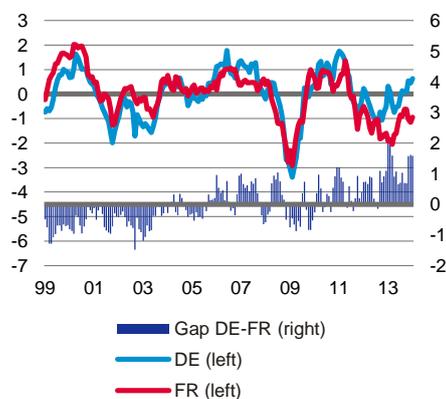


Can Hollande pull off a Schröder and will it work?

Germany & France: Égalité or disparité?

1 Pronounced gap between PMIs

Composite PMIs, standardized values

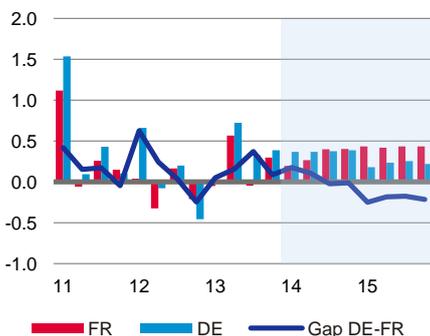


Sources: Deutsche Bank Research, Markit

The Franco/German relationship has always been special. In good times it was the driving force behind further European integration; however, it has never been free of underlying tensions. Since the global financial and economic crisis an increasing rift has become visible as Germany managed – despite the bigger initial blow – a swifter recovery, while France has been plagued by rising unemployment and protracted fiscal deficits. While optimism among German companies and increasingly among German consumers is moving higher and higher, France has remained obsessed with “*la crise*” for the last few years. Now it seems the President Hollande has understood what is at stake and is prepared to drum the message home to the French people: Either France shapes up, or it will over time lose its political clout. While his intended supply side reforms are still scarce when it comes to detail, they mark what is probably a good time for a thorough comparison of the cyclical and structural performance of the two economies.

2 German outperformance temporary

Real GDP, swda, % qoq



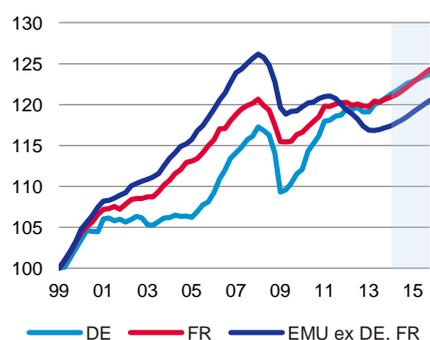
Sources: Eurostat, Deutsche Bank Research

In recent months the German composite PMI has risen strongly while the French counterpart dropped below 50 bringing the gap between the two sentiment indicators close to a 15-year-high.

However, the gap in GDP data is smaller than the PMI surveys suggest. Granted, on average the French economy has stalled more or less over the last 3 years while the German economy grew by almost 2.5%. Combined with France's weak post-2009 recovery French GDP reached its pre Great recession peak of Q1 2008 at year-end 2013, while the German economy was already 3.0% above the pre-crisis peak. Despite this favourable comparison German growth has not been unambiguously strong either. For instance, GDP contracted strongly in Q4 2012 and growth in 2012 (+0.7%) and 2013 (+0.4%) was well below its potential of about 1 ¼%. Relative to the Euro area aggregate (2.7% below peak), France's performance has not been particularly bad, but markets focus on surveys which are directly comparable.

3 Germany and France moving in sync again

Real GDP, Index Q1 1999 = 100



Sources: Eurostat, Deutsche Bank Research

High frequency data is not systematically in favour of the “Germany pulling away” thesis either. For instance, industrial production growth turned positive in France and Germany in late 2013 with the German industry somewhat ahead on the recovery path. Roughly the same can be said for the two countries' export performance – growth has bottomed out, but not gathered much momentum with Germany slightly ahead. In contrast, French retail sales have performed better than the German ones. These indicators support the notion that both countries are on a recovery path.

With EMU recovery on track growth paths are forecast to converge again. Looking at our own forecasts as well as external forecasts, from for instance the European Commission or the IMF, the French economy is expected to accelerate over the course of 2014. In 2015 both economies are seen to expand at roughly the same rate of between 1.5% and 2.0%. France should benefit relatively more from the EMU recovery given its higher exposure to these markets. Over time this improvement should be reflected in falling unemployment. Taking a more long-term perspective reveals that based on these forecasts France and Germany will have posted about the same growth performance since the start of EMU with both economies nearly 25% larger by 2015 than in Q1 1999.

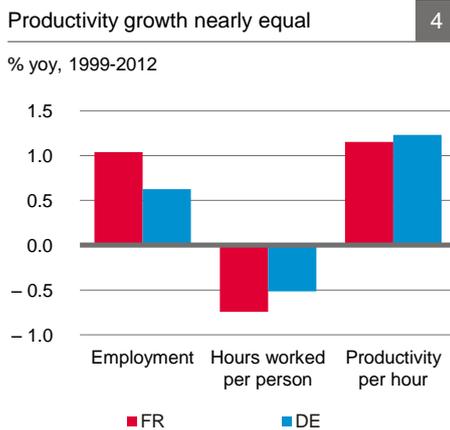
Still, the crucial indicator that points to a materially bleaker picture for France is the unemployment rate. At nearly 11% it was more than double the German rate



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(5.2%, harmonized) in late 2013 – a clear sign of slack in the economy – and while French unemployment has stabilized recently, it has still underperformed relative to the continued downward trend in Germany. This reveals, beyond the similarity in cyclical developments, wide structural differences.

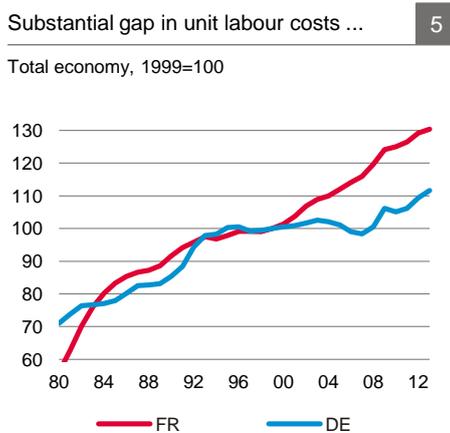
Different growth models



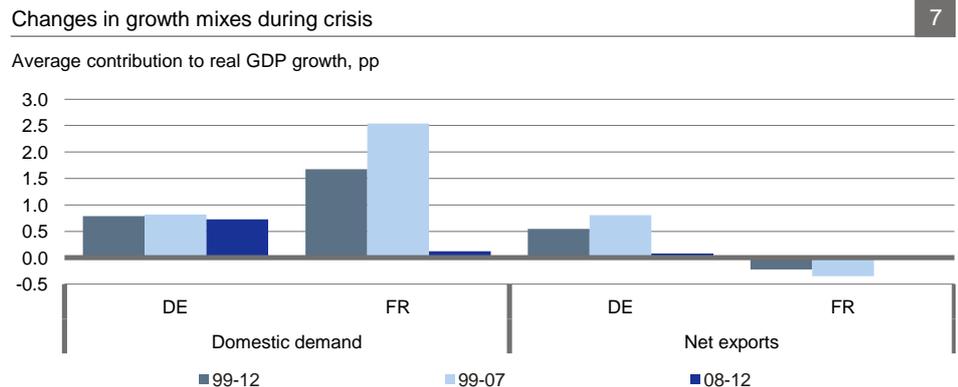
Sources: Eurostat, Deutsche Bank Research

Since the start of EMU the French and German growth structure have shown substantial differences. While GDP growth was nearly the same in both countries at 1.4% on average in France (1999-2012) and 1.3% in Germany, the breakdown by GDP components shows large differences. In Germany, net exports contributed on average 0.6pp to annual GDP growth. In France, net exports shaved off 0.2pp of annual GDP growth. Correspondingly domestic demand was a much more important growth driver in France (1.7pp) than in Germany (0.8pp) with most of that difference stemming from private consumption (France: 1pp; Germany: 0.5pp).

Since the start of the crisis in 2007/08, the growth mixes have changed with net exports contributing only slightly to German GDP growth on average, but domestic demand remaining resilient. In France domestic demand no longer served as a pillar of economic growth, but net exports no longer weighed on growth. It is an open question how much of the change is cyclical.

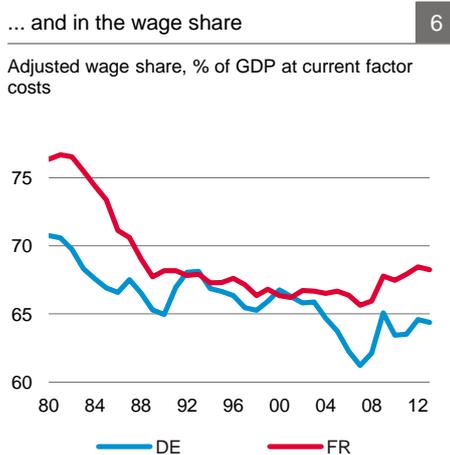


Source: AMECO



Source: Eurostat

France and Germany have already been through phases of acute economic divergence, but ultimately managed to converge relatively swiftly, for instance during German re-unification. In this sense, it is tempting to see Hollande's speech and his offer of a "responsibility pact" to the employers' federation as a replication of Mitterrand's economic U-turn of March 1983, which inaugurated "competitive disinflation" (actually at the time Francois Hollande was an advisor to Mitterrand at the Élysée).



Source: AMECO

Developments in the share of wages in corporate output is we think an interesting, synthetic metric to assess underlying macroeconomic trends, as it informs on profitability, inflationary pressure, unit labour costs and competitiveness. France and Germany were extremely divergent in the late 1970s/early 1980s. Social tension in France at the time, and then the Keynesian/dirigiste experience after Mitterrand's victory in 1981, triggered a significant increase in the share of wages in corporate output. The corresponding decline in profitability smothered French investment, while fast-rising unit labour costs fuelled double-digit inflation. Germany at the time – under the social-democratic/liberal coalition of Helmut Schmidt, successfully resisted those trends. This was incompatible with the currency arrangement of the time, the European Monetary System,

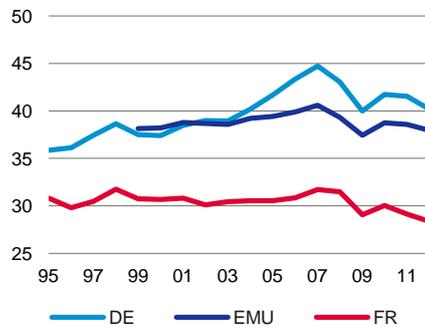


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Gap in corporate profitability has widened

8

Gross operating profits, % of gross value added

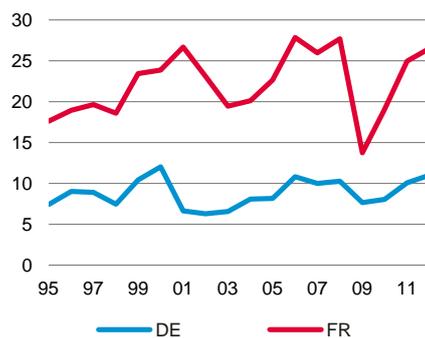


Source: Eurostat

Corporate taxes: high in France

9

Corporate taxes, % of gross operating surplus, Annual sector accounts, non-financial corporations



Source: Eurostat

triggering repetitive devaluations of the French franc which in turn fuelled more inflation.

France's "competitive disinflation" was a success and by the eve of Germany unification the share of wages in GDP was very similar across the two countries. However, the two countries started to diverge again on the few years following monetary union.

Indeed, the strength in French domestic demand was fuelled by substantial out-performance of wages. From 1999 to 2012 total compensation per hour worked grew by 3.1% p.a. in France (Germany: 1.9%). Over time that produced a gap in unit labour costs – up 10% from 1999 to 2012 in Germany, but up 30% in France – as productivity growth was roughly equal in both countries (around 1.2% p.a.).

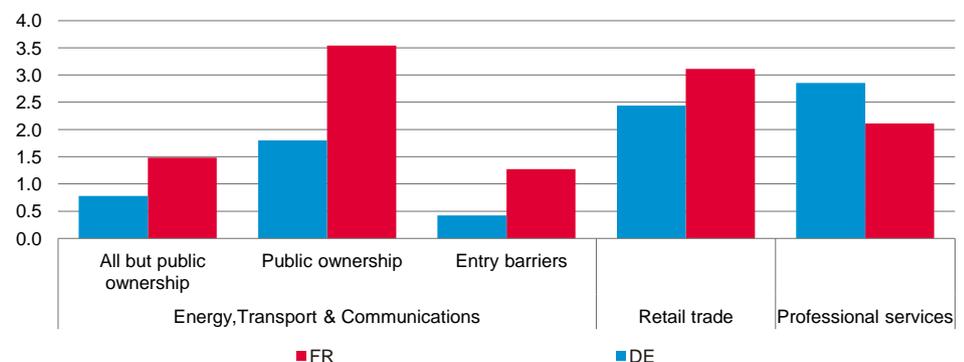
Divergence in corporate profitability is by construction the flip-side of diverging wage behaviour. Since 1999 the gross profit share of German non-financial corporations has risen from nearly 38% in 1999 to just above 40% in 2012 with a peak of nearly 45% in 2007 before the global recession. In contrast, French profitability has been much lower (1999: 31%) and did not improve during the globalization boom of the pre-crisis years. Taxation in France has also not been conducive to a stronger corporate sector. Based on national accounts data taxes accounted for nearly 27% of the gross operating surplus of non-financial corporations in France in 2012 – more than double the rate in Germany (11%). Putting aside cyclical swings, this was slightly higher than the rates in 1999 (Germany: 10%; France: 23%) with the observed gap even increasing a little over the EMU period. Admittedly, corporate tax law differs widely and national accounts data may be too crude to accurately reflect that, but even a study for the European Commission found that effective average corporate tax rates stood at 37.1% in France in 2012 and at 31% in Germany.¹

In addition, the markedly higher share of micro (<10 employees) and small companies (10-49 employees) that are typically less productive compared to larger companies has weighed on French corporate profitability. The share of micro companies is 94% in France and 82% in Germany. Strict labour laws that kick in when companies have 10 employees and intensify significantly at 50 employees hinder companies from exploiting economies of scale.² Furthermore, the overall regulation environment is less restrictive in Germany according to the OECD.

Overall regulation more restrictive in France

10

Index scale of 0-6 from least to most restrictive, 2008



Source: OECD

¹ ZEW (2012). Effective Tax Levels Using The Devereux/Griffith Methodology – Final report.

² Garicano, L. et al. (2013) Firm size distortions and the productivity distribution: Evidence from France, NBER Working Paper 18841.

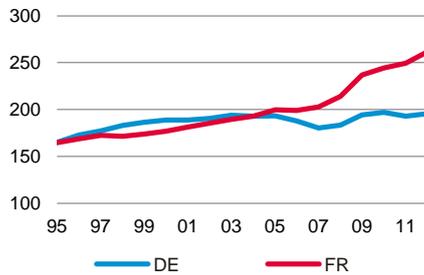


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Rising debt levels in France ...

11

Households, non-financial corporations* and general gov., financial liabilities, % GDP



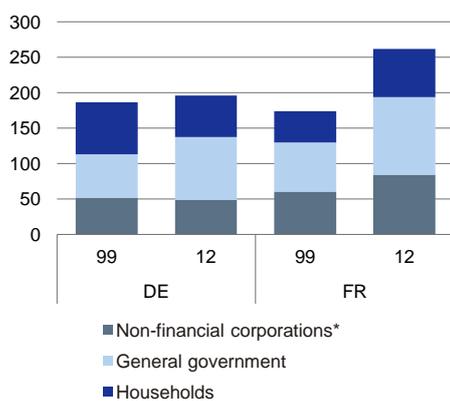
*Loans and securities other than shares

Source: Eurostat

... affecting all sectors

12

Financial liabilities, % GDP



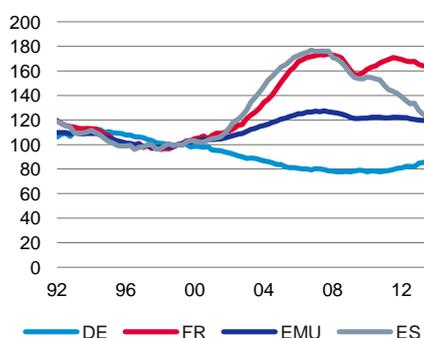
*Loans and securities other than shares

Source: Eurostat

Marked house price appreciation in France

13

Nominal house prices divided by disposable income, Q1 1999=100



Source: OECD

Given the pressure on profitability, companies cannot maintain a decent level of investment without a growing recourse to leverage. Overall debt³ of the French economy rose from 174% of GDP in 1999 to 262% in 2012, while the indebtedness in Germany was roughly unchanged (187% and 196%). In France indebtedness increased across all sectors with public debt rising by 40pp of GDP while households and non-financial corporations each added nearly 24pp of GDP. By contrast, in Germany only public debt was above its 1999 level in 2012.

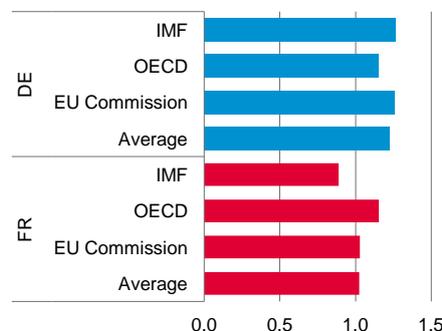
Beyond the pressure from the lack of internal resources in the business sector, the rise in overall debt in France can also be sourced to the "windfall effect" triggered by the drop in interest rates after monetary union. While the decline in the cost of funding was not as acute as in the European periphery, it was still significant in France. Real interest rates on 10 year bonds fell by 240 bps between 1991/1998 and 1999/2007, against less than 100 bps in Germany. France had settled on a highish cost of capital regime before 1999. One sector that benefited in particular from this windfall was real estate. French property prices as measured by the price-to-income ratio rose by a comparable magnitude as in Spain. While the latter experienced a real estate bubble and its subsequent burst, in France the price-to-income ratio has not come down significantly from its pre-crisis peak. In France most the increase in household debt was lower than in Spain, and there it also came from promoters, which is intrinsically more fragile (for the latter property is both the collateral AND the source of income, while for the former it is overwhelmingly only the collateral).

One significant headwind for Germany, though, is demography. Currently the German potential growth rate is 1 ¼%, slightly above the French rate. While the German technological progress as measured by the total factor productivity is above that of France (1999-2013: Germany 0.4% p.a. vs. France 0.1%), the demographical change will weigh significantly on Germany's potential growth rate in the longer-term. The French fertility rate of about 2 is only slightly below the replacement rate and far above Germany's rate of 1.4. Going forward the ageing and shrinking of the labour force in Germany will probably lower the potential growth rate more strongly than in France to a level of markedly below 1% in 2020-2030, when the baby boomer generation will leave the labour market.

German potential growth slightly above the French

14

% yoy, 2013 (5-year average)

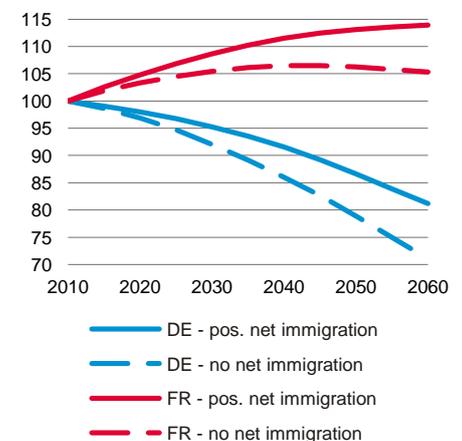


Sources: EU Commission, IMF, OECD

Opposite population trends

15

Index 2010 = 100



Source: Eurostat (Europop2010)

³ Household, general government and non-financial corporations (loans and securities other than shares).

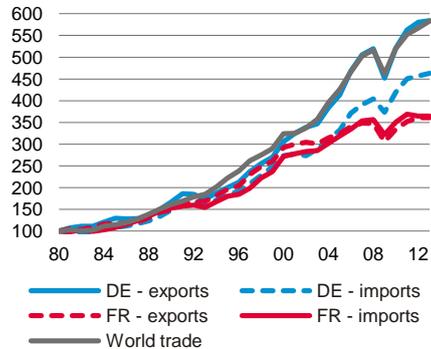


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Real trade development: France lagging behind since the start of the 2000s

16

Index 1980 = 100 (goods and services, national accounts data, real)

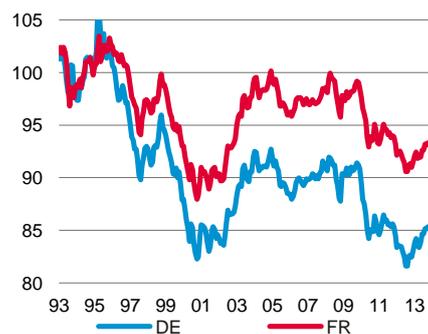


Sources: Eurostat, IMF, Deutsche Bank Research

Competitiveness gap opened since early 2000s

17

1993 = 100



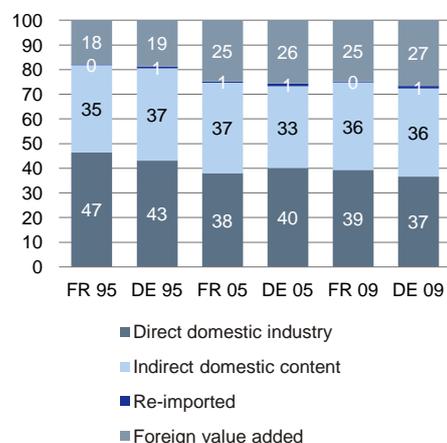
A positive change points to a decrease in price competitiveness

Sources: ECB, Deutsche Bank Research

German value added content of exports marginally higher than French

18

% of gross exports



Source: OECD-WTO TIVA database

Different attitude towards globalization clearly visible

Obviously, the rise in French relative unit labour costs is fuelling the decline in the French export performance, even if this is only one aspect of a generic difficulty with globalization.

German exports moved approximately in line with world trade in recent decades and improved more strongly than imports thereby pushing up GDP growth. Germany ranks 3rd for merchandise and services trade globally. By contrast, France has consistently lost export market shares since the beginning of the 2000s and export growth has been below that of imports. Thus, net exports have been a drag on GDP growth. However, France is still the sixth largest goods exporter and fourth largest service exporter in the world.

This diverging development can be largely explained by the competitiveness of French and German companies not only in their respective home market – France is Germany's largest export destination and vice versa – but also on foreign markets and by different internationalization and reform strategies. By dividing up value chains and outsourcing parts of the value chains to other countries, either by establishing subsidiaries, acquiring stakes in foreign companies or contracting to third parties, firms can boost their competitiveness. The change from a purely national to a global value chain results in imported intermediates constituting an increasing value added share of the exports of a country (bazaar economy).

Facing relatively high and rigid wages for simple work in the mid-1990s, the increasing integration of German companies in global value chains – above all the German "Mittelstand" – played a decisive role in keeping them internationally competitive. By transferring parts of the production chain – mostly of simple and standardised procedures – to countries with lower wage levels, especially in Eastern Europe and emerging markets, or by purchasing foreign intermediates, German companies boosted their productivity and reduced their average wage costs significantly. Germany, by contrast, remained the location for company head offices, research and development and activities that require highly qualified and well paid staff. A shining example of this is provided by the big automakers with their modular manufacturing.⁴ Additionally, the wage moderation as a consequence of skyrocketing unemployment after unification, the mid-2000s labour market reforms and positive industrial relations improved the cost competitiveness of German companies further.

In contrast, French companies reacted to globalization pressures by transferring the near entirety of the value chain abroad and/or by lowering their margins significantly. Offshoring took place not only to supply foreign markets, but also to stay competitive on the French home market which had a significant negative impact on the trade balance.⁵ This has been most pronounced in the automobile sector as can be seen by the lower share of gross value added in total of this sector in France. Due to the intense international competition French exporters were forced to lower their cost with the use of their imported intermediate goods produced in low-wage countries as can be seen by a similar value added content of French and German exports. Additionally, lower margins dampened investment spending and innovation activities with negative medium-term effects on competitiveness. The strong French domestic non-tradable sector – construction, real estate services and the well-paying public sector – constrained the

⁴ See Peters, H. (2013) Global value chains secure competitive advantages for German companies, Focus Germany, July 2013.

⁵ Egert, B., Kierzenkowski, R. (2010) Exports and property prices in France: Are they connected? OECD economics department working paper no. 759. Usciati, B. (2008), "D'où vient la égradation du solde commercial français hors énergie ? Une analyse par types de produits", Bulletin de la Banque de France, No. 173, May-June.

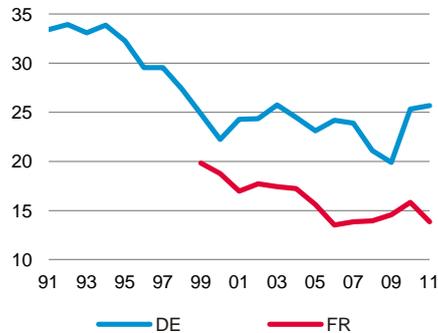


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Share of gross value added to output in Germany higher compared to France

19

%, Manufacture of motor vehicles, trailers and semi-trailers



Sources: Eurostat, Deutsche Bank Research

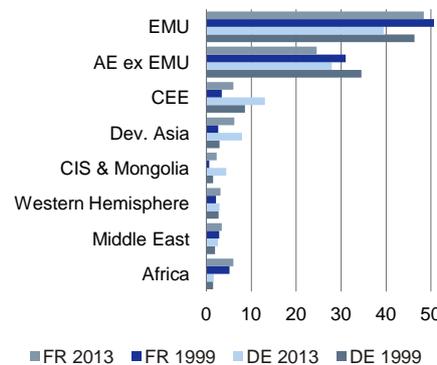
supply side of the export sector. Lastly, tax, financial and regulatory reasons hindered small French companies from growing and reaching the critical size to successfully compete internationally.

Due to a regional export structure more focused on the euro area and a lower diversification across destination countries, French export growth has been significantly below Germany's since the start of the euro crisis and more prone to regionally limited demand shocks. French exporters (27% of total exports going to emerging markets) benefitted less than German exporters (33% of total exports) from the rise of the emerging markets.

French exports more dependent on EMU demand

20

% of total exports

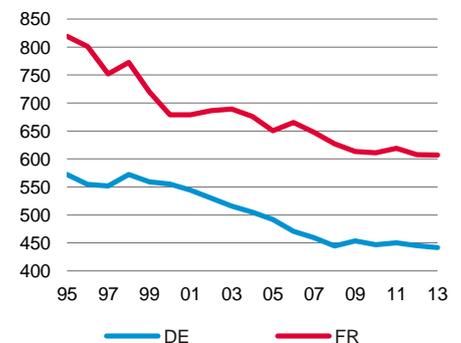


Sources: IMF, Deutsche Bank Research

German exports less concentrated destination countries

21

Herfindahl-Hirschman Index of merchandise exports

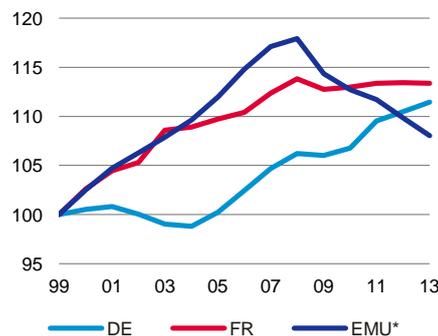


Sources: IMF, Deutsche Bank Research

German has nearly closed the employment gaps

22

Total employment, 1999 = 100



*) excluding Germany & France

Source: Eurostat

From the start of EMU until 2005 employment rose continuously in France while it declined slightly in Germany. However, the Hartz labour market reforms marked the start of a catching-up process with strong employment gains in Germany. The divergence has become more pronounced since the onset of the financial crisis in 2008 when Germany's employment picked-up further, while it more or less stagnated in France. Against this backdrop, the positive French-German employment growth gap since the start of EMU (1999-2013: France +13.4%, Germany +11.5%) is rapidly closing.

French and German unemployment rates coevolved until 2002 (albeit with France at a higher level). After the Hartz reforms the unemployment rate initially jumped dramatically in Germany, exceeding the French level. However, the turning point was reached at the end of 2005. Since then German unemployment decreased strongly while it increased in France. This holds true especially for the young and long-term unemployed, even though public expenditure on active labour market policies is slightly higher in France. Germany's youth unemployment rate of 7.5% is the lowest in Europe and the long-term unemployment rate markedly decreased since mid 2005. In contrast, the French youth unemployment rate of 25% is above the EU average and long-term unemployment is trending up in France.

The Hartz reforms included the introduction of a low-wage sector, deregulation of temporary employment, restructuring of the employment agency and strengthening of the process of procurement "fordern und fördern" (promoting and demanding) as well as the consolidation of social benefits and unemployment benefits. The reform also introduced sanction elements, i.e. additional

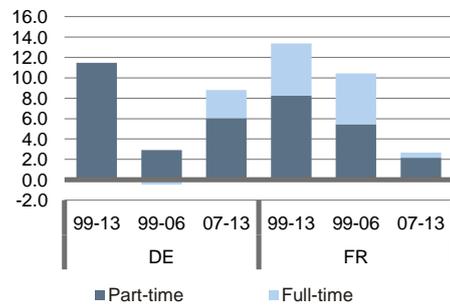


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Part-time important for German employment growth

23

Contribution to change in total employment, pp

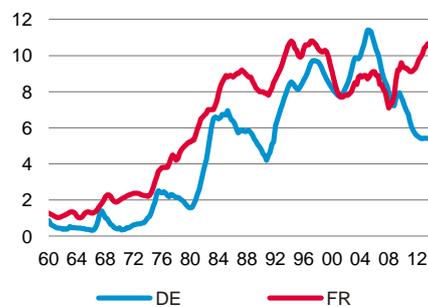


Sources: OECD, Deutsche Bank Research

Large gap in unemployment since '08

24

Unemployment rates, %

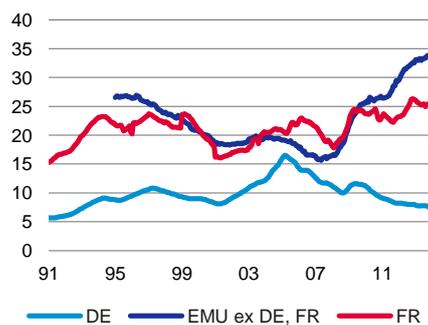


Source: OECD

German youth unemployment lower and falling

25

% (less than 25 years)

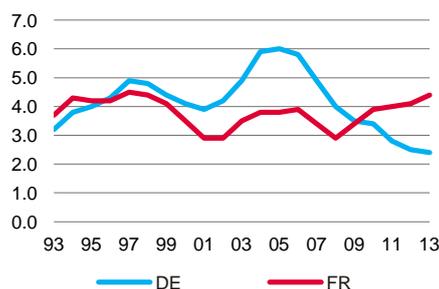


Sources: Eurostat, Deutsche Bank Research

Long-term unemployment halved in Germany since mid-2000s

26

%



Source: Eurostat

means to effectively monitor jobseekers' job search activities and personal efforts to re-integrate into the labour market. The jobseeker is obliged to accept any offer of suitable work thereby reducing the reservation wage. The definition of suitable work was broadened, e.g. including the obligation to move to a different city under certain circumstances. These reforms lead to higher flexibility of the German labour market and a revival of employment growth, which, however, was predominantly concentrated on part-time jobs, while it was more balanced in France. The number of French full-time jobs increased 12% from 1999 to 2013 contributing almost 40% to total employment growth. Still, Germany's labour market improved also in this respect after the Hartz reforms. From 2007 to 2013, full-time jobs positively contributed to employment growth while they were a drag on growth during 1999 to 2006.

The flexibility of the French labour market is lower than in Germany. In France unemployment benefits are on average 70% higher than in Germany. A high minimum wage is also weighing on new entrants – according to OECD calculations the French minimum wage is 62% of the median wage of full-time workers – and regulation of temporary contracts is the highest in Europe, again as measured by the OECD. However, the stricter regulation of temporary employment agreed in the recent coalition contract puts the German labour market success into question.

Regarding the strictness of employment protection of individual and collective dismissals on regular contracts Germany displays actually a slightly higher rigidity than France. However, the dynamics of the unemployment benefits systems are very different.

Shortly after the Hartz reforms, the German government decided to shorten the maximum duration of unemployment benefits, which depends on the contribution period to the unemployment insurance and the age of the unemployed, from 32 months to 18 months in February 2006, but against the backdrop of the deep recession the German government lengthened it again to 24 months in January 2008. To achieve this, an unemployed person has to contribute more than 48 months to the unemployment insurance and must be older than 58 years. The unemployment benefit amounts to 60% of the previous net income if the person has no child and 67% with a child.

In France the unemployment allowance is calculated by reference to the previous wage (between 57% and 75%). A job-seeker will receive this allowance for as long as he/she contributed to the unemployment insurance mechanism within the 28 months before he/she lost his/her job (36 months if the person is older than 50), with a cap at 24 months of benefits or 3 years if the person is older than 50.

While unemployment benefits have been by and large curtailed across OECD countries over the last 20 years, in France they were expanded in 2001. Between 1992 and 2001, the system was regularly degressive. After 9 months the allowance was reduced by 17% every 4 months. Beyond the need at the time to restore the financial position of the benefit system, this decision had been made to raise the incentive to actively seek employment.

Indeed, before 1992, the system was quite complex but in many cases triggered one substantial fall in the allowance after 12 to 14 months. Interestingly, at the time the distribution of jobseekers finding a new job was heavily skewed towards the 13/14 month of unemployment. The impact was particularly strong for skilled workers with a previously high wage (the rate of "return to employment" shot up to 37% in the 13th month of unemployment, against about 10% per month

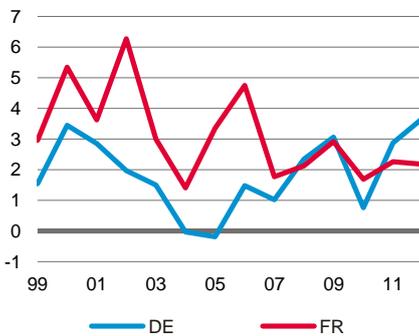


Can Hollande pull off a Schröder and will it work?

French wage growth stronger on average

27

Compensation per hour worked, % yoy

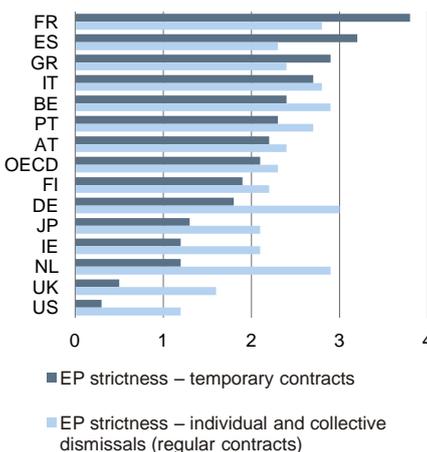


Source: Eurostat

Employment protection: More restrictive in France

28

2013, Scale 0 - 6

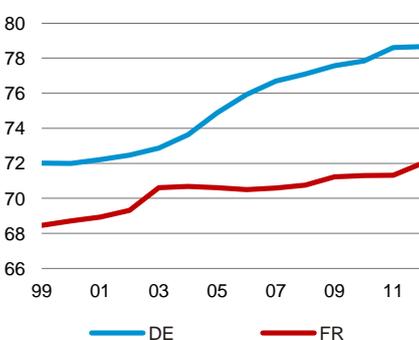


Source: OECD

Active rate: widening gap in 2000s

29

Active population as % of population aged 15-64 years



Source: Eurostat

between 2 and 12 months of unemployment⁶. Quite clearly, a significant proportion of skilled workers with a high probability to find a new job were arbitrating between leisure and work, stepping up their efforts to find work only when their benefits started to fall. This peak in the distribution, quite naturally, disappeared under the degressive system in place between 1992 and 2001.

The decision to abolish regressive allowance in 2001 was traded against more drastic control by the government agency in charge of paying the benefits of the effectiveness of the recipients' job seeking activity. While the number of exclusions for failure to comply has increased lately, it affected in 2012 only 0.9% of those on benefits.

The positive labour market effects of the Hartz reforms were complemented by a second – and often under-appreciated – factor: the constructive role played by the parties to collective agreements. On a sector level they prioritised employment over wage growth and on a company level they agreed to productivity-enhancing internal reforms. For instance, even companies covered by sector wide (e.g. wage or work time) agreements can use opening clauses in the collective agreement in order to cope with their specific needs and challenges, e.g. heavy foreign competition or a slump in demand. This preserved employment during the economic restructuring phase in the late-1990s to mid-2000s and allowed for a much stronger employment build-up thereafter.

Finally and closely related to the second factor, the very decentralized (co-operative) wage finding process in Germany is not subject to much (political) interference and allowed for wage moderation that was broadly acceptable to employees. While industry-wide wage agreements remained the norm, the share of employees covered by these fell and the usage of opening clauses rose strongly.⁷ Also, Germany did not have a minimum wage, though, that is about to change in 2015/2017.

Consequently, nominal hourly wages in Germany rose by 1.5% p.a. from 1999 to 2007 – less than half the rate observed in France (3.6%). As a result unit labour costs expanded by 17% in France, but fell slightly in Germany (-1.1%). Even from 2007 to 2012 when employment was rising strongly and unemployment declined to low levels German wage growth remained close to French levels (Germany: +2.5% p.a.; France: +2.2%), and unit labour costs rose faster in France (+13%) than in Germany (+10%).

Germany has tapped its labour force potential much better than France. The activity rate (the percentage of economically active persons in the population aged 15 to 64 years) rose in Germany by 6.7pp to a good 78% between 1999 and 2012. In France it increased by only 3.5pp to 72%. While employment rates especially of younger and older persons are higher in Germany than in France, employment rates of French mothers exceeded those in Germany.

⁶ "L'effet de l'allocation unique dégressive sur la reprise d'emploi". Dormont, Fougere and Prieto. *Economie et Statistique* # 343, 2001.

⁷ We have often pointed at the importance of industrial relations for Germany's recent successes. For a recent discussion arguing that the Hartz reforms did not even play a role at all see: Dustman, Christian et al (2014). *From Sick Man of Europe to Economic Superstar: Germany's Resurgent Economy*. *Journal of Economic Perspectives* – Volume 28, Number 1.



What is France trying to do: importing a (limited) social-democratic approach

It is tempting to interpret French President Hollande's conference on 14 January as a significant change in the policy stance. True, words matter, and the President's self-definition, for the first time, was as a "social-democrat" and no longer a socialist, implicitly edging towards the Northern European brand of centre-left, including Gerhard Schroeder's reformist approach. Still, there were actually few "new news" in terms of effective measures, even if the supply-side approach was confirmed.

The most salient element was the decision to abolish, by 2017, the proportional contribution employers pay on their payroll to fund family benefits. This stands at EUR 30 bn per annum, 1.5% of GDP. However, beyond the headline this cut in payroll tax is going to be conflated with the EUR 20 bn CICE, launched last year, a complicated mechanism which lowered labour costs by granting businesses a corporate tax credit calculated on the size of their payroll. This means that the incremental reduction in labour costs will in fact amount to EUR10 bn, 0.5% of GDP.

The overall effect is not insignificant: this would shave 4% off total compensation costs in the business sector. This is equivalent to 9.3% of the cumulated increase in compensation costs per head in France since the inception of monetary union in 1999. It would also reduce the accumulated difference between France and Germany in compensation costs by one fifth. Not a radical solution, but some progress. We also find it positive that the CICE can be turned into a straightforward payroll tax cut. Indeed, fully abolishing a social contribution has a more permanent nature than a rebate on corporate tax.

Still, rather than a dramatic change in the policy stance, what we had last month was more a – limited – prolongation of an effort which had started last year already. Interestingly, EUR 30bn was exactly the figure which was mentioned by the "rapport Gallois" – the report commissioned by the government and published in November 2012 on how to restore French competitiveness.

We mentioned the comparison with Gerhard Schroeder. What we think is still a radical difference between the social-democratic stance pledged by Hollande and the SPD strategy in Germany 15 years ago is that a number of crucial areas continue to be "off limits" in France. Ultimately, the success of the structural reforms initiated by the SPD at the time hinged on a deep reform of the labour market. Two topics continue to be avoided in France: one is the ultra-generous unemployment benefit system (in September even the leader of CFDT, the main moderate union in France, which leans towards the social-democratic wing of the socialist party, rejected any radical overhaul there), the other is the external flexibility of the labour market.

However, internal flexibility has improved with the agreement in January 2013 between the unions and the employers federation at the national level allowing companies to modulate working time and pay after cutting deals with the local unions. Hollande is intent on nudging employers and employees towards a more trustful relationship.

Without resorting to too much "ideological archaeology", the French left has often been divided between a "statist wing", for which the government ultimately is the instrument of social and economic transformation, and a social-democratic wing (called in France "deuxième gauche", literally "second left") for which negotiation between the labour movement and the employers' representatives is key. Similar divisions can actually be found within the centre-right, where Christian-Democrats, keen on fostering "social dialogue" coexist with heirs of the



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Gaullist movement, more focused on the centrality of the executive branch of government.

Within organized labour, CFDT (Confédération Française Démocratique du Travail), which finds its origins in the social Christian movement, was – and still is – the spearhead of the “deuxième gauche”. Jacques Delors, former Finance Minister and President of the European Commission initially came from this organization. He was the mentor of Francois Hollande in the 1980s and 1990s.

Hollande’s analysis of Sarkozy’s mandate was that the centre-right had made the mistake of “forcing” a number of reforms against the will of even the moderate wing of the labour movement, for instance on the occasion of the pension reform of 2010. This strategy of tension had actually reduced the capacity of the French population to accept further reforms. Conversely, a strategy based on dialogue would yield more benefits.

A nagging problem, in our view, is that unions’ legitimacy in France is very limited. The country has the lowest union density (proportion of union members in paid employment) across the OECD countries, with the exception of Turkey. The French political tradition favours the intervention of the government in social affairs to offset the weakness of the unions. Labour laws fill the void.

This is a self-reinforcing process: state intervention makes unions seem irrelevant and often lead them to choose a pure “protest attitude”....while union irrelevance and/or radicalism in the end calls for government intervention to avoid social disruptions. It seems that the current French administration is willing to break this spiral, but we are sceptical about the chances of success given the structure of the French labour movement and the electoral constraints on the ruling socialist party.

The self-substitution by the state into negotiations between the unions and the employers’ federation extends to wage bargaining. Indeed, one of the characteristics of France is to mix a high level of wage rigidity with the absence of a centralized bargaining process. In Germany for instance the pay settlements in a few key sectors anchor the overall changes in wages in the economy. In France, the pay scales agreed through collective bargaining in the branches can often stay unchanged for years. To some extent, it is the state-controlled minimum wage that plays the role of an anchor for wage growth.

Normally, the minimum wage should act more as a “safety net” ensuring that wages at the bottom of the distribution do not diverge too much from the overall wage progression. It is calculated as the sum of the change in CPI (now using a specific consumer basket based on the spending structure of low income families), to which half the increase of average real wages is added. However, the government can still opt for “discretionary push” topping up the result of the calculation rule (July 2012 was the latest). These “pushes” account for 60% of the overall rise in the SMIC (the acronym of the minimum wage) since its inception in 1970, to the point that the minimum wage now stands at 62% of median wage in France, the highest level across the European countries. For comparison, it is 47% in the UK and the Netherlands.

The diffusion effect of the SMIC across the wage scale is high. At the peak in 2006 17% of French workers were paid at the minimum wage. In 2000 it stood at 56% of median wage, 6 points below the current level, which implies that more workers have been “caught up” by the mechanism. Gilbert Cette et al⁸ in a very detailed analysis estimate the long term elasticity of average wages to the increases in the minimum wage at 0.77, a very high level. This may help to

⁸ “Les effets des hausses du SMIC sur le salaire moyen”. Cette, Chouard and Verdugo. Economie et Statistiques, # 448-449, 2011.



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explain why aggregate real wage growth in France remained relatively robust in the 1990s and 2000s, while it was subdued in most of the developed world.

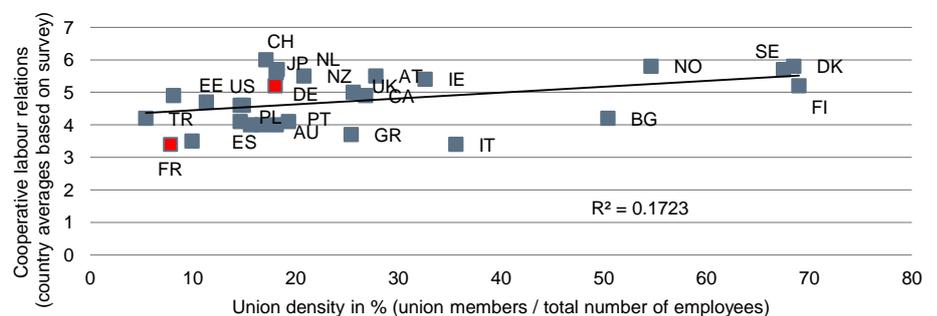
That France – a near unique case in Europe – still pursues a state-controlled “wage policy” has created thorny side-effects.

Obviously this strengthens the “verticality” of French macroeconomic management, where the government – and, therefore, political considerations – plainly intersect with market mechanisms. This is not a French specificity. In the US for instance political pressure can at times force upward revisions in local or federal minimum wages, but this does not take the systematic, annual form it has taken in France. This creates limits to the dialogue between unions and employers, when bargaining is too often reduced to negotiating the form of the diffusion of the SMIC impulse throughout the wage scale.

The consequence of this “disempowering” of the social partners is elegantly summarized in Aghion, Algan and Cahuc⁹: “policies that assign authority to design rules can contribute to erode social capital (...) First, they induce individuals to be narrowly self-interested and to wait for externally imposed inducement of sanctions before voluntarily contributing to collective action. Second, they destroy the capacity of citizens to experiment with diverse ways of coping with multiple problems and to learn from this experimentation over time”. It is therefore not surprising that France stands towards the bottom of the distribution for both union density and the quality of labour relations as measured by the Competitiveness survey.

Low union density and poor labour relations

30



Sources: OECD, World Economic Forum

The very limited role that unions play in what is in the end the bread and butter of organized labour (negotiating pay and working conditions) is “offset” by their role in the management of the welfare system (pension, healthcare, unemployment benefits), which may have turned them into bureaucratic institutions.

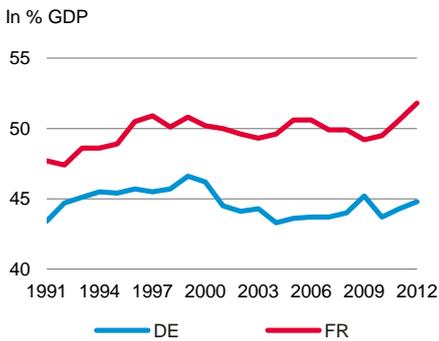
The social-democratic approach to push through unpopular structural reforms has already found some limits. For instance the pension reform last summer did not bring about any meaningful progress on the convergence between the public and the private sector. The next step will be the negotiations between the unions and the employers’ federation on the reform of unemployment benefits, that have recently started. Laurent Berger, leader of CFTD already warned in September 2013 that his organisation would oppose any meaningful change in the system “at a time when employment continues to fall”.

⁹ “Can policy influence culture? Minimum wage and the quality of labor relations”. CEPREMAP, January 2008. It is an illuminating article which provides a thorough analysis of the themes we touch upon in this section.



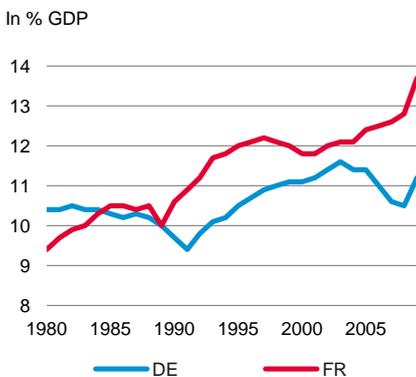
Can Hollande pull off a Schröder and will it work?

Government revenues >50% in France 31



Source: Eurostat

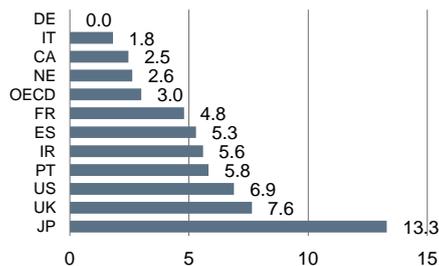
Old-age-related social expenditure: up strongly in France 32



Source: OECD

Large sustainability gap in France 33

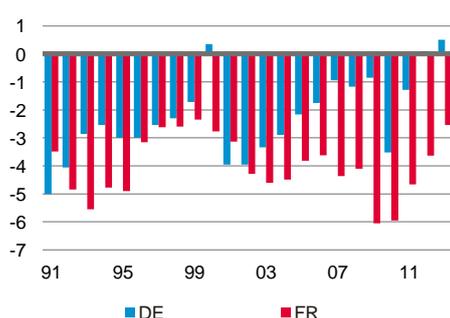
Required change in underlying primary balance to reduced debt to 60% by 2030



Source: OECD

Balanced structural budget in Germany 34

General government, % GDP



Source: EU Commission

The public sector: New legislation to narrow the chasm

When France managed to adjust in the 1980s, the efforts in the private sector were sweetened by an increase in public spending. To a lesser degree, the adverse transition costs of the German adjustment under Schroeder were also mitigated by an increase in the deficits (the initial drop in corporate tax was not fully offset on the spending side). The room for manoeuvre, this time, is going to be limited.

Hollande's January statement on public spending was stern, but the objective of cutting EUR 50 bn by 2017 was in the public domain since September. From what we can infer from Hollande's statement, it seems that the preferred channel for the government is a compression in local government spending. We have often argued in Focus Europe that while reducing the transfers to the local authorities would be a fruitful option, what would be structurally pertinent would be a dramatic change in the administrative organization of the country, in particular addressing the accumulation of various geographical layers (regions, departments, townships) generating inefficiency through staff duplications. The President hinted at some progress there, with the possibility to reduce the number of regions while "the departments in the great metropolitan areas will have to redefine their future". The latter is particularly vague. Thierry Mandon, a socialist MP in charge of administrative simplification stated the following day that the number of regions could be cut to 15 from 22. Again, this is progress, but not a revolution.

Politically, this is a bold move. Indeed, Hollande's socialist party controls 21 regions out of 22 and a majority of departments and medium and large size local authorities. The very structure of the socialist party's apparatus is organized around local government (Hollande himself was the chairman of the department of Correze before being elected). The risk is that to reduce the blow to the socialist party the government is forced to go through a lengthy phase of negotiation.

True, it is not the traditional role of the President in France to get into detailed announcements. The "nitty-gritty" is normally the job of the Prime Minister. Still, we continue to have doubts on the execution of the EUR 50 bn spending cuts targets over 2017 on the basis of the current policies. Another issue arising from this week's press conference is the funding of the additional EUR10 bn for the payroll tax cut. True, this won't be fully effective before 2017, but the equation is still hard to square, especially now that Hollande clearly halted any further increase in tax. The risk is that once France reaches the 3% target for its deficit by 2015, as per the new trajectory agreed with its European peers, some relaxation in the efforts appears, especially since 2017 will be an election year.

Although France was initially less affected by the global recession (GDP dropped by 3.1% in 2009 compared to 5.1% in Germany), the much more muted recovery thereafter has further aggravated the French fiscal problems due to the persistent output gap. The deficit peaked at 7.5% of GDP in 2009 (Germany -4.2% in 2010). It has only slowly receded ever since and is forecasted to still be at around 3% in 2015. The structural deficit, which has been eliminated in Germany since 2012 will probably still stand at 2 to 2 1/2% of GDP in France by 2015. In its consolidation efforts France has relied very strongly on revenue increases. As a result the increasing trend in the French government's share in GDP has continued. In 2013 it stood at 57% compared to 44.5% in Germany. Moreover, French government revenues are heavily geared towards social security funds (49.5% in 2011, Germany 36%), which – as an implicit tax on labour – is one factor behind high structural unemployment in France.

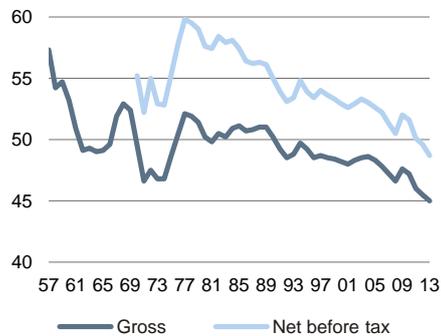


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German pension level falling

35

% (Standard pension/average earnings),
Western German States



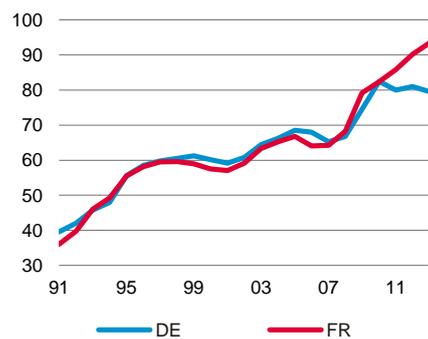
Source: German Pension Insurance

The high government's share in GDP in France is to a large extent the result of three factors: 1) A 33% share of social spending compared to GDP, the highest among the OECD (Germany 26.2%). 2) Public sector employment of 21.9% of the total labour force (Germany 10.6%) due to 3.) Multiple sub-national layers of government combined with a large number of extremely small localities (average size 1,800 inhabitants compared to 7,100 in Germany). Efficiency of state activity seems to be an additional problem. In the World Bank's ease of doing business indicator France ranks 38 (Germany 21), although it beats Germany by a large margin in some measures, such as paying taxes or starting a business. Even in terms of reducing income inequality the French system is only marginally more successful. After taxes and government transfers the Gini-coefficient in France is reduced to 0.30 (from 0.51), while in Germany redistributive policies lower the Gini-coefficient from 0.49 to 0.29 (2010). Both countries muster similar PISA reading scores (France 496, Germany 497), but Germany is ahead in science (524 vs. 499) and mathematics (514 vs. 495) rankings. In addition, France spends an average USD 81,100 per student (aged 6 to 15 years) compared to USD 75,300 in Germany.

Public debt: Crisis left its mark especially in France

36

% GDP



Source: EU Commission

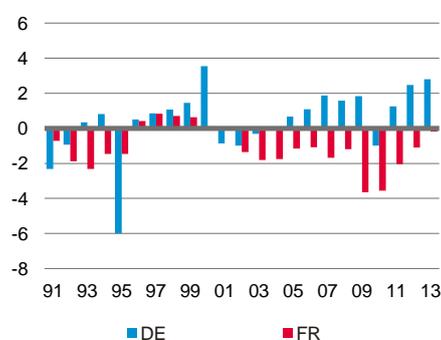
Ultimate challenge: Sustainability

Even more important than the current fiscal position is the long-term fiscal sustainability given substantially rising old-age dependency ratios combined with still rather generous pension commitments. Germany introduced several pension reforms in order to prevent contributions from rising above 22% by 2030. Major measures are a phased in rise of the statutory retirement age to 67 combined with proper actuarial reductions for early retirement. In addition, the replacement level will be further lowered to around 43% (2000: 52.9%; 2010: 47%). According to EU simulations it will reach about 38.5% by 2060. In case of France the replacement levels are 39.8% in 2010, 35.2% in 2030 and 31.7% in 2060. In order to prevent a massive increase in old age poverty these changes were accompanied by the establishment of a private individual pension scheme, i.e. the "Riester-Rente", with favourable taxation and grants especially for families and by strengthening company pensions, the 2nd pillar of the pension system. The participation quota (40%) in the Riester-Rente has remained below expectations. Not surprisingly, the coalition treaty foresees the implementation of a minimum pension.

Structural primary balance: German surplus not matched by France

37

% GDP



Source: EU Commission

Purely based on demographics the overall French fiscal position seems more favourable than the German one. The old-age-dependency ratio (65+) will increase from 27.8 (2013) to 45.8 in 2050, while Germany will be confronted with a surge from 31.2 to 56.6. On the other hand sustainability simulations do depend very much on the starting position – which is currently much more favourable in Germany – and of course assume unchanged policies, i.e. the deterioration in Germany due to more generous pension policies of the new government are not discounted. Therefore available simulations might give too bleak a picture for France (given recent reforms announcements) while the opposite can be said about Germany. The OECD calculates consolidation requirements in order to achieve a 60% debt/GDP level by 2030. Most recent measures (May 2013) indicate no consolidation requirements for Germany (at least until 2030), while France needs to consolidate by 4.8% of its potential GDP. In its Fiscal Sustainability report the European Commission calculates a sustainability-indicator which aims for inter-temporal budgetary stability over a longer (potentially indefinite) horizon. Although France has a more favourable long-term projection (lower aging-related costs) the worse starting position (2014) implies that the sustainability gap (-1.6% of GDP) is slightly higher than in Germany (-1.4%). Another approach to assess fiscal sustainability (or rather un-sustainability) is to calculate the accumulated implicit claims on the government (mainly through unfunded public pensions and other demography-



Can Hollande pull off a Schröder and will it work?

related expenditures). An international comparative analysis – based on the European Commission’s Aging Report (2012) – which might contain some wishful thinking given that governments own estimates for aging-related expenditures were used – gives a sustainability gap (sum of implicit and explicit public debt)¹⁰ of 154% of GDP for Germany and 449% for France (base year 2012). These calculations are far from precise as more detailed calculations (based on an overlapping-generation model) by the some authors show a German sustainability gap of 227% (base year 2013). The changes to pension legislation to be implemented this year will add some 25 percentage points.

Germany needs a stronger France to re-model Europe

The implications of France’s economic relapse reach beyond its borders. At stake is not only the future of France but that of the euro. France – and Germany – carry a special responsibility for Europe and the euro area in particular. As a fragile and ever-evolving institutional construct, in times of crisis Europe needs clear leadership from national governments. In the early 1990s, without the decisive cooperation between Berlin and Paris, the implosion of the European Monetary System after the German unification would have jeopardized the progress made on the single market. In the current crisis, though, at crucial moments the decisive moves came from an unelected body, the ECB, which had to painfully snatch concessions from national governments. There was and still is a political leadership vacuum that, for different reasons, neither Germany nor France are able to fill, let alone join forces for putting the euro area on a more solid footing.

The crisis has revealed the shortcomings of the design of the European monetary union. The member states have taken a number of decisions to upgrade the institutional framework in the course of euro crisis management that had been perceived impossible before the crisis. Still, they remain insufficient for two reasons: first, economic policy coordination does not go far enough given that action taken – or not taken – on national level have spill-over effects to the rest of the euro area. Second, intergovernmental cooperation has pushed aside the European Institutions and has even resulted in three intergovernmental agreements outside the EU treaties.

The key to a more complete – and irreversible – leap forward of the Euro area, with meaningful federal enforcement powers on national fiscal policy, structural reforms and the respective democratic legitimacy, has to be a treaty change. Most relevant provisions for EMU have been negotiated for quieter times twenty years ago and have already been stretched to its limit. The revision of the treaty would also have to consolidate the various intergovernmental agreements on the ESM, the fiscal pact and the Single Resolution Fund. In her first speech of her new term, on 18 December 2013, Angela Merkel expressed her frustration with a *“situation in Europe where everyone says, ‘we can do everything to evolve, but one thing we can’t change are the treaties’*”. In her recent state of the union address she re-emphasized that economic policy coordination in the euro area has proven to be still very poor and that the treaties need to be adjusted to allow monetary union to be complemented by a real economic union. However, at the end of January, on meeting with the British Prime Minister, Francois Hollande stated that France *“wish the Euro area to be better integrated and coordinated but, if there are modifications in the texts, these do not seem to us of any matter of urgency”*.

¹⁰ The sustainability gap is defined as the sum of official/explicit and invisible/implicit public debt. Implicit debt refers e.g. to unfunded government obligations like pensions for federal employees.



Can Hollande pull off a Schröder and will it work?

The French President's call for some caution on the pace of institutional progress is to some extent tactical. At a time when in France (and a number of other countries) the appetite for Europe is at a low ebb, opening a discussion on sovereignty is probably politically suicidal. However, an honest political discourse over the future shape of the euro area is essential – within France and Germany as well as between these two strategic partners. There appears to be a certain circularity in the argumentation between France and Germany: Germany seeks control and political integration before more (fiscal) solidarity – an approach that has been followed through the crisis management as well. France, in turn, would like to see solidarity before further integration. More fundamentally though, we think that France will accept a meaningful federalization of the Euro area only when it has restored its own economic credibility, at its own pace, with as limited pressure from the outside as possible. Only if Paris knows that it won't be found wanting by federal powers, will it accept the constraints accompanying deeper economic union. France is ready to accept enforced rules only to the extent that it can be fairly certain that it will comply. In the meantime, France will do the "basic minimum" e.g. bringing the deficit below 3% by 2015, without necessarily providing more clarity on the next steps and will deliver on the structural reforms in a way, and a pace, that the government will deem politically acceptable.

The political configuration is complex. Hollande may have come out as a social-democrat, but some of the members of the majority have not, and are not planning to. The President is in our view trying to reach out to his left wing by stating that the cut in payroll tax offered to businesses would have to be "traded" against quantified commitments in terms of hiring. Even if we have our doubts on the materiality of any control on these matters (the same intentions had been stated for the CICE), this whiff of "dirigisme" is at odds with the "supply-side" stance adopted by Hollande.

Still, we think that a crucial element of his press conference was his decision to subject the vote by the parliament on his new measures to a "confidence vote", which means that the government would collapse if the package failed to pass. This is a way to force the left wing of the socialist party to stick to the group discipline, which had eroded recently (25 socialist MPs had attempted to water down extensively the CICE). Actually, the leaders of the left wing duly announced that they would support the government and can now hardly criticize the new stance. As the President's authority over his majority had been questioned, this reflects Hollande's new decisiveness and his willingness to put his reformist economic agenda – by French standards – at the centre of his overall message.

We find it interesting as well that he chose to re-state his reformist goals – which are not necessarily popular – ahead of the municipal elections in March and the European elections in May. In our view, Hollande may consider that his perceived lack of authority and direction, which has cost him dearly in the polls, was the most urgent issue to fix, even if that meant alienating the left-wing segments of public opinion.

Still, it seems that, given the political configuration, France needs to be fixed before the European treaty is fixed. While we consider that the new "reformist stance" adopted by Hollande reflects a sincere willingness to reform the French economy we also think, unfortunately, that the adjustment could well take the remainder of this decade. While Germany will be asked to show some patience by Paris, it is an open question if the making-up of the institutional framework of the euro area including treaty changes can be postponed accordingly.



Can Hollande pull off a Schröder and will it work?

Germany's reform process at the beginning of the 2000s went along with the European debate and work on a constitutional treaty whose slimmed-down version was ratified as Lisbon Treaty in 2007. While the meaningful overhaul of the French economy is instrumental for the economic survival of the euro, France should join forces with Germany to fix the political side of monetary union in the very near future.

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