NATIXIS

Flash
Economics

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Consumption or profits?

In some countries (Germany and France for example), employment and consumption have, since the start of the crisis, been sustained by the decline in productivity, i.e. by an incomplete adjustment in employment to output. The cost of the decline in productivity is a reduction in corporate profitability (unless it is covered by the government). In other countries (United States and Spain, for example), employment has been rapidly adjusted; the cost is a weakening of household income and consumption, but corporate profitability is picking up more rapidly.

What is preferable? Stimulating consumption by a slow adjustment in employment or bolstering profits by a rapid adjustment in employment? We will first seek to ascertain what we can learn from the 2001-2003 recession, and we want to look at the situation in the current crisis, an important particularity of which is the lack of stimulation of consumption by credit, and therefore persistently tame growth in the wake of the recession. In the past, a rapid adjustment in employment was favourable, because it sustained profits and productive investment whereas credit kick-started consumption; but currently, if credit cannot pick up, and profits are not invested, a slow adjustment in employment that stimulates consumption is on the contrary preferable, except in countries where profits have fallen to a dangerously low level (France, Spain).

ECONOMIC RESEARCH
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Major differences in the speed of adjustment in employment and productivity

We look at the situation in the **United States, the United Kingdom, Germany, France, Italy, Spain and Japan**. The speed of adjustment in employment to real activity has been very different in each of these countries **(Charts 1A** to **G)**.

Chart 1A
United States: GDP growth, employment and productivity (2002 = 100)

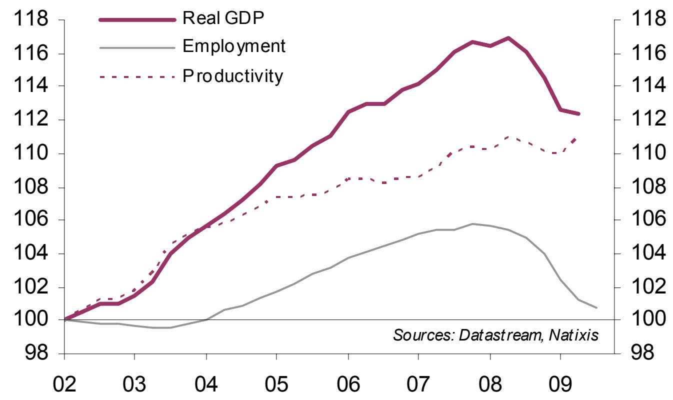


Chart 1B
United Kingdom: GDP growth, employment and productivity (2002 = 100)

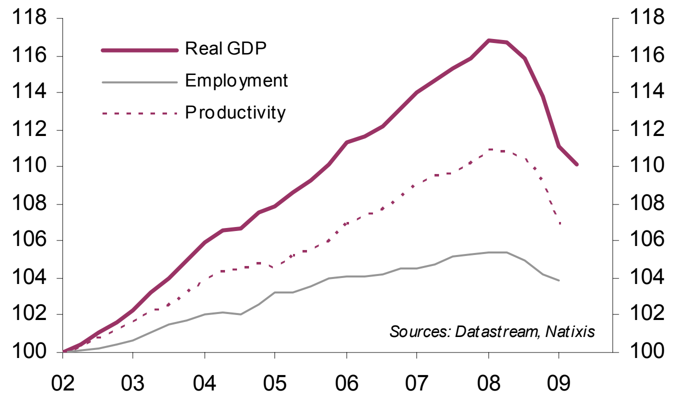


Chart 1C
Germany: GDP growth, employment and productivity (2002 = 100)

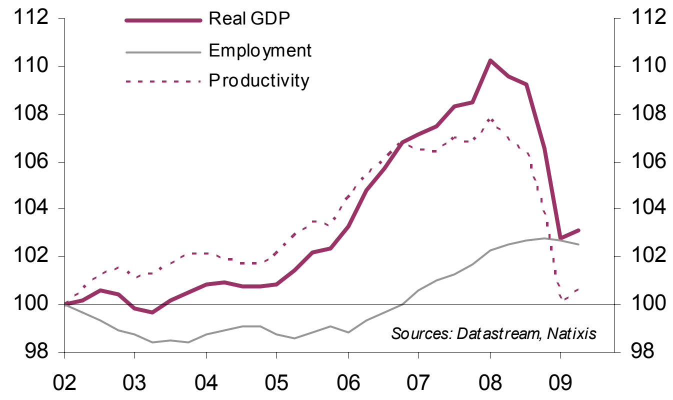


Chart 1D
France: GDP growth, employment and productivity (2002 = 100)

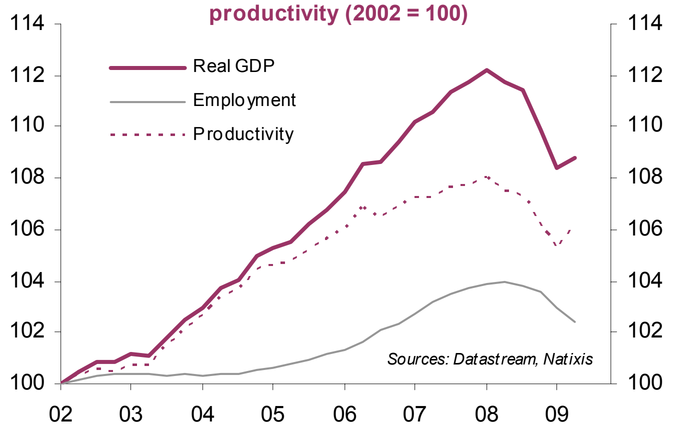


Chart 1E
Italy: GDP growth, employment and productivity (2002 = 100)

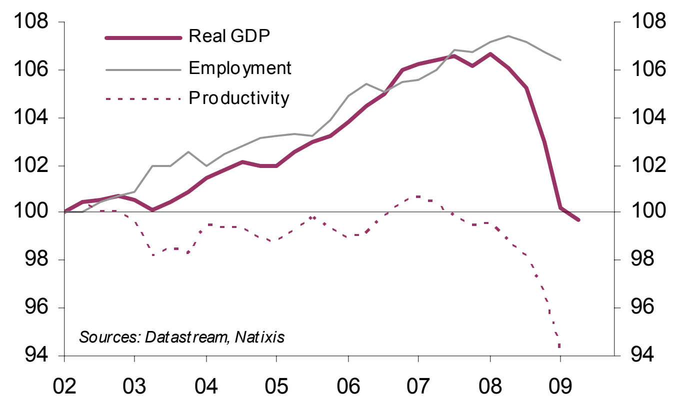


Chart 1F
Spain: GDP growth, employment and productivity (2002:1 = 100)

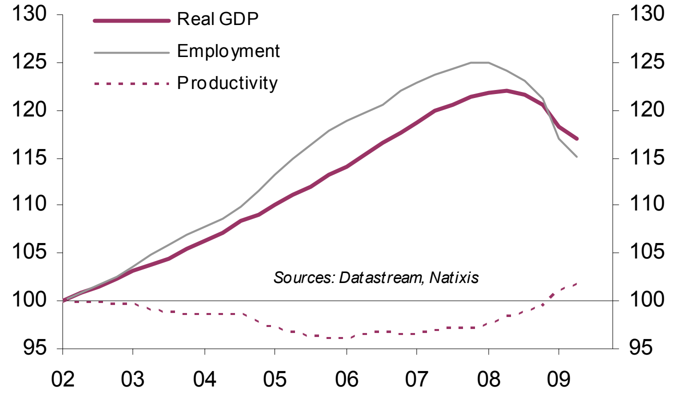
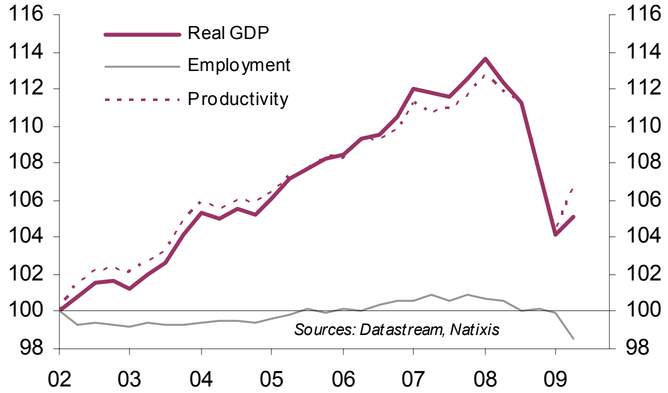


Chart 1G
Japan: GDP growth, employment and productivity (2002 = 100)



We have witnessed **a rapid adjustment in employment** and a lack of shortfall in productivity (or a small shortfall in productivity) **in Spain and the United States; a slow adjustment in employment in France and the United Kingdom**; and **a very slow adjustment in employment in Germany, Japan and Italy**.

When the adjustment in employment is slow, profitability suffers

Profitability declines when the real per capita wage (calculated with the GDP deflator) increases faster than per capita productivity.

However, there may be a bias between the trend in profit rates and the trend in the differential between productivity and real wage because of changes in interest payments, taxes, government transfer payments, etc.

Charts 2A to **2G** show that, in the recent period:

- this is not the case in the United States and Spain;
- it is the case in the United Kingdom, France and Italy;
- it is patently the case in Germany and Japan.

Chart 2A
United States: Wage, productivity and profits

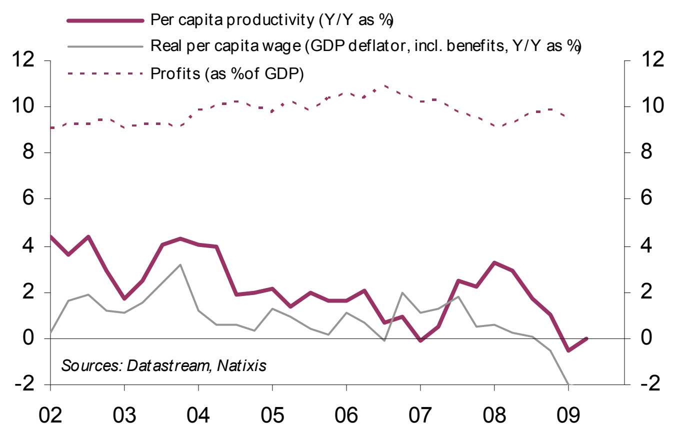


Chart 2B
United Kingdom: Wage, productivity and profits

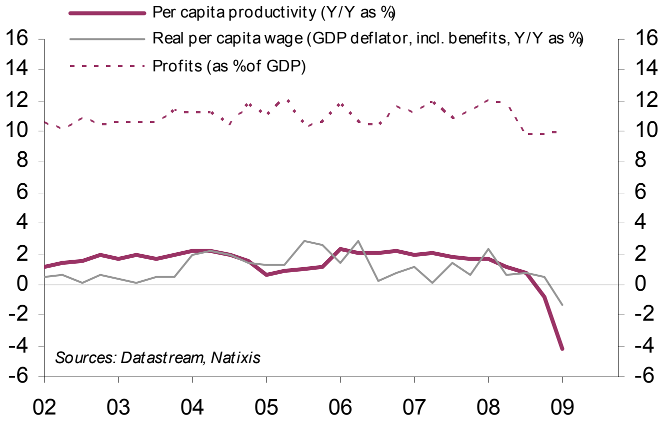


Chart 2C
Germany: Wage, productivity and profits

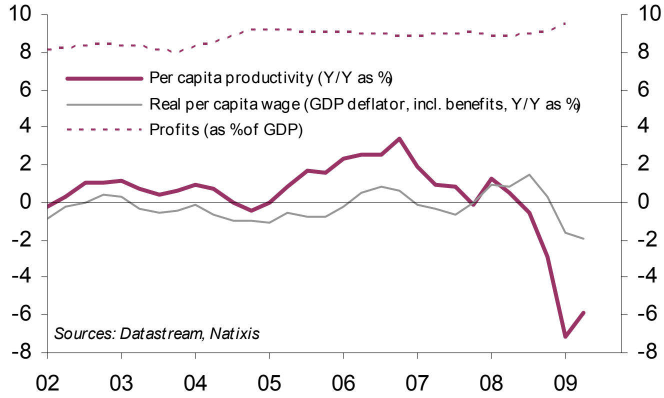


Chart 2D
France: Wage, productivity and profits

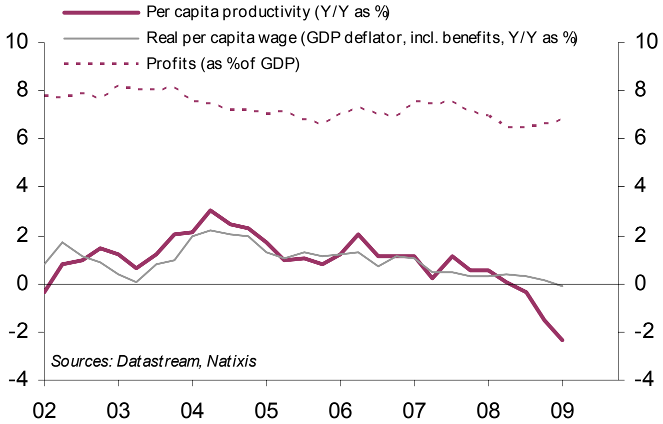


Chart 2E
Italy: Wage, productivity and profits

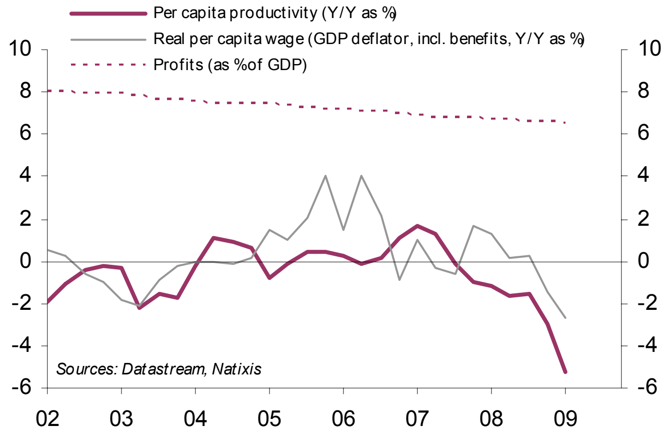


Chart 2F
Spain: Wage, productivity and profits

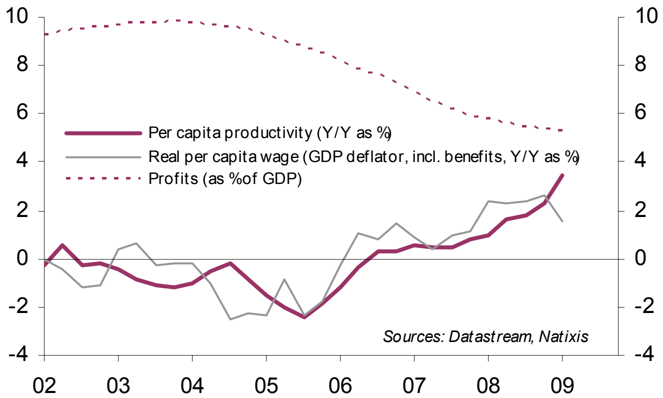
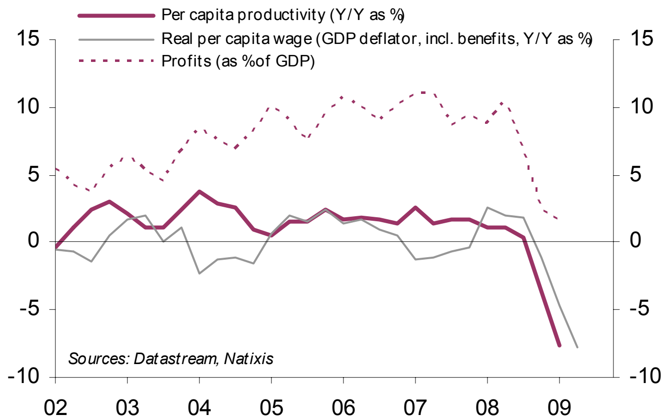


Chart 2G
Japan: Wage, productivity and profits



It is clearly in those countries where the adjustment in employment is slow that profitability is declining.

When the adjustment in employment is slow, consumption is bolstered

The slowness of the adjustment in employment to the contraction in gross domestic product normally means household income and consumption are bolstered.

In this case biases may obviously also appear between employment and consumption due to major changes in real wages **(Charts 3A** and **B)** or in the household savings rate **(Charts 4A** and **B)**, or even due to fiscal policies.

Chart 3A
Real per capita wage (CPI deflator, Y/Y as %)

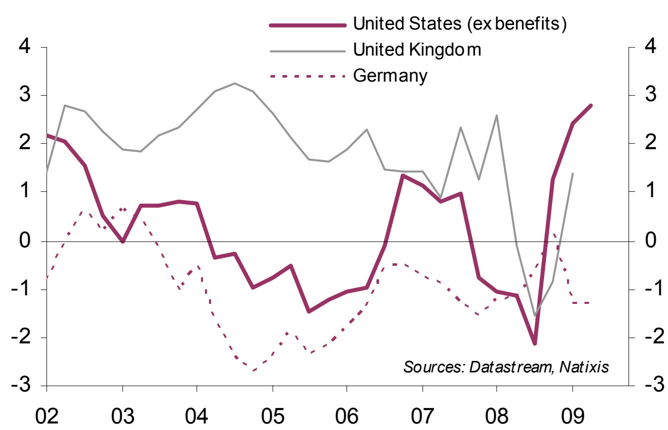


Chart 3B
Real per capita wage (CPI deflator, Y/Y as %)

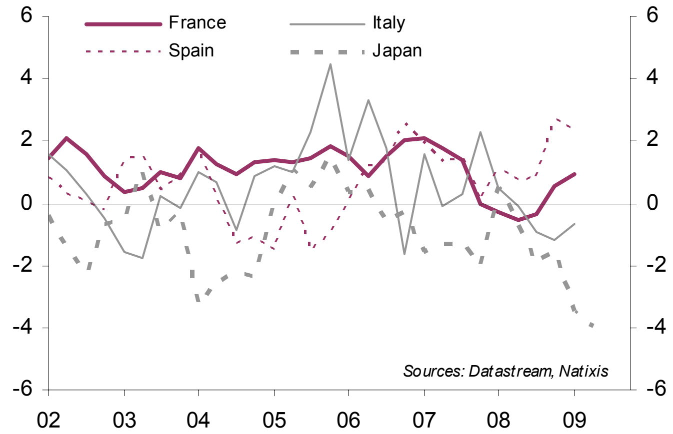


Chart 4A
Gross household savings rate

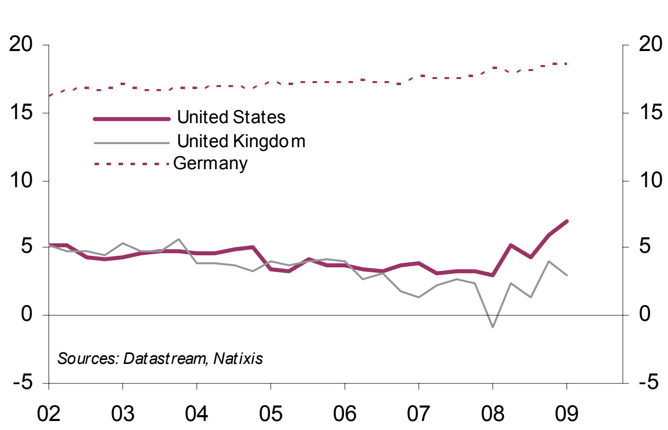
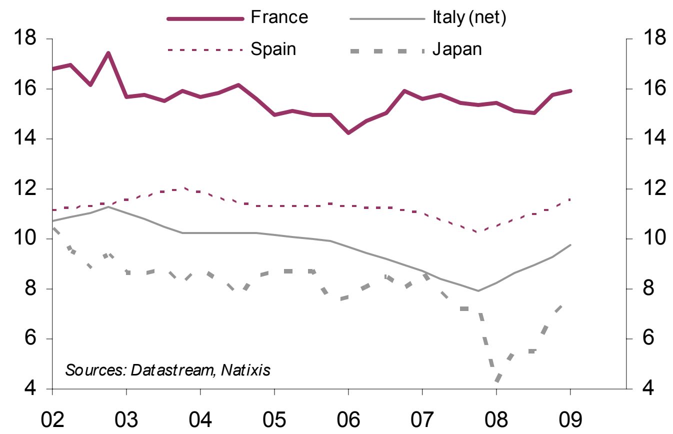


Chart 4B
Gross household savings rate



Charts 5A to **G** show that **the decline in consumption has been significant** in the recent period in the United States, the United Kingdom, Italy and Japan; that it has been **very significant** in Spain; and **limited** in Germany and France.

All in all, what coherence can be seen between the speed of adjustment in employment, the trend in profits and changes in household consumption?

The speed of adjustment in employment clearly corresponds to the trend in profits. When the adjustment in employment is rapid (United States, Spain) there is definitely a shortfall in consumption; when it is slow, consumption is stimulated in France and Germany, but not in the United Kingdom (rise in savings), Italy (rise in savings) or Japan (fall in wages).

Chart 5A
United States: Real payroll received by households, employment and household consumption (Y/Y as %)

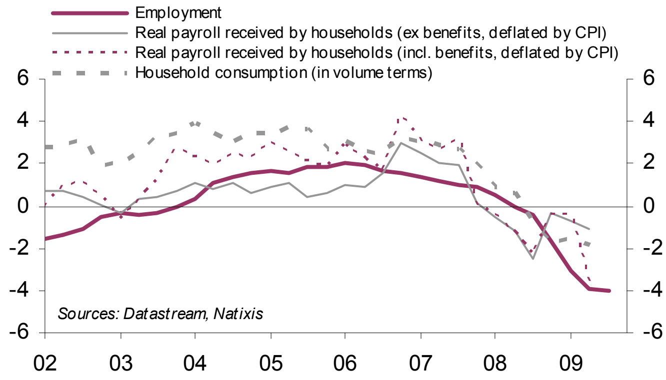


Chart 5B
United Kingdom: Real payroll received by households, employment and household consumption (Y/Y as %)

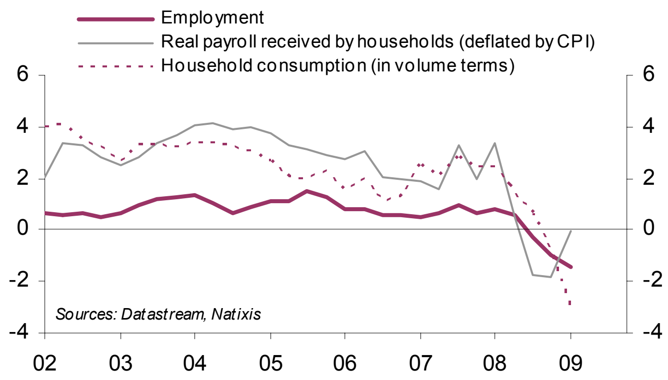


Chart 5C
Germany: Real payroll received by households, employment and household consumption (Y/Y as %)

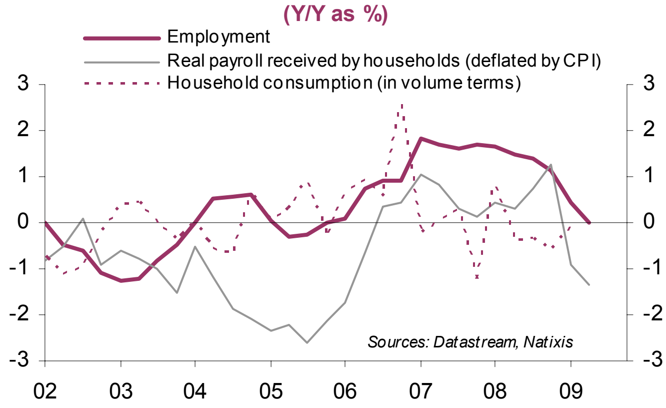


Chart 5D
France: Real payroll received by households, employment and household consumption (Y/Y as %)

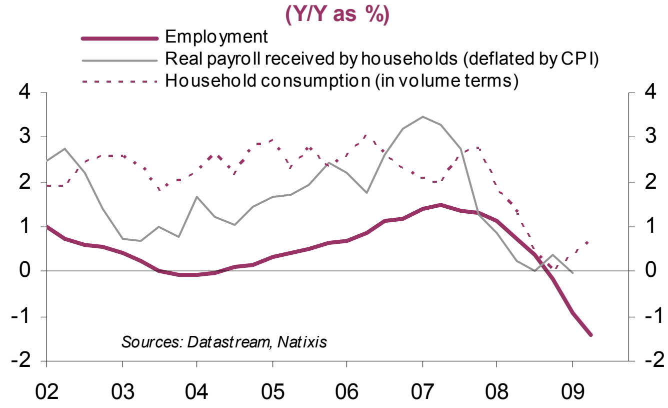


Chart 5E
Italy: Real payroll received by households, employment and household consumption (Y/Y as %)

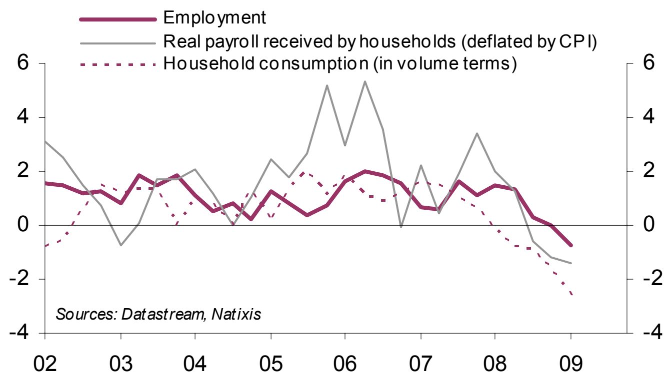


Chart 5F
Spain: Real payroll received by households, employment and household consumption (Y/Y as %)

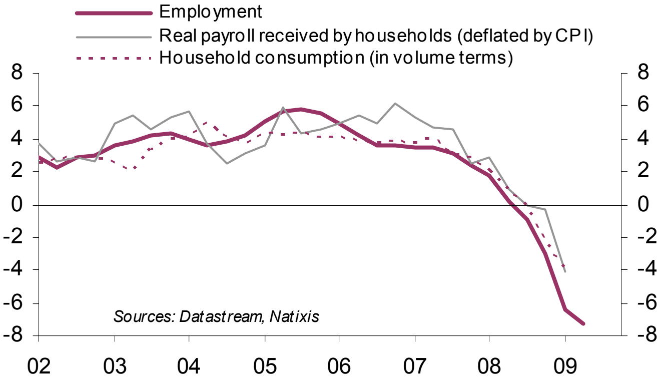
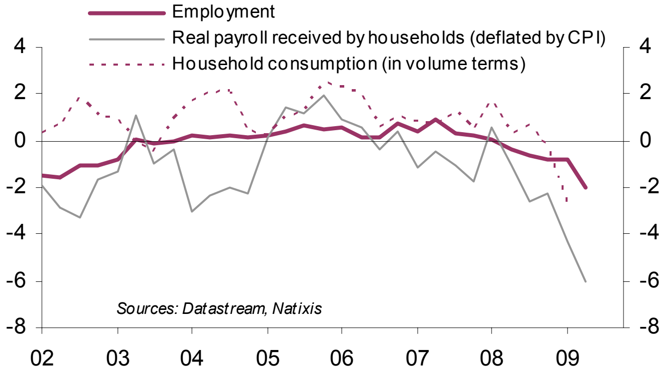


Chart 5G
Japan: Real payroll received by households, employment and household consumption (Y/Y as %)

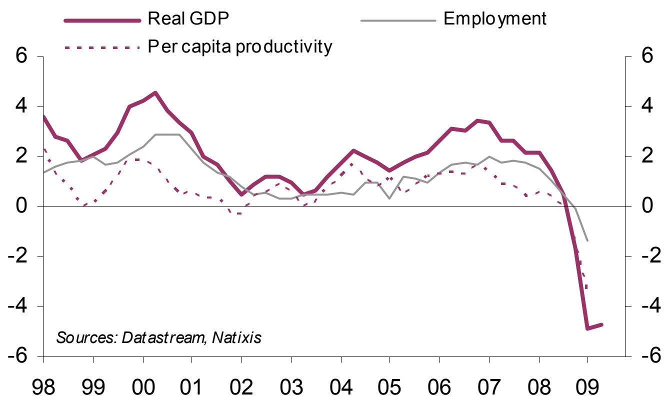


What is preferable: Boosting profits or consumption?

To try to answer this question, we will first look at **the situation witnessed during the 2000-2003 recession**, by comparing the United States (rapid adjustment in employment) and the euro zone (slow adjustment in employment, **Charts 6A** and **B**).

Chart 6A
United States: GDP, employment and per capita productivity (Y/Y as %)

Chart 6B
Euro zone: GDP, employment and per capita productivity (Y/Y as %)



What occurred with regard to **trends in profits, investment and consumption, and the speed at which the economies pulled out of the crisis?**

In the United States, profits and investment picked up from 2003, housing investment and consumption also, due to brisk credit growth **(Charts 7A, B** and **C)**; in **the euro zone**, profits declined, corporate investment picked up only belatedly – and the same held for consumption, housing investment and credit (in 2005, **Charts 8A, B** and **C**).

Chart 7A
United States: Profits and productive investment

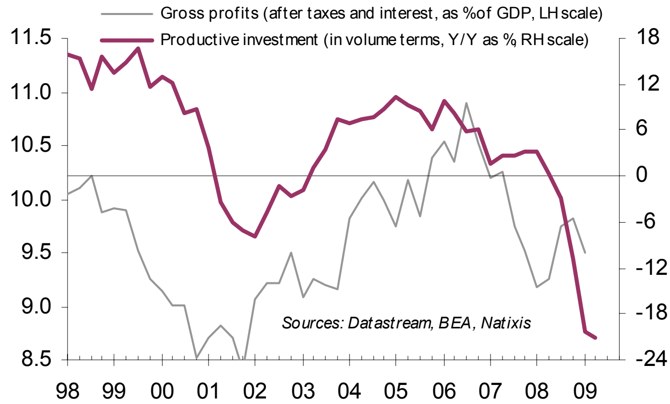


Chart 7B
United States: Real payroll, consumption and household housing investment (Y/Y as %)

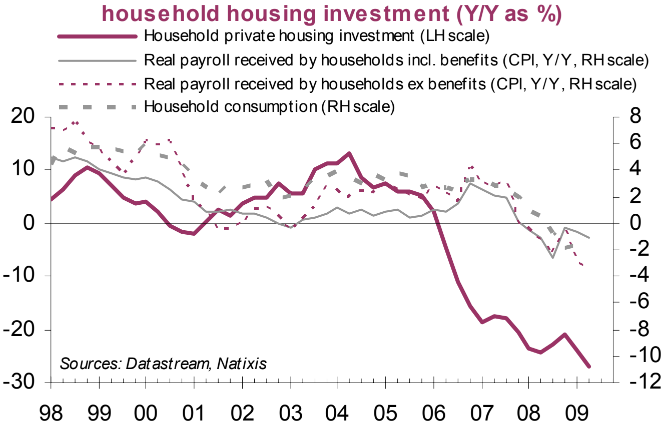


Chart 7C
United States: Loans to households and companies (Y/Y as %)

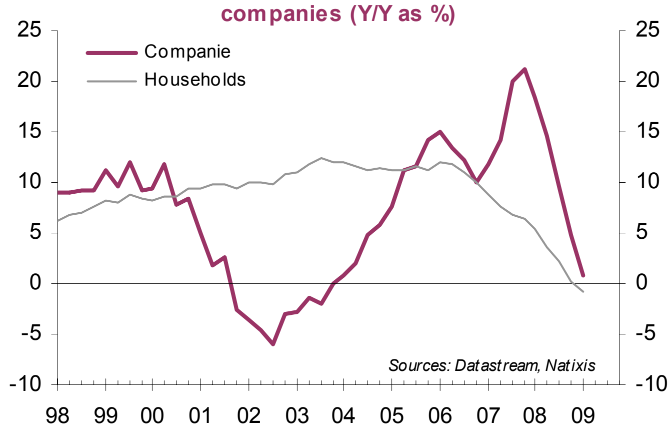


Chart 8A
Euro zone: Productive investment and profits

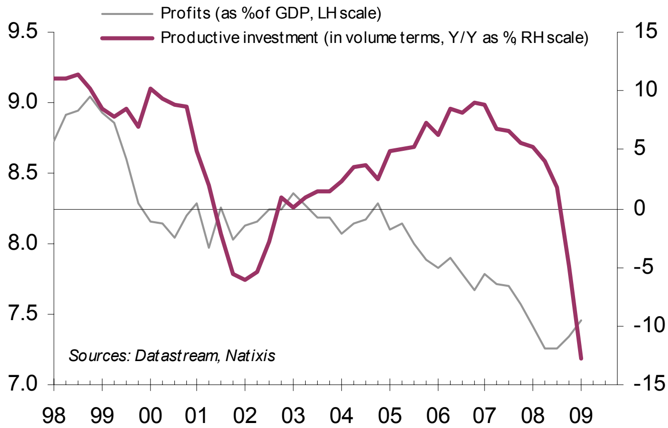


Chart 8B
Euro zone: Real payroll received by households, household consumption and housing investment (Y/Y as %)

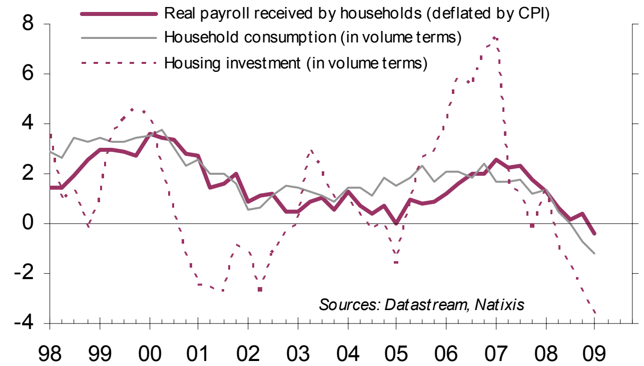
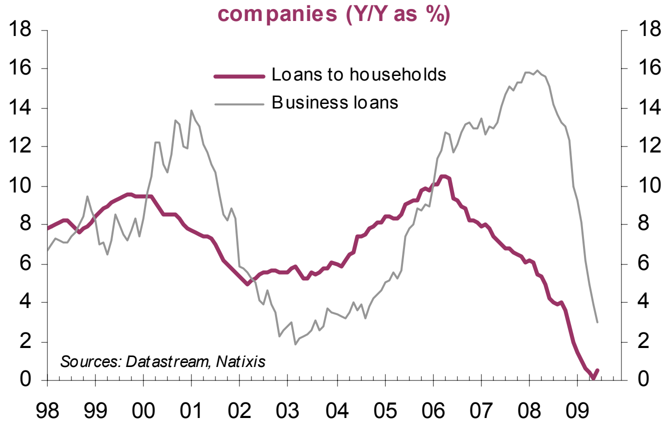


Chart 8C
Euro zone: Bank loans to households and companies (Y/Y as %)

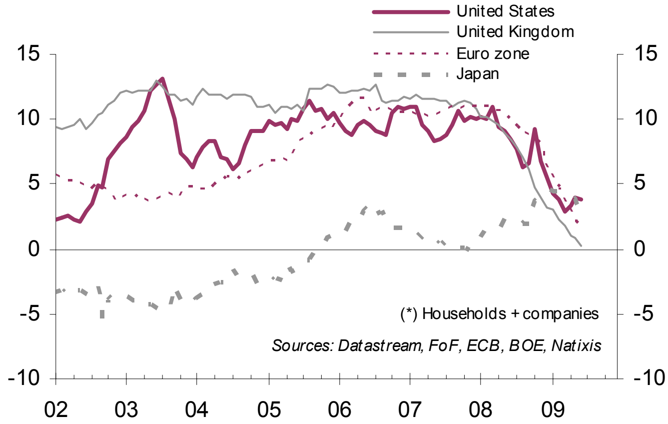


In the past, a rapid adjustment in employment was therefore preferable thanks to its positive effect on profits and investment.

The particularities of the current cycle

We believe that **private economic agents will deleverage** for several years **(Chart 9),** for several reasons: high level of debt ratios, which has led to very high default rates; fall in asset prices; higher risk premia on debts.

Chart 9
Bank lending to the private sector* (Y/Y as %)



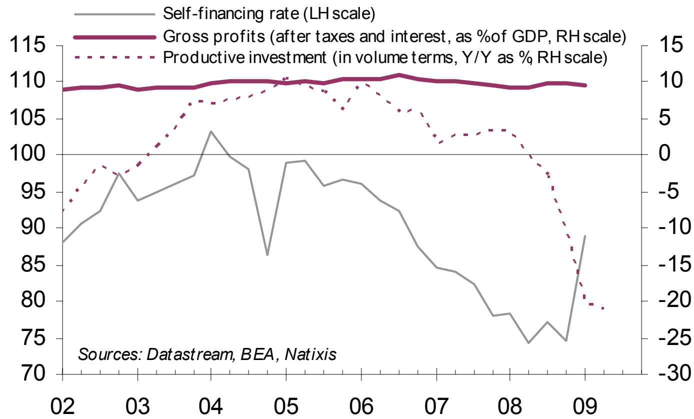
This implies:

- **in the near term, that one cannot rely on credit to jump-start demand**;
- **in the medium term**, that growth will remain tepid since it is not bolstered by credit, and therefore that **the need for production capacity will be reduced**.

If the re-establishment of profits is favoured with a rapid adjustment in employment and therefore a reduction in consumption, there is therefore reason to fear that demand will remain subdued (without the boost from credit) and that companies will not invest the additional profits.

The improvement in profitability in the United States in early 2009 simply led to a rise in the self-financing rate without any increase in investment **(Chart 10)**.

Chart 10
United States: Profits, self-financing rate and productive investment



But it is conversely true that the self-financing rate has fallen to a dangerously low level in certain countries (France, Japan and Spain, Charts 11A and **B).**

Chart 11A
Self-financing rate (as %)

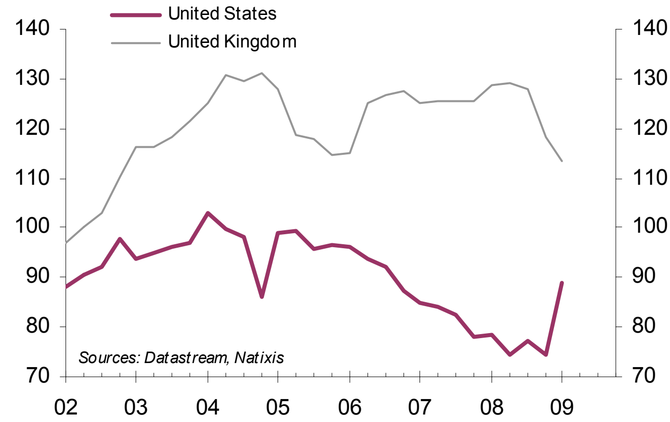
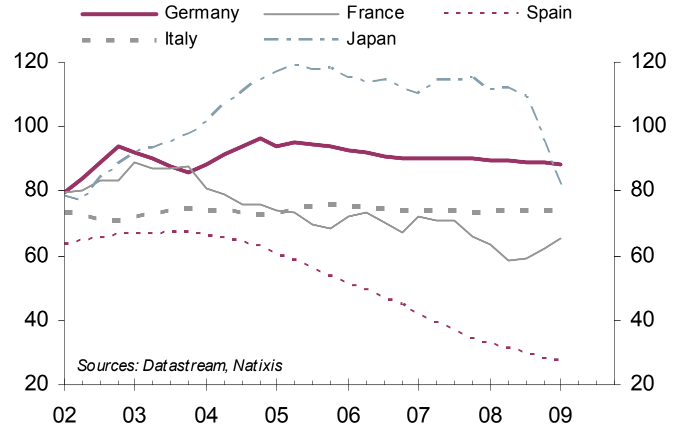


Chart 11B
Self-financing rate (as %)



The message therefore seems to be: in the current situation (impossibility of boosting household demand via credit, limited need for production capacity), it is more favourable to boost consumption than profits, except in countries where the very low level of profits is a threat for companies' survival.

The rise in company bankruptcies, due to low profits, is actually substantial in France and Spain **(Charts 12A** and **B)**.

Chart 12A
Company bankruptcies (number per quarter)

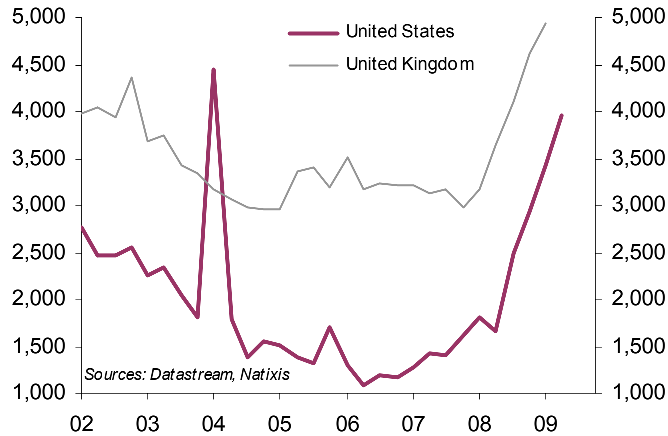
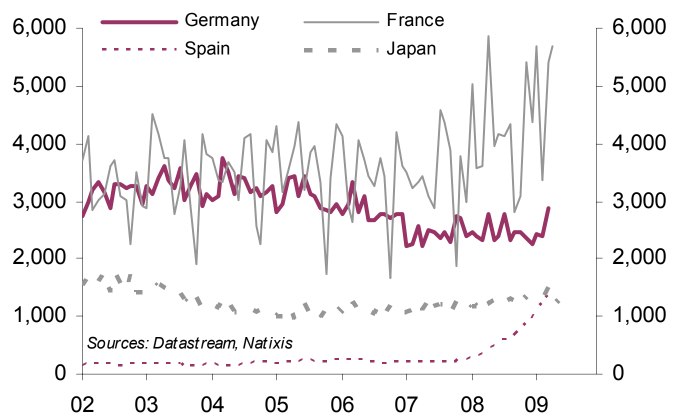


Chart 12B
Company bankruptcies (number per month)



Conclusion: Apart from a few exceptions, a slow adjustment in employment should be preferred during this crisis

Countries where employment is adjusting slowly (Germany, France, Italy, Japan, United Kingdom) are in a majority, and - apart from a few particular trends in wages and savings rates – are countries where consumption is sustained but profitability reduced.

In the past, a rapid adjustment in employment (United States, unlike the euro zone) **was favourable**: the increase in profits boosted investment and it was credit that kick-started consumption.
However, in the current cycle, credit cannot be expected to sustain household demand and, due to the prospect of subdued growth, investment requirements are reduced. This should normally lead to the conclusion that it is better to boost consumption than profits, and therefore to prefer a slow adjustment to a rapid adjustment in employment. An exception can be made for countries where corporate profitability has fallen to a dangerously low level, reflected by the trend in bankruptcies (France and Spain for example).