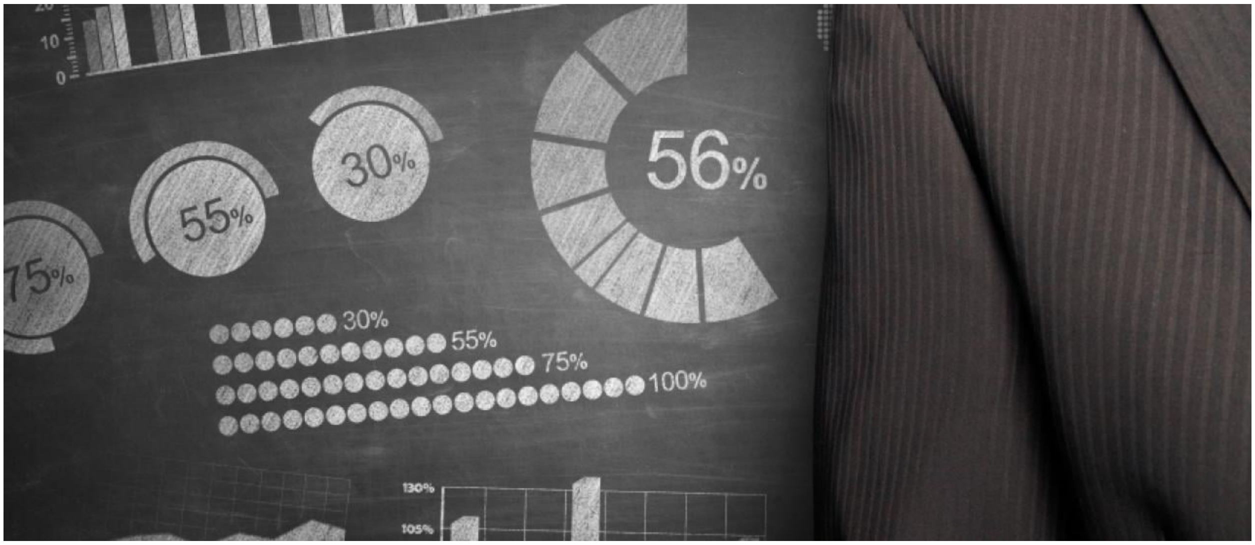
Creating Growth: Stimulate Demand or Supply?



By Theo Vermaelen , INSEAD Professor of Finance

The French government's recent shift to the right on economic policy illustrates the dilemma leaders face when kickstarting growth: Should policy be supply or demand driven?

Recently 600 U.S.-based economists signed a petition asking for an increase in the U.S. minimum wage to US$10.50. This is quite remarkable as microeconomics textbooks generally use minimum wage increases as an illustration of good intentions with bad results: an increase in the minimum wage increases labour costs and therefore unemployment, especially among low skilled workers. So the increase in the minimum wage benefits those who have a job at the expense of the unemployed.

However macroeconomists argue that the increase in wages will stimulate demand and therefore encourage companies to increase investment and hiring. The 600 economists would probably get along well with Arnaud Montebourg, the French Socialist politician who was recently fired for attacking the supply-side approach of French President François Hollande and his advisor Emmanuel Macron who replaced Mr Montebourg as Economy Minister last week.

While Mr Montebourg wanted to create growth by stimulating demand, the Hollande-Macron couple wants to create growth through supply, by making French companies more competitive, i.e. lowering labour costs by reducing social charges and corporate taxes as well as increasing labour market flexibility. They want to keep reducing the deficit so that lenders have confidence in the financial sustainability of the French government, which should keep interest rates low.

Where business decisions are made

A fact often ignored by many macroeconomists is that investments in the private sector are decided at the micro level. When a company decides to invest, it calculates the net present value of the investment. This means forecasting cash flows and discounting at the cost of capital, often over a very long horizon (say 10 years). Forecasting cash flows requires forecasting revenues, labour and other costs and taxes. The cost of capital is determined by the risk-free rate plus a risk premium.

Making a credible commitment to lower the deficit lowers the risk-free rate and therefore the cost of capital. While an increase in wages may increase aggregate demand, the impact on a specific company's revenues is highly uncertain. If McDonald's increases the minimum wage it is not obvious that its workers or workers in other industries will use this increase to buy more Big Macs, rather than to buy a new mobile phone. What is certain is that a wage increase is a cost increase. Costs, such as corporate taxes, are in general easier to measure and forecast than revenues. That's why empirical studies on merger and acquisitions find that cost synergies are easier to realise than revenue synergies. Lack of labour market flexibility (ability to fire people and freedom to determine the specifics of a labour contract such as the length of the work week) discourage investment and hiring, especially in highly competitive and risky industries. If I can't fire workers when revenues are less than forecasted I am less likely to take risk and invest. Ideally I would like all stakeholders, including workers, to share in the risk of new ventures.

The challenges of reform

So, I am siding with the supply-siders: focusing on certain cost reductions rather than uncertain revenue increases will make it easier to convince the actual decision makers that it makes economic sense to invest in France. With one caveat: as capital expenditures are by nature long-term investments, it does not matter to the entrepreneur what the French government decides to do today. It matters what tax and labour market policies will be 5 years from now and beyond. Companies are not like puppets on a string (or a few strings such as interest rates and taxes) that you can push to invest based on the policy of the day. And here political risk is an important factor.

The current political landscape in France does not look very promising. While the appointment of Mr Macron is a hopeful sign that the French Socialists are turning away from their hard-left wing, the fact is his views are not shared by a large faction of the Socialists who fear competition from the extreme left and the extreme right. Although the National Front (FN) is generally described as an extreme right-wing party, the fact is that its leader, Marine Le Pen, owes her success to dismissing the economic liberal policies of her father and endorsing a left-wing economic agenda, in particular opposition to increasing labour market flexibility. In contrast to most other European countries, there is no political majority for economic freedom in France. This makes economic reform far more difficult than elsewhere.

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