Manic-depressive austerity: let's talk about it!

By Christophe Blot, Jérôme Creel, and Xavier Timbeau

Following discussions with our colleagues from the European Commission [1], we return to the causes of the prolonged period of recession experienced by the euro zone since 2009. We continue to believe that premature fiscal austerity has been a major political error and that an alternative policy would have been possible. The economists of the European Commission for their part continue to argue that there was no alternative to the strategy they advocated. It is worth examining these conflicting opinions.

In the iAGS 2014 report (as well as in the iAGS 2013 report and in various OFCE publications), we have developed the analysis that the stiff fiscal austerity measures taken since 2010 have prolonged the recession and contributed to the rise in unemployment in the euro zone countries, and are now exposing us to the risk of deflation and increased poverty.

Fiscal austerity, which started in 2010 (mainly in Spain, Greece, Ireland and Portugal, with a fiscal impulse [2] for the euro zone of -0.3 GDP point that year), and then was intensified and generalized in 2011 (a fiscal stimulus of -1.2 GDP point across the euro zone, see table), and then reinforced in 2012 (-1.8 GDP point) and continued in 2013 (-0.9 GDP point), is likely to persist in 2014 (-0.4 GDP point). At the level of the euro zone, since the start of the global financial crisis of 2008, and while taking into account the economic recovery plans of 2008 and 2009, the cumulative fiscal impulse boils down to a restrictive policy of 2.6 GDP points. Because the fiscal multipliers are high, this policy explains in (large) part the prolonged recession in the euro zone.

The fiscal multipliers summarize the impact of fiscal policy on activity [3]. They depend on the nature of fiscal policy (whether it involves tax increases or spending cuts, distinguishing between transfer, operating and investment expenditure), on the accompanying policies (mainly the ability of monetary policy to lower key rates during the austerity treatment), and on the macroeconomic and financial environment (including unemployment, the fiscal policies enacted by trading partners, changes in exchange rates and the state of the financial system). In times of crisis, the fiscal multipliers are much higher, *i.e.* at least 1.5 for the multiplier of transfer spending, compared with near 0 in the long-term during normal times The reason is relatively simple: in times of crisis, the paralysis of the banking sector and its inability to provide the credit economic agents need to cope with the decline in their revenues or the deterioration in their balance sheets requires the latter to respect their budget constraints, which are no longer intertemporal but instantaneous. The impossibility of generalizing negative nominal interest rates (the well-known "zero lower bound") prevents central banks from stimulating the economy by further cuts in interest rates, which increases the multiplier effect during a period of austerity.

Table. Fiscal impulses in the euro area

In GDP points

	2010	2011	2012	2013	2014
DEU	1,3	-1,1	-1,2	0,2	0,1
FRA	-0,5	-1,8	-1,2	-1,4	-0,7
ITA	-0,7	-0,4	-3,0	-1,5	-0,6
ESP	-1,4	-1,3	-3,4	-1,6	-1,0
NLD	-1,1	-0,5	-1,4	-1,5	-1,0
BEL	-0,1	0,1	-0,6	-1,0	-0,5
IRL	-4,2	-1,5	-2,0	-1,7	-1,7
PRT	-0,3	-3,7	-3,9	-1,5	-1,5
GRC	-7,6	-5,5	-3,9	-3,3	-1,7
AUT	0,5	-1,4	-0,3	-0,9	-0,4
FIN	1,3	-0,7	-0,3	-1,4	-0,3
EA (11)	-0,3	-1,2	-1,8	-0,9	-0,4

Sources: Eurostat, National accounts.

If the fiscal multipliers are higher in times of crisis, then a rational reduction in the public debt implies the postponement of restrictive fiscal policies. We must first get out of the situation that is causing the increase in the multiplier, and once we are back into a “normal” situation then reduce the public debt through tighter fiscal policy. This is especially important as the reduction in activity induced by tightening fiscal policy may outweigh the fiscal effort. For a multiplier higher than 2, the budget deficit and public debt, instead of falling, could continue to grow, despite austerity. The case of Greece is instructive in this respect: despite *real* tax hikes and *real* spending cuts, and despite a partial restructuring of its public debt, the Greek government is facing a public debt that is not decreasing at the pace of the budgetary efforts – far from it. The “fault” lies in the steep fall in GDP. The debate on the value of the multiplier is old but took on new life at the beginning of the crisis.[4] It received a lot of publicity at the end of 2012 and in early 2013, when the IMF (through the voice of O. Blanchard and D. Leigh) challenged the European Commission and demonstrated that these two institutions had, since 2008, systematically underestimated the impact of austerity on the euro zone countries. The European Commission recommended remedies that failed to work and then with each setback called for strengthening them. This is why the fiscal policies pursued in the euro zone reflected a considerable error of judgment and are the main cause of the prolonged recession we are experiencing. The magnitude of this error can be estimated at almost 3 percentage points of GDP for 2013 (or almost 3 points of unemployment): If austerity had been postponed until more favourable times, we would have reached the same ratio of debt-to-GDP by the deadline imposed by treaty (in 2032), but with the benefit of additional economic activity. The cost of austerity since 2011 is thus almost 500 billion euros (the total of what was lost in 2011, 2012 and 2013). The nearly 3 additional points of unemployment in the euro zone are now exposing us to the risk of deflation, which will be very

difficult to avoid.

Although the European Commission follows these debates on the value of the multiplier, it (and to some extent the IMF) developed another analysis to justify its choice of economic policy in the euro zone. This analysis holds that the fiscal multipliers are *negative* in times of crisis *for the euro zone*, and for the euro zone alone. Based on this analysis, austerity should *reduce* unemployment. To arrive at what seems to be a paradox, we must accept a particular counterfactual (what would have happened if we had not implemented austerity policies). For example, in the case of Spain, without an immediate fiscal effort, the financial markets would have threatened to stop lending to finance the Spanish public debt. The rise in interest rates charged by the financial markets to Spain would have pushed its government into brutal fiscal restraint, the banking sector would not have survived the collapse of the value of Spain's sovereign notes, and the increased cost of credit due to the fragmentation of the financial markets in Europe would have led to a crisis that spiralled way beyond what the country actually experienced. In this analytical model, the austerity recommended is not the result of dogmatic blindness but an acknowledgement of a lack of choice. There was no other solution, and in any case, delaying austerity was not a credible option.

Accepting the European Commission's counterfactual amounts to accepting the idea that the fiscal multipliers are negative. It also means accepting the notion that finance dominates the economy, or at least that judgments on the sustainability of the public debt must be entrusted to the financial markets. According to this counterfactual, quick straightforward austerity would regain the confidence of the markets and would therefore avoid a deep depression. Compared to a situation of postponed austerity, the recession induced by the early straightforward budget cuts should lead to less unemployment and more activity. This counterfactual thesis was

raised against us in a seminar held to discuss the iAGS 2014 report organized by the European Commission (DGECFIN) on 23 January 2014. Simulations presented on this occasion illustrated these remarks and concluded that the austerity policy pursued had been beneficial for the euro zone, thereby justifying the policy *a posteriori*. The efforts undertaken put an end to the sovereign debt crisis in the euro zone, a prerequisite for hoping one day to get out of the depression that began in 2008.

In the iAGS 2014 report, publically released in November 2013, we responded (in advance) to this objection based on a very different analysis: massive austerity did not lead to an end to the recession, contrary to what had been anticipated by the European Commission following its various forecasting exercises. The announcement of austerity measures in 2009, their implementation in 2010 and their reinforcement in 2011 never convinced the financial markets and failed to prevent Spain and Italy from having to face higher and higher sovereign rates. Greece, which went through an unprecedented fiscal tightening, plunged its economy into a deeper depression than the Great Depression, without reassuring anyone. Like the rest of the informed observers, the financial market understood clearly that this drastic remedy would wind up killing the patient *before* any cure. The continuation of high government deficits is due largely to a collapse in activity. Faced with debt that was out of control, the financial markets panicked and raised interest charges, further contributing to the collapse.

The solution is not to advocate more austerity, but to break the link between the deterioration in the fiscal situation and the rise in sovereign interest rates. Savers need to be reassured that there will be no default and that the state is credible for the repayment of its debt. If that means deferring repayment of the debt until later, and if it is credible for the State to postpone, then postponement is the

best option.

Crucial to ensuring this credibility were the intervention of the European Central Bank during the summer of 2012, the initiation of the project for a banking union, and the announcement of unlimited intervention by the ECB through Outright Monetary Transactions (Creel and Timbeau (2012), which are conditional upon a programme of fiscal stabilization. These elements convinced the markets almost immediately, despite some institutional uncertainty (particularly concerning the banking union and the state of Spain's banks, and the judgment of Germany's Constitutional Court on the European arrangements), and even though OMT is an option that has never been implemented (in particular, what is meant by a programme to stabilize the public finances conditioning ECB intervention). Furthermore, in 2013 the European Commission negotiated a postponement of fiscal adjustment with certain Member States (Cochard and Schweisguth (2013). This first tentative step towards the solutions proposed in the two IAGS reports gained the approval of the financial markets in the form of a relaxation of sovereign spreads in the euro zone.

Contrary to our analysis, the counterfactual envisaged by the European Commission, which denies the possibility of an alternative, assumes an unchanged institutional framework [5]. Why pretend that the macroeconomic strategy should be strictly conditioned on institutional constraints? If institutional compromises are needed in order to improve the orientation of economic policies and ultimately to achieve a better result in terms of employment and growth, then this strategy must be followed. Since the Commission does not question the rules of the game in political terms, it can only submit to the imperatives of austerity. This form of apolitical stubbornness was an error, and in the absence of the ECB's "political" step, the Commission was leading us into an impasse. The implicit pooling of the public debt embodied in the ECB's

commitment to take all the measures necessary to support the euro (the “Draghi put”) changed the relationship between the public debt and sovereign interest rates for every country in the euro zone. It is always possible to say that the ECB would never have made this commitment if the countries had not undertaken their forced march towards consolidation. But such an argument does not preclude discussing the price to be paid in order to achieve the institutional compromise. The fiscal multipliers are clearly (and strongly) positive, and it would have been good policy to defer austerity. There was an alternative, and the policy pursued was a mistake. It is perhaps the magnitude of this error that makes it difficult to recognize.

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[1] We would like to thank Marco Buti for his invitation to present the iAGS 2014 report and for his suggestions, and also Emmanuelle Maincent, Alessandro Turrini and Jan in’t Veld for their comments.

[2] The fiscal impulse measures the restrictive or expansionary orientation of fiscal policy. It is calculated as the change in the primary structural balance.

[3] For example, for a multiplier of 1.5, tightening the budget by 1 billion euros would reduce activity by 1.5 billion euros.

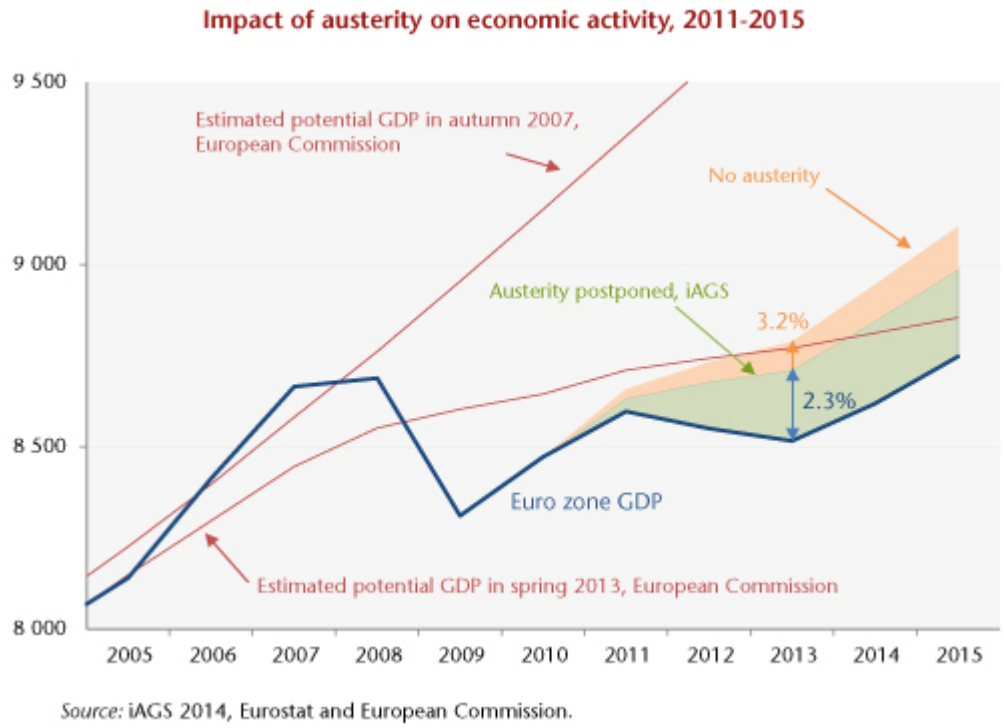
[4] See Heyer (2012) for a recent review of the literature.

[5] The institutional framework is here understood broadly. It refers not only to the institutions in charge of economic policy decisions but also to the rules adopted by these institutions. The OMT is an example of a rule change adopted by an institution. Strengthening the fiscal rules is another element of a changing institutional framework.

From austerity to stagnation

By Xavier Timbeau

Since 2010, the European Commission has published the Annual Growth Survey to stimulate discussion on the occasion of the European semester, during which the governments and parliaments of the Member States, the Commission, and civil society discuss and develop the economic strategies of the various European countries. We considered it important to participate in this debate by publishing simultaneously with the Commission an independent Annual Growth Survey (iAGS), in collaboration with the IMK, a German institute, and the ECLM, a Danish institute. In the 2014 iAGS, for instance, we estimate the cost of the austerity measures enacted since 2011. This austerity policy, which was implemented while the fiscal multipliers were very high and on a scale unprecedented since the Second World War, was followed simultaneously by most euro zone countries. This resulted in lopping 3.2% off euro zone GDP for 2013. An alternative strategy, resulting after 20 years in the same GDP-to-debt ratios (*i.e.* 60% in most countries), would have been possible by not seeking to reduce public deficits in the short term when the multipliers are high. In order to lower the fiscal multipliers again, it's necessary to reduce unemployment, build up agents' balance sheets and get out of the liquidity trap. A more limited but ongoing adjustment strategy, just as fiscally rigorous but more suited to the economic situation, would have led to 2.3 additional points of GDP in 2013, which would have been much better than under the brutal austerity we find ourselves in today. This means there would not have been a recession in 2012 or 2013 for the euro zone as a whole (see the figure below: GDP in million euros).



It is often argued that the state of euro zone public finances left no choice. In particular, market pressure was so great that certain countries, like Greece for example, were concerned that they would lose access to private financing of their public debt. The amounts involved and the state of the primary deficit are advanced to justify this brutal strategy and convince both the markets and the European partners. However, the sovereign debt crisis, and hence market pressure, ended when the European Central Bank announced that no country would leave the euro and set up an instrument, Outright Monetary Transactions, which makes it possible under certain conditions to buy back public debt securities of euro zone countries and therefore to intervene to counter the distrust of the markets (see an analysis here). From that point on, what matters is the sustainability of the public debt in the medium term rather than demonstrating that in an emergency the populace can be compelled to accept just any old policy. Sustainability does however require an adjustment policy that is ongoing (because the deficits are high) and moderate (because fiscal policy has a major impact on activity). By choosing the difficult path of austerity, we paid a high price for the institutional incoherence of the euro zone, which was

exposed by the crisis. In the 2014 iAGS, we point out costs due to austerity that go beyond the loss of activity. On the one hand, inequality is increasing, and "anchored poverty", *i.e.* as measured from the median incomes of 2008, is increasing dramatically in most countries affected by the recession. The high level of unemployment is leading to wage deflation in some countries (Spain, Portugal and Greece). This wage deflation will result in gains in cost competitiveness but, in return, will lead the countries' partners to also take the path of wage deflation or fiscal devaluation. Ultimately, the adjustment of effective exchange rates either will not take place or will occur at such a slow pace that the effects of deflation will wind up dominant, especially as the appreciation of the euro will ruin the hopes of boosting competitiveness relative to the rest of the world. The main effect of wage deflation will be a greater real burden (*i.e.* relative to income) of private and public debt. This will mean a return to centre stage of massive public and private defaults, as well as the risk of the euro zone's collapse. It is possible nevertheless to escape the trap of deflation. Possible methods are explored and calculated in the 2014 iAGS. By reducing sovereign spreads, the countries in crisis can be given significant maneuvering room. The levers for this include the continuation of the ECB's efforts, but also a credible commitment by the Member states to stabilizing their public finances. Public investment has been cut by more than 2 points of potential GDP since 2007. Re-investing in the future is a necessity, especially as infrastructure that is not maintained and is allowed to collapse will be extremely expensive to rebuild. But it is also a way to stimulate activity without compromising fiscal discipline, since the latter must be assessed by trends not in the gross debt but in the net debt. Finally, the minimum wage should be used as an instrument of coordination. Our simulations show that there is a way to curb deflationary trends and reduce current account imbalances if surplus countries would increase their minimum wage faster in real terms than their productivity while

deficit countries would increase their minimum wage slower than their productivity. Such a rule, which would respect both national practices in wage bargaining as well as productivity levels and the specific features of labour markets, would lead to gradually reducing macroeconomic imbalances in the euro zone.

Why France is right to abandon the 3% public déficit target by 2013

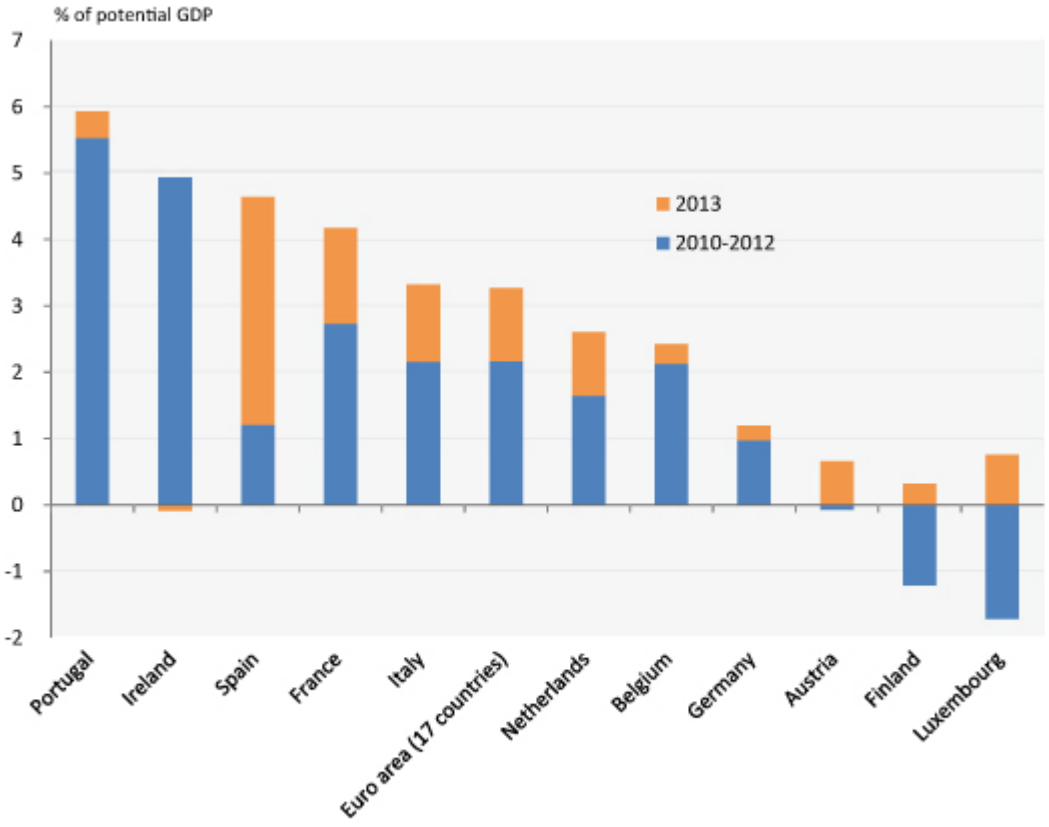
By Mathieu Plane

Given the statements by the Minister of Economy and Finance, the government seems to have reached a decision to abandon the goal of a deficit of 3% of GDP by 2013. In addition to the change of tack in the policy announced up to now, which was to bring the deficit down to 3% by 2013 "whatever the cost", we can legitimately conclude that France is right to abandon this goal, and we offer several arguments for this. While in this post we do not review the economic consequences of the fiscal policy being undertaken in France and the euro zone, which has been dictated by nominal targets for the deficit that do not take into account the way it breaks down structurally / cyclically and that have a dangerously pro-cyclical character, we nevertheless present several arguments that the European Commission may find of value:

1 – According to the latest figures from the European Commission on 22 February 2013[1], of the euro zone countries

making the greatest fiscal adjustment in 2013 from a structural viewpoint, France, with 1.4 GDP points, comes behind only Spain (3.4) and Greece (2.6). For the 2010-2013 period, the reduction in France's structural deficit represents 4.2 GDP points, which makes France the euro zone country which, alongside Spain (4.6 GDP points), has carried out the largest budget cutbacks of the major countries in the zone, ahead of Italy (3.3 GDP points), the Netherlands (2.6) and of course Germany (1.2) (Figure 1).

Figure 1. Change in the structural deficit of the euro zone countries*



* For reasons of scale, we have not put Greece in the figure. Over the 2010-2013 period, Greece's structural fiscal adjustment came to 16.9 GDP points, including 2.6 in 2013.

Sources: European Commission, OFCE calculations.

2 – In 2007, before the crisis, according to the European Commission France had a structural public deficit of -4.4 GDP points, compared with an average of -2.1 for the euro zone and -0.9 for Germany. In 2013, this came to -1.9 GDP points in France, -1.3 for the euro zone, and +0.4 for Germany, which represents an improvement of the structural deficit of 2.5 GDP

points for France since the start of the crisis, *i.e.* three times the average for the euro zone and twice that for Germany (Table 1). Leaving aside public investment, France's structural public deficit in 2013 was positive and higher than the euro zone average (1.2 GDP point in France, versus 0.8 for the euro zone average and 1.9 for Germany). Note that France is spending 3.1 GDP points on public investment in 2013 (0.2 GDP point less than in 2007), against a euro zone average of only 2 points (0.6 point less than in 2007) and 1.5 in Germany (equivalent to 2007). However, public investment, which has a positive impact on potential growth, and which also increases public assets, while not changing the public administration's financial situation, can reasonably be excluded from the calculation of the structural public deficit.

Table. Public deficit and structural deficit with and without public investment

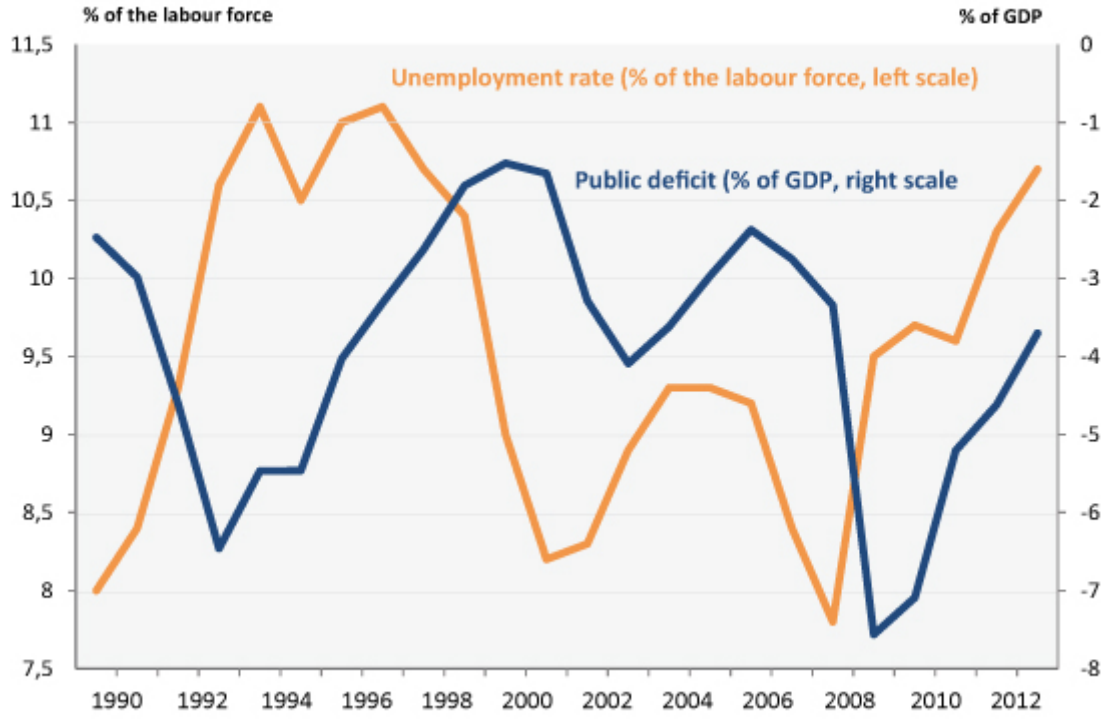
In GDP points	Public balance				Structural public balance				SPB w/o public investment			
	FRA	DEU	EZ	FRA-EZ diff.	FRA	DEU	ZE	FRA-EZ diff.	FRA	DEU	EZ	FRA-EZ diff.
2007	**-2.8**	**0.2**	**-0.7**	**-2.1**	**-4.4**	**-0.9**	**-2.1**	**-2.3**	**-1.1**	**0.6**	**0.5**	**-1.6**
2013	-3.7	-0.2	-2.8	-0.9	-1.9	0.4	-1.3	-0.6	1.2	1.9	0.8	0.4
Change 2007-2013	*-0.9*	*-0.4*	*-2.1*	*1.2*	*2.5*	*1.3*	*0.8*	*1.6*	*2.3*	*1.3*	*0.3*	*2.1*

Sources : European Commission, OFCE calculations.

3 – In 2013, the public deficit, even at 3.7% of GDP according to the European Commission, is once again at a level close to that of 2008, similar to that of 2005, and below that of 2004 and of the entire 1992-1996 period. The public deficit figure expected for 2013 corresponds to the average over the past thirty years, and thus no longer seems so exceptional, which is easing the pressure that France could experience on the financial markets. In contrast, according to the European Commission the unemployment rate in France in 2013 will reach 10.7% of the workforce, which is very close to its historic peak in 1997 (Figure 2). With an unemployment rate in 2013

that is 1.3 percentage points higher than the average over the last thirty years, an exceptional situation now characterizes the labour market more than it does the government deficit. While new austerity measures would help to reduce the deficit, however painfully, due to the high value of the fiscal multiplier in the short term they will lead on the other hand to going well beyond our historic unemployment peak. Indeed, as we showed in our latest forecast in October 2012, if France really tries to meet its budget commitment for 2013 "whatever the cost", this will require a new fiscal tightening of over 20 billion euros, in addition to the 36 billion euros already planned. This would lead to a recession, with GDP down -1.2% and 360,000 job losses (instead of expected growth of 0% and the loss of about 160,000 jobs), with the unemployment rate reaching 11.7% of the labour force by late 2013.

Figure 2. Public deficit and unemployment rate



Source: European Commission.

To restore its public accounts since 2010, France has

undertaken a historic fiscal effort, well beyond the average of its European partners, which has cost it in terms of growth and employment. Adding another layer of austerity in 2013 to the already historic build-up of austerity would lead us this year straight into a recession and an unprecedented worsening in the labour market. If there is a choice, are a few tenths of a point in the public deficit worth such a sacrifice? Nothing is less certain. It is thus essential to put off the goal of reducing the deficit to 3% of GDP to at least 2014.

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[1] We have a different evaluation of the level of the structural deficit. For example, for 2013 we evaluate the improvement in France's structural public deficit at 1.8 GDP points, but in order not to prejudice the analysis we are using the figures provided by the Commission.

Spain: a lose-lose strategy

by Danielle Schweisguth

At a time when the IMF has publicly recognized that it underestimated the negative impact of fiscal adjustment on Europe's economic growth, Spain is preparing to publish its public deficit figure for 2012. The initial estimate should be around 8% of GDP, but this could be revised upwards, as was the case in 2011 – while the target negotiated with the European Commission is 6.3%. With social distress at a peak,

only a sustainable return to growth would allow Spain to solve its budget problems through higher tax revenue. But the austerity being imposed by Europe is delaying the return of economic growth. And the level of Spain's fiscal multiplier, which by our estimates is between 1.3 and 1.8, is rendering the policy of fiscal restraint ineffective, since it is not significantly reducing the deficit and is keeping the country in recession.

At a time when the IMF has publicly recognized that it underestimated the negative impact of fiscal adjustment on Europe's economic growth – the famous fiscal multiplier – Spain is preparing to publish its public deficit for 2012. The initial estimate should be around 8% of GDP, but this could be revised upwards as was the case in 2011. If we exclude the financial support for the banking sector, which is not taken into account in the excessive deficit procedure, the deficit then falls to 7% of GDP. This figure is still higher than the official target of 6.3% that was the subject of bitter negotiations with the European Commission. Recall that until September 2011, the initial target deficit for 2012 was 4.4% of GDP. It was only after the unpleasant surprise of the publication of the 8.5% deficit for 2011 (which was later revised to 9.4%) – which was well above the official 2011 target of 6% of GDP – that the newly elected government of Mariano Rajoy asked the European Commission for an initial relaxation of conditions. The target deficit was then set by Brussels at 5.3% of GDP for 2012. In July 2012, pressure on Spain's sovereign rate – which approached 7% – then led the government to negotiate with the Commission to put off the 3% target to 2014 and to set a deficit target of 6.3% of GDP in 2012.

Tableau. Growth, fiscal impulse and the public deficit in Spain

	2007	2008	2009	2010	2011	2012
GDP growth (%)	3,5	0,9	-3,7	-0,3	0,4	-1,4
Fiscal impulse (% of GDP)	0,6	1,0	1,3	-2,2	-0,9	-3,3
Public deficit* (% of GDP)	1,9	-4,5	-11,2	-9,7	-9,4	-8,0

* The public deficit includes the financial support given to the banking sector.
Sources : Ministerio de Hacienda y Administraciones Publicas, OFCE forecast for 2012.

But the strategy of trying to reduce the deficit by 2.6 GDP points while in a cyclical downturn proved to be ineffective and even counter-productive. Furthermore, the result has not been worth the effort involved, even though the European authorities have praised it repeatedly. A succession of three consecutive years of austerity plans of historic proportions (2010, 2011 and 2012) has led to only a very small improvement in the budget balance (Table). The deficit was reduced by 3.2 percentage points in three years, while two years of crisis were enough to expand it by 13.3 points (from 2007 to 2009). The fiscal impulse was -2.2 percentage points of GDP in 2010, -0.9 point in 2011 and -3.3 points in 2012, or a total of 6.4 GDP points of fiscal effort (68 billion euros). Yet the crisis has precipitated the collapse of the real estate market and greatly weakened the banking system. Since then, the country has plunged into a deep recession: GDP has fallen by 5.7% since the first quarter of 2008, which puts it 12% below its potential level (assuming potential growth of 1.5% per year), with 26% of the workforce currently unemployed, in particular 56% of the young people.

The deterioration of Spain’s economic situation has hit tax revenue very hard. Between 2007 and 2011, the country’s tax revenues have fallen further than in any other country in the euro zone. Revenue declined from 38% of GDP in 2007 to 32.4% in 2011, despite a hike in VAT (2 points in 2010 and 3 points in 2012) and an increase in income tax rates and property taxes in 2011. The successive tax increases only slightly alleviated the depressive effect of the collapse of the tax

base. VAT revenues recorded a sharp drop of 41% in nominal terms between 2007 and 2012, as did the tax on income and wealth (45%). In comparison, the decrease in tax revenue in the euro zone was much more modest: from 41.2% of GDP in 2007 to 40.8% in 2011. Finally, rising unemployment has undermined the accounts of the social security system, which will experience a deficit of 1 percentage point of GDP in 2012 for the first time in its history.

To compensate for the fall in tax revenue, the Spanish government had to take drastic measures to restrict spending to try to meet its commitments, including a 5% reduction in the salaries of civil servants and the elimination of their Christmas bonus; a hiring freeze in the public sector and increasing the work week from 35 to 37.5 hours (without extra pay); raising the retirement age from 65 to 67, along with a pension freeze (2010); a reduction of unemployment benefits for those who are unemployed more than seven months; and lowering severance pay from 45 days per year worked to 33 days (20 if the company is in the red). Even though household income has stagnated or declined, Spanish families have experienced a significant increase in the cost of living: a 5-point increase in VAT, higher electricity rates (28% in two years), higher taxes on tobacco and lower reimbursement rates for medicines (retirees pay 10% of the price and the employed 40% to 60%, depending on their income).

The social situation in Spain is very worrying. Poverty has increased (from 23% of the population in 2007 to 27% in 2011, according to Eurostat); households failing to pay their bills are being evicted from their homes; long-term unemployment has exploded (9% of the labour force); unemployed youth are a lost generation, and the best educated are emigrating. The VAT increase in September has forced households to tighten their budgets: spending on food declined in September and October 2012, respectively, by 2.3% and 1.8% yoy. Moreover, the Spanish health system is suffering from budget cuts (10% in

2012), which led to the closure of night-time emergency services in dozens of municipalities and to longer waiting lists for surgery (from 50,000 people in 2009 to 80,000 in 2012), with an average waiting time of nearly five months.

Social distress is thus at a peak. The movement of the *indignados* led millions of Spaniards to take to the streets in 2012, in protests that were often violently suppressed by riot police. The region of Catalonia, the richest in Spain but also the most indebted, is threatening to secede, to the consternation of the Spanish government. On 24 January, the Catalan government passed a motion on the region's sovereignty, the first step in a process of self-determination that could lead to a referendum in 2014.

Only a lasting return to growth would enable Spain to solve its budget problems through higher tax revenue. But the tightening of financing conditions on Spain's sovereign debt since the summer of 2012 has forced the government to strengthen its austerity policy, which is delaying the return to economic growth. Furthermore, the European Commission has agreed to provide financial assistance to Spain only if it renounces its sovereignty in budget matters, at least partially, which the government of Mariano Rajoy is still reluctant to accept. The initiative of the European Commission on the exclusion of capital expenditures from calculations of the public deficit for countries close to a balanced budget, the details of which will be published in the spring, is a step in the right direction (El Pais). But this rule would apply only to the seven countries where the fiscal deficit is below 3% of GDP (Germany, Luxembourg, Sweden, Finland, Estonia, Bulgaria and Malta), which leaves out the countries facing the most difficult economic situations. Greater awareness of the social dramas that underlie these poor economic performances should lead to greater respect for the fundamental rights of Europe's citizens. Moreover, in the 2013 iAGS report the OFCE showed that a restrained austerity policy

(budget restrictions limited to 0.5 percent of GDP each year) is more effective from the viewpoint of both growth and deficit reduction in countries like Spain where the fiscal multipliers are very high (between 1.3 and 1.8, according to our estimates).

Repeat

By Jérôme Creel

In a beautiful book for children, every two pages Claude Ponti drew two chicks, one of which says to the other: "Pete and Repeat are in a boat. Pete falls overboard. Who is left?" Then the other chick says, "Repeat", and off we go again. At the end of the book, the second chick, its eyes bulging, screams: "Repeat!" And it never stops. It's a bit like these analyses of economic growth and fiscal contractions where almost every month it is rediscovered that the ongoing fiscal contractions are reducing economic growth or that underestimating the real impact of fiscal policy is leading to forecast errors.

Recently, and after having authored a box in the *2013 World Economic Outlook* in October 2012, Daniel Leigh and Olivier Blanchard of the IMF published a working document that confirms that the IMF's recent forecasting errors are due to erroneous assumptions about the multiplier effect. Because this effect was underestimated, especially at the bottom of the economic cycle, the IMF forecasters, though they are not alone (see in particular the note by Bruno Ducoudré), underestimated growth forecasts: they had not anticipated that what was required by the austerity measures and their implementation would have such a negative impact on consumer spending and business investment. The attempt to reduce state

debt was taking place during a period when households and businesses were also deleveraging, meaning that it would be difficult to avoid falling into the trap of recession.

Since it must be repeated, let's repeat! "Expansionary-fiscal-contractions and Repeat are in a boat. Expansionary-fiscal-contractions falls overboard. Who is left in the boat? Repeat!" In support of this short story, it is worth referring to a literature review conducted by Eric Heyer: he shows the extent of the consensus that actually exists on the value of the fiscal multipliers, a consensus that has emerged since 2009, *i.e.* in the midst of a recession and at the very time that recommendations for austerity measures began to emerge. A note by Xavier Timbeau shows that the analysis of current fiscal cutbacks supports an assessment that the value of the fiscal multiplier is much higher in a crisis than in normal times … What paradoxes!

What is to be done now? Repeat, yet again, that recession may not be inevitable: as Marion Cochard, Bruno Ducoudré and Danielle Schweisguth pointed out in a supplement to the 2013 iAGS report, it is urgent to temper existing fiscal austerity measures in the euro zone: European growth but also actual fiscal consolidation would improve at last.

Revising the multipliers and

revising the forecasts – From talk to action?

By Bruno Ducoudré

Following on the heels of the IMF and the European Commission (EC), the OECD has also recently made a downward revision in its forecast for GDP growth in the euro zone in 2012 (-0.4%, against -0.1% in April 2012) and in 2013 (0.1%, against 0.9% in April 2012). In its latest forecasting exercise, the OECD says it now shares with the other international institutions (the IMF [i] and EC [ii]) the idea that the multipliers are currently high in the euro zone [iii]: the simultaneous implementation of fiscal austerity throughout the euro zone while the economy is already in trouble, combined with a European Central Bank that has very little leeway to cut its key interest rate further, is increasing the impact of the ongoing fiscal consolidation on economic activity.

The revision of the positioning of the three institutions poses two questions:

- – What are the main factors leading to the revision of the growth forecasts? Given the scale of the austerity measures being enacted in the euro zone, we can expect that the revised forecast of the fiscal impulses is a major determinant of the revisions to the growth forecasts. These revisions are, for example, the main factor explaining the OFCE's revisions to its growth forecasts for France in 2012.
- – Is this change in discourse concretely reflected in an upward revision of the multipliers used in the forecasting exercises? These institutions do not generally specify the size of the multipliers used in their forecasting. An analysis of the revisions to the forecasts for the euro zone in 2012 and 2013 can,

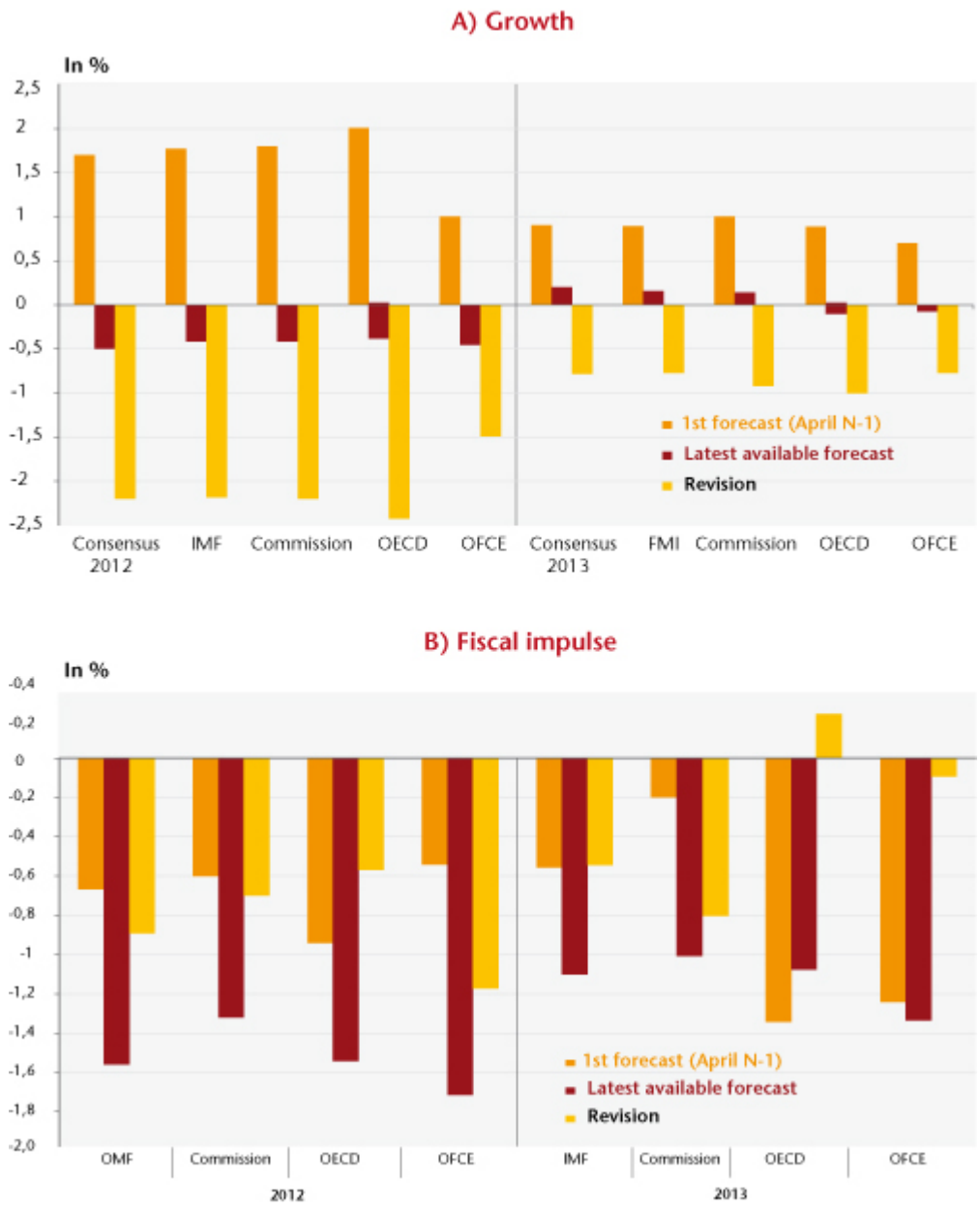
however, tell us the extent to which the multipliers have been revised upwards.

The following graph shows that between the forecast made in April of year N-1 for the euro zone and the latest available forecast for year N, the three institutions have revised their forecast sharply downward, by -2.3 points on average in 2012 and -0.9 point on average in 2013.

At the same time, the fiscal impulses have also been revised, from -0.6 GDP point for the OECD to -0.8 GDP point for the IMF for 2012, and by 0.8 point for the Commission to +0.2 point for the OECD in 2013, which explains some of the revisions in growth for these two years.

Comparatively speaking, for 2012 the OFCE is the institute that revised its growth forecast the least, but which changed its forecast for the fiscal impulse the most (-1.7 GDP points forecast in October 2012, against the forecast of -0.5 GDP point in April 2011, a revision of -1.2 points). In contrast, for 2013 the revision in the growth forecast is similar for all the institutions, but the revisions of the impulses are very different. These differences may thus arise in part from the revision of the multipliers.

Figure. Forecasts of growth and of the fiscal impulse for the euro zone*



* For each of the two years, the first forecast is for April N-1. The latest forecast is the one for October / November 2012 (IMF, OFCE, OECD, European Commission) or September 2012 (Consensus Forecast).
The fiscal impulse is defined as the opposite of the change in the primary balance corrected for any cyclical variation.
Sources: Consensus Forecast, IMF, European Commission, OECD, OFCE calculations and forecast October 2012.

The revisions of the growth forecasts $\check{g}$ can be broken down into several terms:

- – A revision in the fiscal impulse IB, denoted ΔIB;
- – A revision in the multiplier k, denoted Δk, k_0 being the initial multiplier and k_1 the revised multiplier;
- – A revision of the spontaneous growth in the euro zone

(excluding the impact of fiscal policy), of fiscal impulses outside the euro zone, etc.: *Δe*

$$\Delta\tilde{g} = \Delta\tilde{\varepsilon} + \Delta(\mathrm{k}.IB) = \Delta\tilde{\varepsilon} + \Delta\mathrm{k}.IB + \mathrm{k}.\Delta IB$$

The revision of the OFCE forecast by -1.5 points for 2012 that took place between April 2011 and October 2012 breaks down as follows: -1.3 points from the revision of the fiscal impulses, and -0.3 point from the upward revision of the multiplier (table). The sum of the effects of the other sources of revision adds 0.1 percentage point growth in 2012 compared with the forecast made in April 2011. In contrast, the revision for 2013 is due mainly to the increase in the size of the multiplier.

As for the international institutions, these elements (size of the multiplier, spontaneous growth, etc.) are not all known to us, except for the fiscal impulses. There are a number of polar cases that can be used to infer an interval for the multipliers used in the forecasting. In addition, if it is mainly revisions of the fiscal impulse and revisions of the size of the multiplier that are the source of the revision of the growth forecasts, as a first approximation it can be assumed that Δe = 0. We can then calculate the implied multiplier for the case that the entirety of the revision is attributed to the revision of the fiscal impulses, and for the case that the revision is divided between the revision of the multiplier and the revision of the impulse.

Attributing the entirety of the revisions of the forecasts for 2012 to the revision of the impulses would imply very high initial multipliers, on the order of 2.5 for the IMF to 4.3 for the OECD (Table), which is not consistent with the IMF analysis (which evaluates the current multiplier at between 0.9 and 1.7). On the other hand, the order of magnitude of the inferred multipliers for the IMF (1.4) and the Commission (1.1) for the year 2013 seems closer to the current consensus, if we look at the current literature on the size of the

multipliers.

The hypothesis could also be made that in the recent past the Commission, the OECD and the IMF based themselves on multipliers derived from DSGE models, which are generally low, on the order of 0.5 [1]. Adopting this value for the first forecasting exercise (April 2011 for the year 2012 and April 2012 for 2013), we can calculate an implicit multiplier such that the entirety of the revisions breaks down between the revision of the impulse and the revision of the multiplier. This multiplier would then be between 2.8 (OECD) and 3.6 (EC) for the year 2012, and between 1.3 (OECD and IMF) and 2.8 (EC) for 2013.

Table. Breakdown of the revisions in the growth forecasts for the euro zone

Revision of the OFCE forecasts							
		$\Delta\tilde{g}$	$\Delta k.IB$	$k.\Delta IB$	$\Delta\tilde{\varepsilon}$	k_0	k_1
2012		-1.5	-0.3	-1.3	0.1	1.1	1.6
2013		-0.8	-0.7	-0.1	0.0	1.1	1.6
The entire revision is attributed to the revision of the impulse							
		$\Delta\tilde{g}$	$\Delta k.IB$	$k.\Delta IB$	$\Delta\tilde{\varepsilon}$	k_0	k_1
IMF	2012	-2.2	0.0	-2.2	0.0	2.5	2.5
	2013	-0.7	0.0	-0.8	0.0	1.4	1.4
Commission	2012	-2.2	0.0	-2.2	0.0	3.1	3.1
	2013	-0.9	0.0	-0.9	0.0	1.1	1.1
OECD	2012	-2.4	0.0	-2.4	0.0	4.3	4.3
	2013	-1.0	0.0	-1.0	0.0	-4	-4
The entire revision is attributed to the revision of the multiplier							
		$\Delta\tilde{g}$	$\Delta k.IB$	$k.\Delta IB$	$\Delta\tilde{\varepsilon}$	k_0	k_1
IMF	2012	-2.2	-1.7	-0.4	0.0	0.5	3.1
	2013	-0.7	-0.4	-0.3	0.0	0.5	1.3
Commission	2012	-2.2	-1.9	-0.4	0.0	0.5	3.6
	2013	-0.9	-0.5	-0.4	0.0	0.5	2.8
OECD	2012	-2.4	-2.2	-0.3	0.0	0.5	2.8
	2013	-1.0	-1.1	0.1	0.0	0.5	1.3
The final multiplier is valued at 1.3							
		$\Delta\tilde{g}$	$\Delta k.IB$	$k.\Delta IB$	$\Delta\tilde{\varepsilon}$	k_0	k_1
IMF	2012	-2.2	-0.5	-0.4	-1.2	0.5	1.3
	2013	-0.7	-0.4	-0.3	0.0	0.5	1.3
Commission	2012	-2.2	-0.5	-0.4	-1.4	0.5	1.3
	2013	-0.9	-0.2	-0.4	-0.3	0.5	1.3
OECD	2012	-2.4	-0.8	-0.3	-1.4	0.5	1.3
	2013	-1.0	-1.1	0.1	0.0	0.5	1.3

Sources : IMF, European Commission, OECD, OFCE 2012 calculations and forecasts.

The revisions of the forecast for 2012 are not primarily drawn from a joint revision of the fiscal impulses and the size of the multipliers. A significant proportion of the revisions for

growth also comes from a downward revision for spontaneous growth. Suppose now that the final multiplier is worth 1.3 (the average across the range estimated by the IMF); the revision of the spontaneous growth in the euro zone then accounts for more than 50% of the revision in the forecast for the euro zone in 2012, which reflects the optimistic bias common to the Commission, the OECD and the IMF. In comparison, the revision of spontaneous growth accounts for less than 10% of the revision in the OFCE forecast for 2012.

On the other hand, the size of the multipliers inferred from the revisions of the forecasts for 2013 appears to accord with the range calculated by the IMF – on the order of 1.1 for the Commission, 1.3 for the OECD and 1.3 to 1.4 for the IMF. The revisions of the growth forecasts for 2013 can therefore be explained mainly by the revision of the fiscal impulses planned and the increase in the multipliers used. In this sense, the controversy over the size of the multipliers is indeed reflected in an increase in the size of the multipliers used in the forecasting of the major international institutions.

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[1] See, for example, European Commission (2012): "Report on public finances in EMU", *European Economy* no. 2012/4. More precisely, the multiplier from the QUEST model of the European Commission is equivalent to 1 the first year for a permanent shock to public investment or civil servant pay, 0.5 for other public expenditure, and less than 0.4 for taxes and transfers.

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[i] See, for example, page 41 of the World Economic Outlook of the IMF from October 2012: "The main finding … is that the multipliers used in generating growth forecasts have been systematically too low since the start of the Great Recession, by 0.4 to 1.2, depending on the forecast source and the

specifics of the estimation approach. Informal evidence suggests that the multipliers implicitly used to generate these forecasts are about 0.5. So actual multipliers may be higher, in the range of 0.9 to 1.7."

[ii] See, for example, page 115 of the European Commission's Report on Public finances in EMU: "In addition, there is a growing understanding that fiscal multipliers are non-linear and become larger in crisis periods because of the increase in aggregate uncertainty about aggregate demand and credit conditions, which therefore cannot be insured by any economic agent, of the presence of slack in the economy, of the larger share of consumers that are liquidity constrained, and of the more accommodative stance of monetary policy. Recent empirical works on US, Italy, Germany and France confirm this finding. It is thus reasonable to assume that in the present juncture, with most of the developed economies undergoing consolidations, and in the presence of tensions in the financial markets and high uncertainty, the multipliers for composition-balanced permanent consolidations are higher than normal."

[iii] See, for example, page 20 of the OECD Economic Outlook from November 2012: "The size of the drag reflects the spillovers that arise from simultaneous consolidation in many countries, especially in the euro area, increasing standard fiscal multipliers by around a third according to model simulations, and the limited scope for monetary policy to react, possibly increasing the multipliers by an additional one-third."