The 35 billion euro man

By Henri Sterdyniak

Sarkozy has cost France 500 billion. This is the central point of the book *Un quinquennat de 500 milliards d'euros* [*A 500 billion euro five-year term*] by Melanie Delattre and Emmanuel Levy. According to the authors, out of the 632 billion euro rise in France's debt between late 2006 and late 2011, only 109 billion can be attributed to the crisis, while the remaining 523 billion are the price of the five-year reign of Nicolas Sarkozy. Of this total, 370 billion is said to be due to a failure to correct past mismanagement and 153 billion to wasteful decisions taken during his 5-year term in office. Should we take these figures seriously?

Let's start with an international comparison. From late 2006 to late 2011, the debt of France increased by 21.4 percentage points of GDP, that of the euro zone by 21.5 points, that of the United Kingdom by 40.6 points, and that of the United States by 29.2 points. There is no French specificity, no "Sarkozy effect". France's debt has increased in line with the average for the euro zone, that is to say, by 500 billion euros, representing 20 percent of GDP. Can it be argued that without Sarkozy the country's debt would have been stable as a percentage of GDP, even though it was increasing without him everywhere else?

In fact, according to the government's latest economic report, from late 2006 to late 2012 French public debt will have increased by 620 billion euros. This increase can be broken down as follows: 275 billion from interest payments, 310 billion due to the economic crisis, 30 billion from the stimulus policies implemented in 2009-2010, and 60 billion in tax reduction policies; but on the other hand, policies restricting public spending (fewer officials, no automatic increase in their wages, rigorous management of social benefits, etc.) has saved 55 billion euros. Sarkozy's responsibility is thus sharply reduced, to at most 35 billion.

The tricky part is measuring the impact of the crisis. To do this, we need to measure the gap between GDP as it has actually evolved and GDP as it would have evolved without the crisis. In our opinion, in the absence of the crisis, GDP would have continued to grow at an annual rate of about 2%. Using this estimate, the loss in output due to the crisis was 6.8% in 2009, which would have caused a tax loss of 4.4% of GDP. The authors use an estimate by the Cour des comptes, which in turn comes from an assessment by the European Commission: the loss of output due to the crisis in 2009 was only 2.8% and the loss of tax revenues was only 1.4%. According to this calculation, the share of the deficit caused by the crisis is relatively low. But this assumes that in 2007-2009 structural GDP declined by 4% from its trend growth. Why? Is this really not linked to the crisis? According to the calculation by the Cour des comptes, the structural decline in GDP caused a significant increase in our structural deficit, which the authors blame on Nicolas Sarkozy. Is this legitimate? Following the Commission's logic, this 4% is lost forever; we must accept this and adjust by reducing the deficit. In our opinion, it would be better to recover this loss through the use of expansionary policies.

In 2006, the year before Nicolas Sarkozy came to power, the public deficit was 2.3%, which was entirely structural. This deficit was "normal" since it ensured debt was stable at 60% of GDP and it corresponded to the volume of public investment. In 2012, with a deficit of 4.5% of GDP, the cyclical deficit is 4.3% of GDP while the structural deficit is only 0.2% of GDP. Overall, from 2006 to 2012 Nicolas Sarkozy will have increased the level of compulsory taxation by 0.7 point (as the large increases in 2011-12 more than offset the declines in the earlier period) and decreased the share of public expenditure in potential GDP by 1.2 point.

Above all, throughout this entire period, France was in crisis, with a shortfall in demand. An expansionary fiscal policy was necessary to avoid economic collapse. Can we blame Nicolas Sarkozy for the 30 billion euro cost of the stimulus plan? Can we blame him for not having adopted a restrictive fiscal policy to "correct past mismanagement"? No, but what we can call into question are the tax cuts that do little for growth (inheritance tax, the *bouclier fiscal* tax cap, overtime) and the cuts in certain vitally needed public expenditures (downsizing staff levels in schools and hospitals, for example).

The irresistible attraction to recession

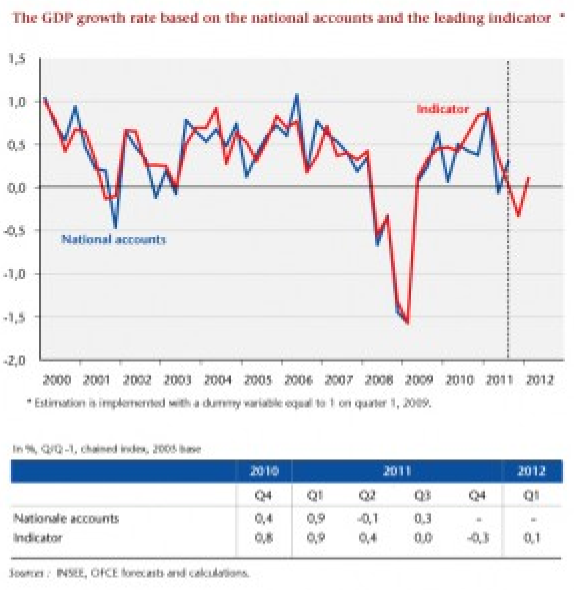
By Hervé Péléraux

Here is the leading indicator for the French economy, updated to 30 January 2011.

The February forecasts of the leading indicator significantly worsened the outlook for the French economy at the turn of 2011 and 2012.

On the one hand, GDP is expected to have fallen more than expected in the fourth quarter of 2011, by -0.3% instead of the -0.2% estimated last month. On the other hand, the pick-up in growth in the first quarter of 2012 observed in January is fast disappearing, with GDP rising by 0.1% and not 0.3% as in the previous estimates. In total, GDP will contract by 0.2% over the two quarters. The uncertainty hanging over a forecast of GDP over two quarters, which we have pointed out earlier, is gradually being lifted in an unfavourable sense as the negative information builds up. In particular, the climate in industry continued to worsen in January at a higher rate than expected last month.

The deteriorating business environment is taking precedence over the more positive elements that up to now blunted the impact of the sovereign debt crisis on growth, namely, the decline in the euro against the dollar in the third quarter of 2011 and the interruption of the dive by the CAC40 stock market index in the fourth quarter. If this same dynamic repeats in February and March, France would be unlikely to escape a recession in the usually accepted meaning of the term, *i.e.* the occurrence of two consecutive quarters of falling GDP.



In %, Q/Q -1, chained index, 2005 base

	2010	2011				2012
	Q4	Q1	Q2	Q3	Q4	Q1
Nationale accounts	0,4	0,9	-0,1	0,3	-	-
Indicator	0,8	0,9	0,4	0,0	-0,3	0,1

Sources : INSEE, OFCE forecasts and calculations.

Next update on 29 February 2012

Austerity is not enough

By André Grjebine and Francesco Saraceno

It is certainly possible to question whether the role acquired by the rating agencies in the international economy is legitimate. But if in the end their message must be taken into account, then this should be done based on what they are really saying and not on the economic orthodoxy attributed to them, sometimes wrongly. This orthodoxy is so prevalent that many commentators are continuing to talk about the decision by Standard & Poor’s (S&P) to downgrade the rating of France and other European countries as if this could be attributed to an insufficiently strong austerity policy.

In reality, the rating agency justifies the downgrade that it has decided with arguments opposed to this orthodoxy. For instance, the agency criticises the agreement between European leaders that emerged from the EU summit on 9 December 2011 and the statements that followed it, making the reproach that the agreement takes into account only one aspect of the crisis, as if it “… stems primarily from fiscal profligacy at the periphery of the euro zone. In our view, however, the financial problems facing the euro zone are as much a consequence of rising external imbalances and divergences in competitiveness between the EMU’s core and the so-called ‘periphery’. As such, we believe that a reform process based on a pillar of fiscal austerity alone risks becoming self-defeating, as domestic demand falls in line with consumers’ rising concerns about job security and disposable incomes, eroding national tax revenues.”

Based on this, S&P believes that the main risk facing the European states could come from a deterioration in the fiscal positions of certain among them “in the wake of a more recessionary macroeconomic environment.” As a result, S&P does not exclude a further deterioration in the coming year of the rating of euro zone countries.

So if the European countries do indeed take into account the explanations of the rating agency, they should implement economic policies that are capable of both supporting growth and thereby facilitating the repayment of public debts while at the same time rebalancing the current account balances between the euro zone countries. This dual objective could be achieved only by a stimulus in the countries running a surplus, primarily Germany.

Unsustainable debt

The budget adjustments being imposed on the countries of the periphery should also be spread over a period that is long enough for its recessionary effects to be minimised. Such a strategy would accord with the principle that in a group as heterogeneous as the euro zone, the national policies of member countries must be synchronised but certainly not convergent, as is being proposed in some quarters. Such a policy would boost the growth of the zone as a whole, it would make debt sustainable and it would reduce the current account surpluses of some countries and the deficits of others. The least we can say is that the German government is far from this approach.

Didn’t Angela Merkel respond to the S&P statement by calling once again for strengthening fiscal discipline in the countries that were downgraded, that is to say, adopting an analysis opposed to that of the rating agency? Given its argumentation, one begins to wonder whether the agency wouldn’t have been better advised to downgrade the country that wants to impose austerity throughout the euro zone rather than wrongly to give it a feeling of being a paragon of virtue by making it one of the few to retain its AAA rating.

The economic crisis is a crisis of economic policy

By Jean-Luc Gaffard

The simultaneous increase of inflation and unemployment in the 1970s indicated that Keynesian theory and policy had run into a wall. No longer was it simply possible to arbitrate between the two evils and fine-tune economic activity by acting solely on aggregate demand through the budget channel. This failure together with the persistence of high inflation eventually convinced policymakers of the need and urgency of prioritising the fight against inflation.

The economic theory devised by the new classical school came in support of this policy decision with the claim that inflation and unemployment were distinct phenomena that should be handled with distinct methods. If inflation takes off, it is because of a lack of monetary discipline. If unemployment rises, it is due to increased rigidities in the functioning of the markets. The famous Phillips curve, the basis for arbitrating between the two, theoretically becomes vertical, at least in the long run. Macroeconomic policies thus become dissociated from structural policies: the first are intended to stem inflation, the second to curb unemployment. The only relationship that they have with each other is that cyclical policy does not allow the economy to escape for long from the position determined by structural policy, a position that reflects the so-called natural unemployment rate. One attraction of this theory is the simplicity of its recommendations to government. Policymakers can (and should) meet a single target, inflation, by using a single instrument wielded by a central bank that is now independent, especially as hitting this target also ensures that the natural employment level will be achieved at the lowest cost in terms of inflation. If by chance the unemployment rate is considered too high, policymakers should take the view that this reflects dysfunctions in the markets for goods and labour, and they can then decide to introduce a well-organised set of structural reforms designed for market liberalisation. In this wonderful world, reducing the budget deficit is always profitable. The basic model teaches that, after such a reduction, income and employment decrease initially, but then, thanks to a reduction in interest rates, private investment quickly increases and with it income and employment. The new medium-term equilibrium may even correspond to a higher level of income and employment, as private investment expenditure is considered to be more efficient than government expenditure. An independent central bank and financial markets that are deemed efficient play the role of disciplining the government by punishing any inappropriate budget deficits.

Europe has been a prime testing ground for this theory. Monetary policy is in the hands of a central bank, and its governing treaties ensure that it is independent and that its sole objective is price stability. Structural policies and reforms are a matter for the states, which are responsible for choosing the natural unemployment rate that they consider acceptable or, if they consider unemployment to be too high, they can impose reforms. If unemployment is higher in one country than in another, in the medium term, this can only be due to structural differences, in other words, to the existence of greater rigidities in the way the markets in this country operate. Once the recommended reforms are implemented, things will get back to normal. The theory thus formulated is expected to survive the crisis: for Europe to regain its lost coherence is a simple matter of policy choices. Excessively indebted countries need to reduce their budget deficits and make the structural reforms that they have put off for too long in order to restore growth, full employment and price stability. At most, some are proposing that debts be pooled in return for a commitment to implement structural reform. Germany, which has preceded the others down this particular path to virtue, has nothing to fear from this scenario, since the renewed growth of its partners will ensure the long-term viability of its commercial outlets. Furthermore, the European Central Bank does not need to concern itself with financial stability, as markets punish impecunious States and force them into fiscal austerity by driving up the interest rates paid on their borrowings.

This entire beautiful structure rests on assumptions that are not very robust, in particular that any increase in market rigidities, particularly on the labour market, *e.g.* due to an increase in unemployment benefits, redundancy costs or employee bargaining power, shifts the long-term equilibrium position of the economy and inevitably produces an increase in the “natural” unemployment rate. It is, of course, always possible to compare long-run equilibria that are distinguished only by the value of certain structural data. It is riskier to deduce the path that leads from one to another. We should have learned from the experience of the 1930s that rigidities in prices and wages are a way to stem rising unemployment in a depressed economy, that is to say, when it becomes important to block reductions in prices and wages that are increasing the burden of private debt and putting downward pressure on aggregate demand. It should also be clear that structural reforms intended to reduce the natural rate of unemployment often lead immediately to a redistribution and reduction in income, which leads in turn to higher unemployment. But nothing says that this increase will only be temporary and will not trigger a chain reaction through the channel of aggregate demand. Rigidities remain a factor in reducing the risk of instability inherent in any structural change, whether this involves reforms in market organisation, the emergence of new competitors on the market or technological breakthroughs. A better allocation of resources may justify calling these rigidities into question, but care must be taken to avoid the inherent risk of instability. Certainly, when structural reforms aimed at introducing more flexibility undermine domestic demand, the latter can then be boosted by stimulating external demand with lower prices. The unemployment rate may then fall. But it is actually exported to countries that might well not yet have undertaken such reforms, where unemployment thus inevitably exceeds the level deemed natural. “Every man for himself” begins to prevail over solidarity.

Europe is currently going through this scenario. Germany, in particular, carried out the structural reforms required by the prevailing theory, but at the cost of the segmentation of its labour market and the growth of low-paid insecure jobs, which resulted in turn in a slowdown in domestic demand. The improvement in Germany’s export performance, based on the quality of its goods as well as on the international fragmentation of the production process, has been offsetting the slowdown and helping to contain or even reduce the budget deficit. The unemployment rate has been rising in many other European countries in parallel to their budget deficits. The correction required by the experts (and in fact imposed by the financial markets), which involves simultaneously reducing public spending, raising taxes and making structural reforms, will very likely further reduce domestic demand in these countries, increase their budget deficits and ultimately hit German exports. Recession, if not a general depression, lies at the end of this path. The cause is a series of internal and external imbalances. And things could get even more complicated if performance gaps in the countries concerned widen even further and lead to divergences in their goals and interests.

Economic policy is unfortunately more complex than modern macroeconomics would have it. The long term is not independent of the short term; and the goals pursued are not independent of each other, and not always inter-compatible. Policies that are categorised as cyclical and structural are not really independent of each other, nor can they be targeted exclusively at a single goal. If there must be structural reforms, they need to be accompanied by expansionary cyclical policies to counteract the immediate recessionary effects that they may amplify. Even so, cyclical policies are not sufficient in themselves to ensure strong, steady growth.

It is unrealistic and dangerous to expect to break free of the current impasse through generalised fiscal austerity in Europe. Compromises are needed that involve the acceptance of some disequilibria in order to alleviate others. The only way out is to accept budget deficits for a while longer. Without a recovery in the balance sheets of both firms and households, there will be no positive outcome from the rebalancing of public accounts, if indeed that even occurs.

There is of course no doubt that we must achieve greater harmony in the fiscal positions of countries belonging to the same monetary zone. Fiscal federalism is necessary to deal with monetary federalism. But federalism does not stop with the actions of a central bank that has been stripped of its basic functions and is unable to carry out common national fiscal contractions. It demands genuine budget solidarity, including to intervene to prevent the insolvency of States that are facing exorbitant interest rates. It also involves structural policies that not only refrain from reforms that could exacerbate fiscal and social competition, but also promote industrial and technological projects funded by a common European budget that has been strengthened through the establishment of a federal tax. State budget deficits will not be contained and the objectives and interests of states will not converge without the implementation of the cyclical and structural policies needed for a general recovery of growth.