Austerity in Europe: a change of course?

By Marion Cochard and Danielle Schweisguth

On 29 May, the European Commission sent the members of the European Union its new economic policy recommendations. In these recommendations, the Commission calls for postponing the date for achieving the public deficit goals of four euro zone countries (Spain, France, Netherlands and Portugal), leaving them more time to hit the 3% target. Italy is no longer in the excessive deficit procedure. Only Belgium is called on to intensify its efforts. Should this new roadmap be interpreted as a shift towards an easing of austerity policy in Europe? Can we expect a return to growth in the Old Continent?

These are not trivial matters. An OFCE Note (no. 29, 18 July 2013) attempts to answer this by simulating three scenarios for fiscal policy using the iAGS model. It appears from this study that postponing the public deficit targets in the four euro zone countries does not reflect a real change of course for Europe's fiscal policy. The worst-case scenario, in which Spain and Portugal would have been subject to the same recipes as Greece, was, it is true, avoided. The Commission is implicitly agreeing to allow the automatic stabilizers to work when conditions deteriorate. However, for many countries, the recommendations with respect to budgetary efforts still go beyond what is required by the Treaties (an annual reduction in the structural deficit of 0.5 percent of GDP), with as a consequence an increase of 0.3 point in the unemployment rate in the euro zone between 2012 and 2017.

We believe, however, that a third way is possible. This would involve adopting a "fiscally serious" position in 2014 that does not call into question the sustainability of the public debt. The strategy would be to maintain a constant tax burden

and to allow public spending to keep pace with potential growth. This amounts to maintaining a neutral fiscal stimulus between 2014 and 2017. In this scenario, the public deficit of the euro zone would improve by 2.4 GDP points between 2012 and 2017 and the trajectory in the public debt would be reversed starting in 2014. By 2030, the public deficit would be in surplus (0.7%) and debt would be close to 60% of GDP. Above all, this scenario would lower the unemployment rate significantly by 2017. The European countries could perhaps learn from the wisdom of Jean de La Fontaine's fable of the tortoise and the hare: "Rien ne sert de courir, il faut partir à point", i.e. Slow and steady wins the race.

The euro zone in crisis: challenges for monetary and fiscal policies

By <u>Catherine Mathieu</u> and <u>Henri Sterdyniak</u>

The 9th EUROFRAME conference [1] was held on 8 June 2012 in Kiel on issues concerning the economic policy of the European Union. The topic was: "The euro zone in crisis: challenges for monetary and fiscal policies". The conference was, of course, dominated by the issue of the sovereign debt crisis in the euro zone. How did it come to this? Should the blame be put on mistakes in national economic policies? Must the way the euro zone is organized be changed?

A number of fault lines appeared (cf. also the related <u>Note</u> in French):

Some believe that it is irresponsible domestic policies

that are the cause of the imbalances: the southern countries were allowed to develop real estate and wage bubbles, while the northern countries carried out virtuous policies of wage moderation and structural reform. The southern countries must adopt the strategy of the northern countries and accept a prolonged dose of austerity. For others, the single currency has allowed the development of mirror opposite imbalances: too much austerity in the North, and too many wage increases in the South; what is needed is a convergence where stimulus in the North facilitates the absorption of the external imbalances in the South.

- For some, every country must implement policies that combine fiscal consolidation and structural reform. For others, what is needed is an EU-wide growth strategy (in particular by financing an ecological transition) and a guarantee of public debt so as to promote a convergence of national interest rates at lower levels.
- Some believe that any new solidarity measures involve developing a Union budget, which means the inclusion of binding rules in the Fiscal Compact; for others, what is needed is the open coordination of economic policies, without pre-established standards.

We provide a report that includes brief comments [2] in a lengthy Note.

[1] <u>EUROFRAME</u> is a network of European economic institutes that includes: DIW and IFW (Germany), WIFO (Austria), ETLA (Finland), OFCE (France), ESRI (Ireland), PROMETEIA (Italy), CPB (Netherlands), CASE (Poland), NIESR (United Kingdom).

[2] Most of the articles are available at: http://www.euroframe.org/index.php?id=7. Selected articles will be published in an issue of the *Revue de l'OFCE*, in the "Débats et Politiques" collection, at the end of 2012. The

report reflects the views of the authors alone.

AAA, AA+: much Ado About no+hing?

by <u>Jérôme Creel</u>

The loss of France's AAA rating on Friday the 13th of January 2012 was a historic event. It poses three questions: should the austerity measures announced in autumn 2011 be strengthened? Why has Germany been singled out? And what is to be done now?

The loss of the AAA rating on French government bonds is not surprising — far from it. The sovereign debt crisis that has shaken the euro zone for over two years, starting in the autumn of 2009, was not managed properly because it occurred during a recession, at a time when all the EU Member States had their eyes glued to their own economic difficulties. In the absence of a concerted response that included immediate solidarity and mutual guarantees by the euro zone Member States of the zone's entire public debt, with the support of the European Central Bank (cf. Catherine Mathieu and Henri Sterdyniak, here), the foreseeable contagion occurred. The objective public finance mistakes committed by successive Greek governments followed by the vagaries of the Irish banks have now led to a systemic crisis in Europe.

By implementing austerity measures simultaneously, Europe's governments have magnified the economic difficulties: economic stagnation and even recession are now on the agenda for the

euro zone (cf. Xavier Timbeau *et al.*, <u>here</u>). A downgrade of debt ratings in the euro zone was thus to be expected. It does, however, raise three questions.

- 1. Should the austerity measures be strengthened? In a commentary on the supplementary 7 billion euro French austerity plan announced in November 2011, Mathieu Plane (see in French here) pointed out that the race for the AAA rating had already been lost. The impact of this austerity plan on economic growth was objectively inconsistent with the fiscal consolidation target and Standard & Poor's was surely not unaware of this argument.
- 2. Why did S&P single out Germany and Slovakia, the only economies in the euro zone not downgraded on Friday 13 January? While their commercial links are undeniable (cf. Sandrine Levasseur, 2010, here), which could justify their comparable treatment, the main markets for both of these economies, and particularly Germany, lie in the euro zone. Slowing growth in the euro zone outside Germany will not leave the other side of the Rhine unaffected (cf. Sabine Le Bayon, in French here). It is difficult to see how the contagion of the crisis could stop at the borders of Germany and Slovakia. The recent take-up of German government 6-month bonds at a negative interest rate could even be interpreted to reflect extreme distrust of Germany's commercial banks. In any case, its economy, situated in the euro zone, is no less fragile than that of France.
- 3. What should be done now in France? The loss of the AAA rating reflects a negative outlook both for the state of public finances and for economic growth. While Germany has not been downgraded, it is possible that this is because S&P takes a positive view of its non-cooperative strategy in the past. From this perspective, the principle of a social VAT measure can be considered a way to help France catch up with Germany in terms of

competitiveness, as Jacques Le Cacheux points out (here): if the Germans did it, why can't we? This would help boost tax revenue by increasing the competitive advantage of businesses established in France. If such a measure were to be adopted, Germany and France would be on equal footing. The two countries could then sensibly consider a cooperative policy for a recovery in Europe. Some possible focuses include: industrial policy (cf. Sarah Guillou and Lionel Nesta, in French here); social policy; an ambitious climate and energy policy (cf. Eloi Laurent, here); and a financial policy that includes a common tax on financial transactions, with the revenue raised being used to ensure that the taxpayer would never again need to bail out the private banks, which would free up additional maneuvering room for the first three policies. The policy outlines would of course need to be defined, but it is crucial to recognize that policy action is urgently needed.

What new European austerity plans await us in 2012?

By <u>Eric Heyer</u>

To meet French commitments vis-à-vis Brussels to a general government deficit in 2012 of 4.5% of GDP, the French Prime Minister Francois Fillon announced a new plan to cut the budget by 7 billion euros. Will the plan, announced 7 November, be sufficient? Certainly not! So what new austerity plans should we expect in the coming months, and what impact will they have on growth in 2012?

In early October 2011, among the points we indicated in our

<u>forecast dossier</u> was that, of all the finance bills approved in Europe, no major country has met its commitment to reduce the deficit.

This will be the case in particular of Italy and the UK, which could face a gap of between 1.5 and 2 percentage points between the final public deficit and their commitment. In the case of France and Spain, the gap will probably be 0.6 and 0.7 point, respectively. Only Germany will come very close to its commitments (Table 2).

Unlike in previous years, the implementation of these commitments would seem probable: in an uncertain financial context, being the only State not to comply with its promise of fiscal consolidation would be punished immediately by more expensive financial terms on the repayment of its debt.

This will therefore require the adoption of new austerity plans in the coming months. But by attempting to reduce their deficits too early, too quickly and in a synchronized fashion, the governments of the European countries are running the risk of a new downturn. Indeed, as we noted in a recent study, tightening budget policy during a cyclical downturn in all the European countries and doing so in a situation of a persistent "liquidity trap" is contributing to the formation of a strong multiplier, close to unity.

How many billion euros will be targeted by the next fiscal savings plans? What impact will they have on economic growth? Several possible cases were considered.

Case 1: Each country respects its commitment alone

In order to isolate the impact on growth of the national savings plan and those of the partners, we have assumed that each country meets its commitment alone. Under this assumption, the effort would be significant in Italy and the UK, which would present new austerity plans for, respectively, 3.5 and 2.8 points of their GDP (56 and 48.7 billion euros).

France and Spain would implement an austerity plan two to three times smaller, about 1.2 points of GDP, representing 27 and 12.1 billion euros, respectively. Finally, the German savings plan would be the weakest, with 0.3 point of GDP (7 billion euros) (Table 1).

Table 1. Amount needed to meet the public deficit commitments in 2012

	Germany	France	Italy	Spain	United Kingdom
If each country meets its cor	nmitment alone				
in billions of euros	7.0	27.0	56.0	12.1	48.7
In GPD points	0.3	1.3	3.5	1.1	2.8
If the EU countries respect to	heir commitments	rii.			
in billions of euros	22.3	39.8	63.9	19.6	55-2
In GDP points	0.9	2.0	4.0	1.8	3.2
If the euro zone countries m	eet their commits	ments			
in billions of euros	16.6	36.1	61.7	17.9	
In GDF points	0.6	1.8	3.9	1.7	

These different national austerity plans, taken in isolation, would have a non-negligible impact on the growth of the countries studied. With the exception of Germany, which would continue to have positive growth in 2012 (0.9%), this kind of strategy would plunge the other economies into a new recession in 2012, with a decline in their GDP ranging from -0.1% for Spain to -2.9% for Italy. France would experience a decline in activity of -0.5% and the British economy of -1.9% (Table 2).

Table 2. Impact on GDP of meeting the deficit reduction commitments in 2012

	Germany	France	Italiy	Spain	United Kingdom
OFCE forecast					
GDP	1.2	0.8	0.4	0.9	0.7
Public deficit (in GDP points)	-1.4	-5.2	-3.4	-5.0	-8.0
Il each country meets its commitm	ent alone				
GDP	0.9	-0.5	-2.9	-0.1	-1.9
Public deficit (in GDP points)	-1.3	4.5	-1.5	-4.4	-6.5
II the EU countries respect their co	mmitments				11200
GDP	-0.3	-1.7	-3.9	-1.5	-2.6
Public deficit (in GDP points)	-1.3	-4.5	-1.5	-4.4	-6.5
If the euro zone countries meet th	eir commitme	nts			
GDP	0.1	-1.4	-3.6	-1.2	0.3
Public deficit (in GDP points)	-1.3	-4.5	-1.5	4.4	-8.2
Reminder of commitments for 2012	-1.3	-4.5	-1.5	-4.4	-6.5

Source: OFCE calculations.

Case 2: All the EU countries meet their commitment

Of course, if all the major European countries were to adopt

the same strategy at the same time, then the savings effort would be greater. It would amount to about 64 billion euros in Italy and 55 billion euros in the UK, accounting for 4 and 3.2 percentage points of GDP, respectively. The additional effort would be about 2.0 percentage points of GDP for France and Spain (respectively 39.8 and 19.6 billion euros) and 0.9 GDP point for Germany (22.3 billion euros). In total for the five countries studied, the cumulative savings effort would represent more than 200 billion euros in 2012.

The shock on the activity of these countries would be powerful: it would cause a violent recession in 2012 for some countries, with a fall in GDP of -3.9% in Italy (against -5.1% in 2009), and -2.6 % in the UK (against -4.9% in 2009). France would be close to recession (-1.7%), as would Spain (-1.5%), while German GDP would decline slightly (-0.3%).

Case 3: Only the countries in the euro zone meet their commitment

As the UK has already implemented a substantial austerity program, and given that their constraints in terms of the deficit are more flexible than those of countries in the euro zone, we assumed that only the major countries in the euro zone complied with their commitments on the public deficit. Under these conditions, the cumulative savings effort would represent more than 130 billion euros in 2012, almost half of which would be from Italy alone (61.7 billion).

The recessionary shock would thus be focused on the euro zone, with a recession in all the countries studied except Germany (0.1%). The British economy would avoid a new period of recession (0.5%), but it would not meet the target of 6.5 percentage points of GDP for the public deficit, which would come to 8.2 GDP points.