

The United Kingdom on the eve of elections: The economy, David Cameron's trump card (1/2)

By [Catherine Mathieu](#)

In the countdown to the general elections on 7 May 2015, there is so much suspense that the bookmakers are putting the Conservative Party as winners and Ed Miliband, the Labour leader, as the next Prime Minister! Not only are the Labour Party and the Conservative Party running neck-and-neck in the polls, but with voting intentions fluctuating between 30 and 35% for many months now, neither party seems poised to secure a sufficient majority to govern alone. David Cameron, current PM and leader of the Tories, has placed the British economy at the heart of the election campaign. And the figures do seem rather flattering for the outgoing government with regard to growth, employment, unemployment, public deficit reduction, etc., though there are some less visible weaknesses in the UK economy.

A flattering macroeconomic result

With growth of 2.8% in 2014, the UK topped the charts for growth among the G7 countries (just ahead of Canada at 2.5% and the United States at 2.4%). The British economy has been on the road to recovery for two years, as growth picked up from 0.4% yoy in the fourth quarter of 2012 to 3% in the fourth quarter of 2014. This recovery stands in contrast to the situation of the large euro zone economies, where there was a weak recovery in Germany (respectively, 1.5% after 0.4%) and weak growth in France (only 0.4%, against 0.3% in 2012), with Italy still in recession (-0.5% after -2.3%).

At the end of 2014, Britain's GDP was 5% above its pre-crisis level (*i.e.* first quarter 2008), due to a strong recovery in services, which was particularly spectacular in business services (where value added (VA) was 20% above its pre-crisis level, representing 12% of VA), with a good performance in the fields of health care (VA 20% above the level of early 2008; 7% of VA) and in real estate (VA 17% above the pre-crisis level; 11% of added value).

According to the initial estimates released on April 28 by the Office of National Statistics (ONS), GDP nevertheless increased by only 0.3% in the first quarter of 2015, instead of 0.6% as in the previous quarters. While this initial estimate is likely to be revised (upwards or downwards, only half of the data on the quarter is known for this first estimate), this slowdown in growth just a few days before the elections comes at a bad time for the outgoing government...

A strong decline in the unemployment rate ...

Another highlight of the macro-economic record as the elections approach: the unemployment rate has been falling steadily since late 2011, and was only 5.6% (ILO definition) in February 2015, against 8.4% in late 2011. This rate is one of the lowest in the EU, better than in France (10.6%) and Italy (12.6%), though still behind Germany (only 4.8%). While the unemployment rate has not yet reached its pre-crisis level (5.2%), it is now close. The number of jobs has increased by 1.5 million in the UK since 2011, and David Cameron unhesitatingly boasts of the UK's success as "the jobs factory of Europe", creating more jobs on its own than the rest of Europe combined! [\[1\]](#)

Behind this strong increase in employment, however, there are many grey areas.... First, the nature of the jobs created: 1/3 of the jobs created during this recovery are individual entrepreneurs, who now represent 15% of total employment. In times of crisis, a rise in the number of the self-employed

generally reflects hidden unemployment, although according to a recent study by the Bank of England[\[2\]](#) this increase is part of a trend. The issue of the growth in what are called “zero hour” contracts, which are contracts for jobs with no guaranteed number of hours, has also burst into the discussion. Until 2013, this type of contract was not subject to statistical monitoring, but according to surveys recently released by the ONS, 697,000 households were affected by this type of contract (representing 2.3% of employment) in the fourth quarter of 2014, against 586,000 (1.9% of employment) a year earlier, *i.e.* an increase of 111,000 persons, while total employment increased by 600,000 over the period: zero-hours contracts therefore concern only a relatively small portion of the jobs created.

One corollary of the job creation that has taken place since 2011 is low gains in productivity. The British economy began to create jobs from the beginning of the recovery, while productivity fell sharply during the crisis. Companies have kept more employees on the payroll than they usually do in times of crisis, but in return wage increases have been curtailed. UK productivity today remains well below its pre-crisis level. Will the British economy keep a growth model based on low productivity and low wages for a long time to come? It is too early to tell, but this is a subject lying in the background of the election campaign.

Very low inflation

Inflation, as measured by the harmonized index of consumer prices (HICP), fell in February 2015 to only 0% yoy against 1.9% at the end of 2012. This slowdown was due to lower energy prices, but since the end of 2012, also to a slowing in core inflation: from 1.9% at end 2012 to 1.2% in February 2015. The question of inflationary risks has been debated within the UK Monetary Policy Committee for many months now: growth and low unemployment are potentially harbingers of short-term inflationary pressure, if one accepts that the economy is once

again approaching full employment. In fact, the continuous decline in inflation since 2012, coming amid low wage increases, a more expensive pound and falling energy prices, has put off the prospect of an acceleration in short-term inflation. For the moment, the members of the Bank of England's Monetary Policy Committee are voting unanimously for the status quo.

Long-term interest rates on government debt remain at low levels, which was one of the goals hammered at by the Conservatives during the 2010 electoral campaign. In fact, UK rates are moving in much the same way as US rates, in line with similar growth prospects.

Despite this relatively good record, the British economy is still fragile.

The vulnerabilities of the British economy over the medium term

Household debt continues to be high

Household debt had reached record levels before the 2007 crisis, and at that time represented 160% of household annual income. Since then, households have begun to deleverage, with indebtedness falling to 136% at end 2014, which is still well above the 100% level of the 1990s. This deleveraging is lessening households' vulnerability to a further economic slowdown or to a fall in the price of assets (especially property), but this also has the effect of reining in private domestic demand, while the household savings rate remains low (about 6%) and growth in nominal and real wages moderate. The rebalancing of domestic demand should continue, especially in terms of business investment.

Business investment is catching up

Business investment was structurally weak in the 2000s in the UK. But the recovery has been underway for 5 years, and the

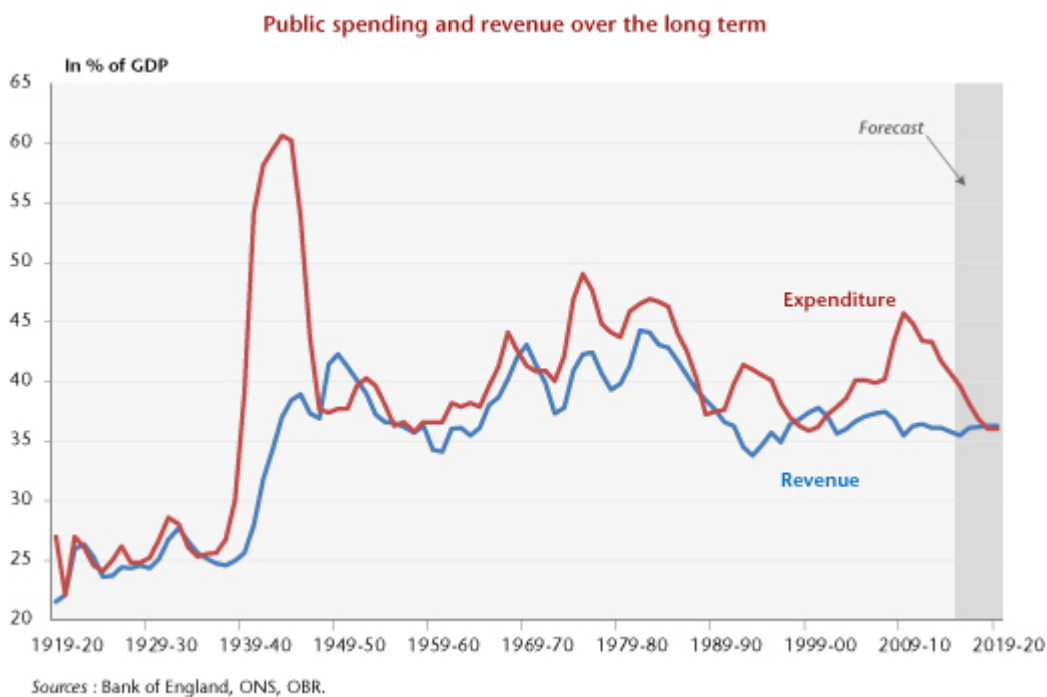
rate of investment volume is now close to its level of the early 2000s. The recovery of investment is obviously good news for the UK's productive capacity. But there is still an external deficit, a sign that the UK is struggling to regain competitiveness, at least with regard to the trade in goods. The stabilization of the trade deficit at around 7 GDP points in 2014, however, was due to the goods deficit being partially offset by a growing surplus in services (5 GDP points at end 2014), a sign that the UK economy still has a high level of specialization in services. Nevertheless, taking into account the balance in income[\[3\]](#), the current account deficit came to 5.5 GDP points, which is high.

The deceptive appearance of the public finances

In 2010, the Tory campaign blamed the previous government for letting the deficits mount during the crisis. Their electoral programme included a large-scale fiscal austerity plan, which corresponded to the archetypical IMF plans: 80% spending cuts and 20% revenue increases over a 5-year horizon. In fact, as soon as they came to power, the government increased the VAT rate, which in 2010-2011 interrupted the recovery; it cut spending, while preserving the public health system (NHS) that the British hold so dear, as well as public pensions, which are low in the UK, but which the government decided to peg to inflation or wages (using whichever is the higher of the two variations, with a guaranteed minimum of 2.5%).

Five years later, David Cameron is highlighting the "success" of his government, which has cut the public deficit in half, from a level of 10% in 2010 to 5.2% in 2014. But with respect to the government's initial ambitions, this is in fact only a partial success: its first budget in June 2010 set out a public deficit of only 2.2% of GDP in 2014. The originally planned decrease in public expenditure relative to GDP was in fact realized, but revenue rose much less than expected (due in part to sluggish household income).

While the austerity programme was generally weaker than what had been announced, in the March 2015 budget the government set out sharp cuts in public spending by 2019, which would bring it down from the current level of 40% of GDP to only 36% of GDP, one of the lowest levels of public spending since World War 2 (graphic). This reduction in public spending would be sufficient in itself to balance the public deficit, without any significant tax hikes: this would represent large-scale budget cuts, whose components are not specified and which it is hard to imagine would not sooner or later affect spending on health care and pensions, which the government has so carefully avoided doing up to now...



[1] “We are the jobs factory of Europe; we’re creating more jobs here than the rest of Europe put together” (Speech on 19 January 2015).

[2] “Self-employment: what can we learn from recent developments?”, *Quarterly Bulletin*, 2015Q1.

[3] But the deficit of the balance of direct investment income (2 percentage points of GDP) is probably inflated by the

relatively good performance of foreign companies operating in the UK in comparison to British companies operating abroad.

The Greek debt – a European story ...

By [Catherine Mathieu](#) and [Henri Sterdyniak](#)

At end 2014, Greece's debt was 317 billion euros, or 176% of its GDP, up from 103% in 2007, despite debt relief of 107 billion in 2012^[1]. This debt is the result of a triple blindness, on the part of: the financial markets, which lent to Greece until 2009, heedless of the unsustainable level of its public deficit (6.7% of GDP in 2007) and its trade deficit (10.4% of GDP in 2007); the Greek government and ruling elite who, thanks to the low interest rates permitted by its membership in the euro zone, allowed unbalanced growth, based on financial and real estate bubbles, corruption, poor governance, fraud and tax evasion; and Europe's institutions, which after the laxism of 2001-2007, imposed crushing, humiliating austerity programmes on the country, with the oversight of the troika, a strange threesome consisting of the International Monetary Fund (IMF), the European Central Bank (ECB) and the European Commission (EC). In the eyes of the troika, the austerity programmes were needed to cut the public deficit and debt and put the Greek economy on a path to growth. While the programmes did indeed help to reduce the public deficit (which was only about 2.5% of GDP in 2014, i.e. after excluding interest expenses, a surplus of around 0.5% of GDP), they have pushed up the ratio of debt to GDP, due to the

collapse in the country's GDP, which is now 25% less than in 2008. Austerity has above all plunged Greece into economic and social distress, as is sadly illustrated in an unemployment rate of over 25% and a poverty rate of 36%.

The tree of Greek debt must not, however, hide the forest: from 2007 to 2014, the public debt of the OECD countries as a whole increased from 73% of GDP to 112%, reflecting profound imbalances in the global economy. Due to financial globalization, the victory of capital over labour and growing inequality, the developed countries need large public debts; these debts are generally not reimbursable, since reimbursement assumes that agents with a surplus agree to run deficits.

Take the example of Germany. It wants to maintain a large external surplus (7% of GDP), which weighs down its European partners and has contributed to an excessively strong euro. In order for Greece and other European countries to repay their public debts, they need to be able to export, especially to Germany; Germany would in turn have to accept an external deficit and thus greatly increase public spending and wages, which it does not want to do. The contradictory demands of the surplus countries (to maintain a surplus but be repaid) are leading the entire euro zone into depression. Fortunately for the European economy, neither France nor Italy is adhering strictly to its European commitments, while the UK is not subject to them.

Can we require Greece to continue to meet its European commitments, which have led to a deep depression? To reduce its debt to 60% of GDP within 20 years? The effort needed to do this depends on the difference between the interest rate paid on debt (1.9% in 2014) and the nominal rate of GDP growth (-1.2% in 2014). Even if Greece managed to accelerate its growth so that the growth rate equalled the interest rate for its loans, it would still have to turn over 6% of its GDP every year; this drain would unbalance the economy and put the

brakes on growth. The Greek people cannot be asked to make further economic and social sacrifices.

If Greece were an emerging country, the solution would be obvious: a strong devaluation and default on the debt. The euro zone, on the contrary, cannot be maintained without solidarity between its members and without a turnabout in its economic policies. Europe cannot ask Greece's new government to maintain an austerity programme that has no prospects or to abandon its electoral programme and implement the failed policy negotiated by the previous government. A refusal to compromise would lead to the worst result: a showdown, a financial freeze on Greece, and then its withdrawal from the euro zone and perhaps the EU. The people would rightly feel that Europe is a straitjacket and that democratic votes don't count. On the other hand, it will be difficult for the northern European countries and the Commission to give up their demands: tight control of national fiscal policies, a reduction in public debts and deficits, conditionalities on aid, privatization policies and structural reforms.

Syriza's programme includes the restoration of social welfare and the public services as well as a decent standard of living for retirees and employees, but also, very clearly, tax reform, the fight against corruption and bad governance, and the search for a new development model based on the renovation of production and re-industrialization, driven by the State and a restored banking sector, based on public and private investment. This is an ambitious path that presupposes a fight against greed and the inertia of the dominant classes by mobilizing the whole of society, but it is the only future with promise.

The only solution is a compromise that would open the door to a new policy in Europe. Let's distinguish the Greek question from the European question. Europe's institutions must agree to negotiate a restructuring of Greek debt. This 317 billion euro debt is now held as follows: 32 billion by the IMF, and

223 billion by the ECB, the European Financial Stability Facility, and the other Member States, i.e. 80% by public institutions. This enabled the private sector to shed Greek debt, but it has not helped the Greek economy. Greece already benefits from low interest rates and lengthy repayment deadlines [\[21\]](#). Given the low level of current interest rates and the hunger of financial investors for the risk-free sovereign debt of most Member States, there is no reason for a default on Greek debt; it simply needs to be restructured and secured. We must avoid a situation where every year Greece is in the position of having to repay and refinance an excessive amount of debt, and thus finds itself at the mercy of the capital markets or new negotiations with the troika. Greece needs a long-term agreement based on mutual trust.

Europe should give the Greek people time for their economy to recover. Greece's debt needs to be made sustainable by converting it into very long-term secured debt, possibly confined within the European Stability Mechanism, so that it is sheltered from speculation. This debt could be financed by Eurobonds with very low rates (0.5% at 10 years, or even slightly negative rates by issuing securities indexed to inflation). European taxpayers would thus not be saddled with the burden, and the Greek debt load would be acceptable. It is Greek economic growth that will make it possible to cut the ratio of debt to GDP. The reimbursement should be limited and, as proposed by Greece, depend on growth (e.g. be zero when the volume of growth is less than 2%, and then 0.25 GDP point per additional point of growth). The agreements with Greece should be reviewed to allow the new government to implement its programme for social and production renewal. Two key points must guide the negotiations: that responsibility for the situation is shared between Greece and Europe, that each must bear its share of the burden (the banks have already undergone a partial default); and that Greece must be helped to recover from its deep depression, which means support for consumption in the short term, and in the medium term stimulating and

financing the country's productive renewal.

France should support Syriza's proposal for a European conference on debt, because the problem is not just Greek. The Greek experience merely exemplifies the structural problems with Europe's economic governance and the challenges facing all the Member States. This governance needs to be overhauled in order to overcome the economic, social and political crisis gripping the euro zone. The turning point represented by the Juncker Plan must be given resolute support (investment support of 315 billion euros in three years), as must the ECB's quantitative easing programme (1140 billion in 18 months).

The public debts of the euro zone countries must be guaranteed by the ECB and all the Member States. To absorb them, the ECB must keep long-term rates well below the rate of growth, which will require taxing financial activities and controlling the orientation of bank loans to prevent the rise of speculative bubbles. Instead of cutting public and social welfare spending, Europe must coordinate the fight against tax competition and tax evasion by the wealthy and by multinational firms. The unsustainable fiscal straitjacket imposed by the Stability Pact and the European fiscal treaty must be replaced by the coordination of economic policies aimed at full employment and resolving imbalances between euro zone countries. Finally, Europe must propose a strategy for recovery from the crisis based on boosting domestic demand in the surplus countries, coordinating wage policies, and supporting investments that prepare the ecological and social transition. The challenge here is crucial. We need to rethink the way economic policies are organized in Europe in order to allow countries to conduct policies that are different and autonomous, but coordinated. This is the only way the euro zone can survive and prosper.

[\[1\]](#) More than half of which was used by the Greek state to secure the country's banking system.

[\[2\]](#) Moreover, the ECB Member states are repaying it any gains that they make on Greek bonds.

Towards a better governance in the EU?

By [Catherine Mathieu](#) and [Henri Sterdyniak](#)

The 10th EUROFRAME Conference on economic policy issues in the European Union was held on 24 May 2013 in Warsaw on the topic, "Towards a better governance in the EU?" Revised versions of twelve of the papers presented at the Conference are included in issue 132 of the "Debates and Policies" collection of the *Revue de l'OFCE* entitled "[Towards a better governance in the EU?](#)". The papers are organized around four themes: fiscal governance, analysis of fiscal policy, bank governance, and macroeconomic issues.

The global financial crisis of 2007 and the sovereign debt crisis in the euro area that began in 2009 have highlighted shortcomings in EU governance. The intense debate that has been going on among economists over how to analyze these shortcomings and proposals for improved governance also marked the EUROFRAME Conference.

How can the Economic and Monetary Union be strengthened between countries that are still fundamentally different? How can we get out of the financial and economic crisis, the sovereign debt crisis, fiscal austerity and depression? Is it possible to develop a governance of the euro area that ensures the strength of the single currency, that avoids widening the disparities between Member States, and that gives the Members the flexibility needed, while forbidding non-cooperative policies, whether that means the excessive pursuit of competitiveness and trade surpluses or the irresponsible swelling of their public or foreign debt?

The articles in this issue provide readers with various viewpoints on possible pathways that Europe could take:

– Some authors think that we should stick to the original Treaty, abolish solidarity mechanisms, prohibit the Central Bank from buying the debt of member countries, and make it compulsory for them to find financing on the financial markets, which, stung by the Greek experience, will now be more vigilant and impose risk premiums on countries they consider lax. But is this compatible with the single currency? Are the markets really competent in macroeconomic matters? And will the euro zone members accept being reduced to the rank of countries without monetary sovereignty, whose public debt is considered risky and who do not control their interest rates?

– Other authors believe that we should gradually move towards a federal Europe, where the European authorities would be responsible for the fiscal policy of each MemberState; this would need to be accompanied by a democratization of EU institutions, perhaps including even some form of political union. But can there be centralized management of countries in different economic circumstances with different economic and social structures, and which thus need differentiated strategies? Isn't the euro zone just too heterogeneous for this? Would every country agree to submit its social and economic choices to European trade-offs?

– Other authors believe that such heterogeneous countries cannot share a single currency; that the Northern countries will refuse to give an unconditional guarantee of public debt, even though this is a prerequisite for maintaining the euro zone's unity; that Europe is incapable of organizing a common but differentiated strategy; and that the differentials accumulated in terms of competitiveness require large exchange rate adjustments in Europe. Exchange rates need to be allowed to reflect the Members' different situations, *i.e.* sharp exchange rate falls in the Southern countries, and sharp rises in the Northern countries, by returning to the European Monetary System, or even to flexible exchange rates. Each country would then have to face up to its responsibilities: the Northern countries will have to boost domestic demand, while the Southern ones will have to use their gains in competitiveness to rebuild their export sectors. But no country is demanding this leap into the unknown – the financial consequences could be terrible.

– Finally, some authors, including ourselves, believe that public debts should once again be risk-free assets, guaranteed by the ECB, as part of a process of genuine coordination of economic policy by the Member States, while explicitly targeting full employment and the coordinated reduction of imbalances in the zone. But isn't such coordination a myth? Is a country going to agree to change its economic policy objectives to help the situation of its partners? Don't the European countries today mistrust each other too much to agree to guarantee the public debt of their partners?

These are the questions addressed in this issue, which, as the European elections draw near, we hope will make a useful contribution to the debate on EU governance.

[1] [EUROFRAME](#) is a network of European economic institutes,

which includes: the DIW and IFW (Germany), WIFO (Austria), ETLA (Finland), OFCE (France), ESRI (Ireland), PROMETEIA (Italy), CPB (Netherlands), CASE (Poland) and NIESR (United Kingdom).

[\[2\]](#) This issue is published in English.

Renewed growth in the United Kingdom in 2013: trompe-l'oeil effects

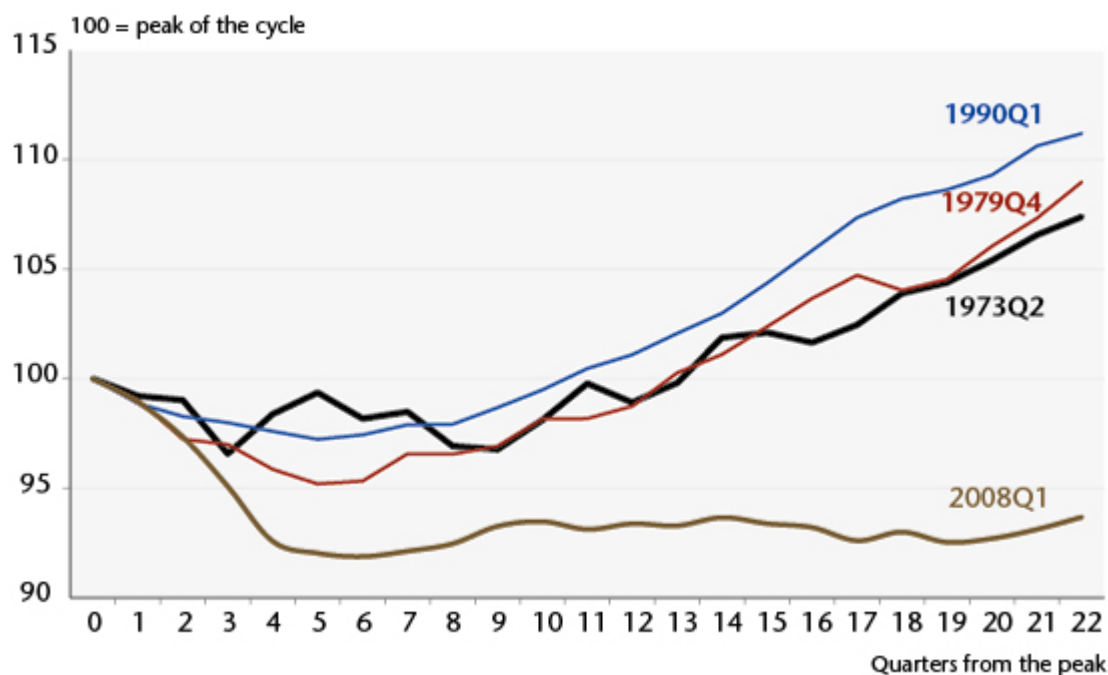
By [Catherine Mathieu](#)

The latest estimate of the British national accounts, published on 27 November, confirmed GDP growth of 0.8% in the third quarter of 2013, following 0.7% in the second quarter and 0.4% in the first quarter. This represents a sparkling performance for the UK economy, especially in comparison with the euro zone. GDP was up 1.5% year on year in the third quarter of 2013 in the UK, against -0.4% in the euro zone, 0.2% in France and 0.6% in Germany. In the eyes of some observers, Britain's return to growth shows that fiscal austerity does not undermine growth ... on the contrary. But the argument seems at a minimum questionable.

Let's look at the numbers a little more closely. Admittedly, GDP is up 1.5% year on year in the third quarter, but it rose by only 0.1% in 2012 and is still 2.5 percentage points below its pre-crisis level: this does not really represent a great success. Even more striking has been the change in GDP since

the start of the crisis: GDP initially fell 7 points between the first quarter of 2008 and the second quarter of 2009; the recovery then got underway, allowing GDP to rise 2 points in the third quarter of 2010, before it fell again. The GDP trajectory since the third quarter of 2010 has been quite unusual with respect to recoveries from previous crises (Figure 1).

Figure 1. Change In British GDP during recessions and recoveries



In 2008, the United Kingdom was one of the first industrialized countries to implement a recovery plan. Gordon Brown, Chancellor of the Exchequer in the Tony Blair government, lowered the standard VAT rate by 2.5 percentage points in December 2008 in an effort to boost household consumption. The measure, which was announced as temporary, was ended in late 2009. In 2009, fiscal policy was highly expansionary, with a fiscal impulse of 2.8 percent of GDP following a 0.6 point impulse in 2008 (Table 1). The public deficit increased under the dual impact of the recession and fiscal policy, as did the public debt.

In May 2010, the Conservatives won the election on a programme focused on reducing the public debt and deficit. This was

supposed to ensure market confidence and maintain the AAA rating of Britain's public debt, and thus keep the interest rate on the debt at a low level. This was combined with a very active monetary policy, with the Bank of England maintaining its key rate at 0.5%, buying government securities and making great efforts to facilitate the refinancing of banks and kick-start lending to businesses and households. The resumption of growth was supposed to come from business investment and exports.

The fiscal policy implemented by the David Cameron government has therefore been highly restrictive. At first, the measures focused on increasing revenue by raising the VAT rate and cutting spending, including on social benefits. The resumption of growth was interrupted. Fiscal policy had also become restrictive elsewhere in Europe, so economic activity slowed in the UK's main trading partners. In 2012, fiscal austerity was sharply curtailed (Table 1). The growth figures in recent times are a long way from demonstrating the success of austerity.

Table 1. Growth and fiscal Impulses in the United Kingdom since 2008

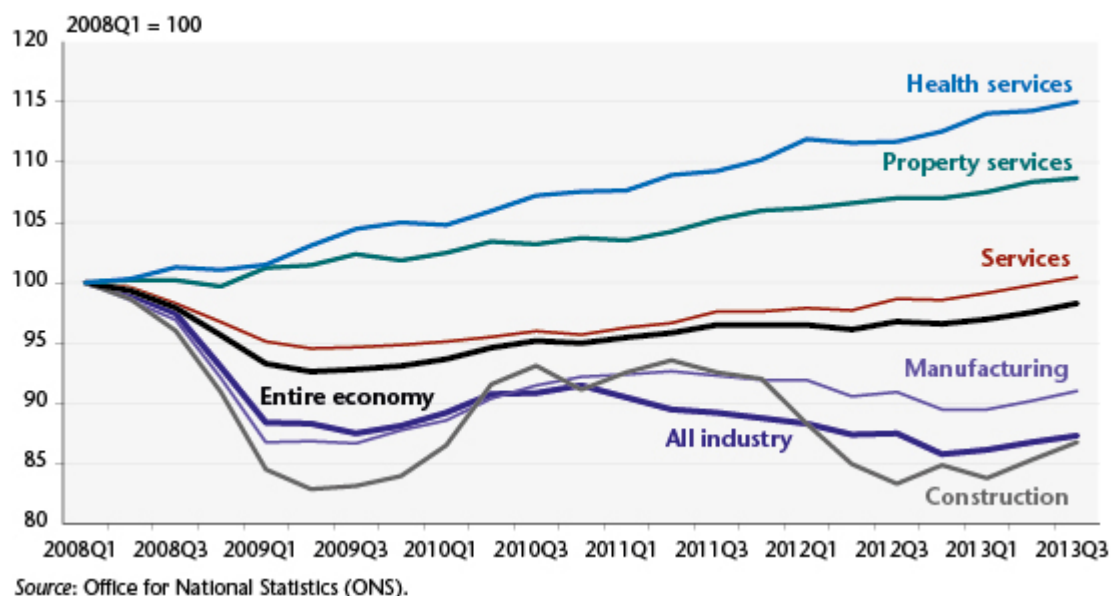
	2008	2009	2010	2011	2012
Growth	-0,8	-5,2	1,7	1,1	0,1
Fiscal impulse	0,6	2,8	-2,7	-3,2	-0,5

Sources : Office for National Statistics (ONS), OECD, author's estimates.

It is also important to note that David Cameron has excluded health expenditure from his cost-cutting plan. The British are attached to their public health care system, and the newly elected Conservatives were determined in 2010 not to repeat the mistake made in the 1980s when Margaret Thatcher was head of government. So fiscal austerity has not hit the health sector. The result is clear in terms of activity: value added (by volume) in the health sector is now 15 points above its pre-crisis level – in other words, it has continued to grow at an average annual rate of nearly 3% (Figure 2). The second sector where activity has remained strong since 2008, and

which has even accelerated since the end of 2012, is real estate. Property prices in the UK had risen sharply before the crisis, leading to record household debt, and have not dropped much since then. Indeed, they have remained historically high and even begun to rise from 2012 (at an annual rate of about 5%). But other sectors are lagging behind. Most services have for instance only now regained the level of pre-crisis output, and some of them are still well below this level: -9% for financial services and insurance, which is comparable to the figure for manufacturing, while output in the building sector is down 13%.

Figure 2. : Changes in added value (in volume) by sector since the onset of the crisis



Since 2008, British growth has thus been driven in part by a public service spared from fiscal austerity and by real estate services supported by an ultra-active monetary policy... The British recovery could, moreover, give birth to a new housing bubble. Household consumption is now the main engine of growth (Table 2). The failure of investment to pick up represents one of the main setbacks suffered by the supply-side policy implemented since 2010 by the government. The government wants to make the UK tax system the most competitive in the G20, and to this end has slashed the corporate tax rate to the lowest in the G20 (the rate, lowered to 23% this year, will be only 20% in 2015). But business investment has nevertheless not

picked up again. The government is also relying on exports to drive growth, but given the economic situation prevailing in Britain's main foreign markets, in particular the euro zone, this is just not realistic. After having experienced sustained growth in previous quarters, boosted by strong sales outside the European Union until the summer, exports have contributed to a sharp fall-off in growth in the third quarter (-0.8 GDP point). As the British government prepares to present its budget on 5 December, support for fiscal policy would be welcome to help keep the UK economy on the road to recovery in the coming months...

Tableau 2. Contributions of demand components to growth

In GDP points (except GDP)

	2010		2011		2012		2013	
	1st half	2nd half	1st half	2nd half	1st half	2nd half	1st half	2nd half
GDP, in %	1,3	0,8	0,4	0,6	-0,3	0,2	0,6	0,8
Household consumption	0,2	0,6	-0,6	0,1	0,5	0,4	0,6	0,5
Spending by general government	0,0	0,0	0,0	0,0	0,4	-0,1	0,1	0,1
GFCF	0,7	0,2	-0,4	0,1	0,5	-0,8	-0,2	0,2
Productive private	0,6	0,0	-0,2	0,1	0,4	-0,5	-0,2	0,1
Change in inventory	1,0	0,4	0,0	0,6	-1,0	0,7	-0,2	0,9
Foreign trade	-0,5	-0,3	1,5	-0,2	-0,6	-0,0	0,2	-0,9
Exports	1,1	1,1	0,7	0,2	0,1	0,3	0,2	-0,8
Imports	-1,5	-1,4	0,8	-0,4	-0,6	-0,3	-0,0	-0,1

Note: Half-year contributions, except * 3rd qtr contributions. The sum of the contributions may not correspond exactly to GDP growth, due to rounding.

Source: Office for National Statistics.

Competitiveness: danger zone!

By [Céline Antonin](#), [Christophe Blot](#), Sabine Le Bayon and [Catherine Mathieu](#)

The crisis affecting the euro zone is the result of macroeconomic and financial imbalances that developed during

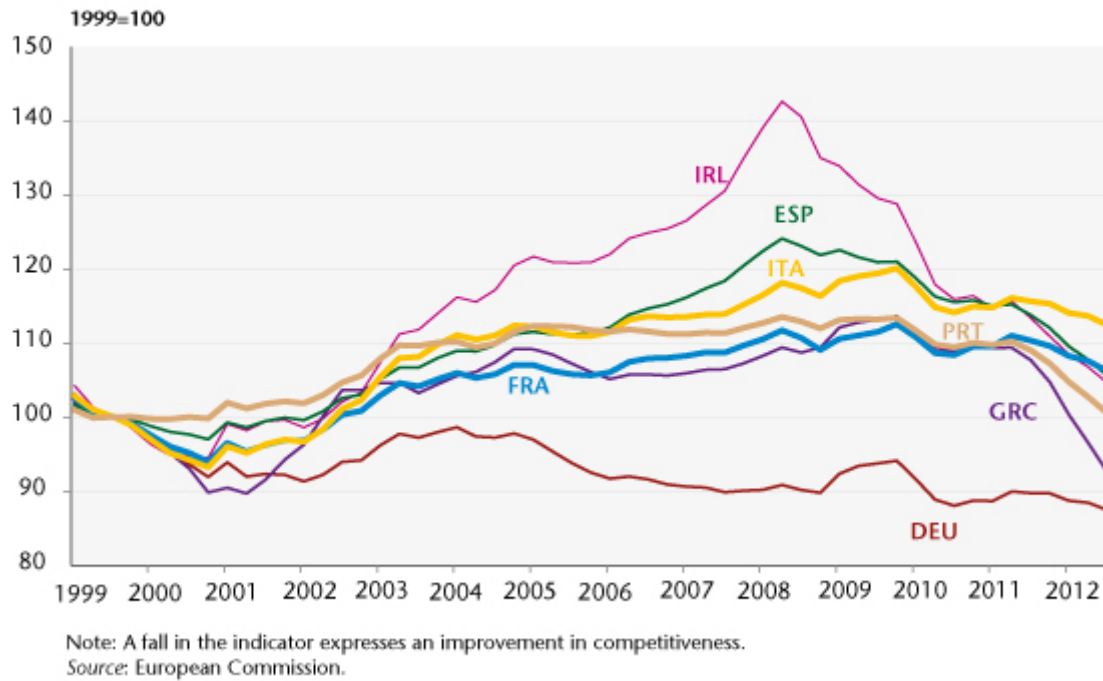
the 2000s. The European economies that have provoked doubt about the sustainability of their public finances (Spain, Portugal, Greece and Italy [\[1\]](#)) are those that ran up the highest current account deficits before the crisis and that saw sharp deteriorations in competitiveness between 2000 and 2007. Over that same period Germany gained competitiveness and built up growing surpluses, to such an extent that it has become a model to be emulated across the euro zone, and especially in the countries of southern Europe. Unit labor costs actually fell in Germany starting in 2003, at a time when moderate wage agreements were being agreed between trade unions and employers and the coalition government led by Gerhard Schröder was implementing a comprehensive programme of structural reform. This programme was designed to make the labour market [\[2\]](#) more flexible and reform the financing of social protection but also to restore competitiveness. The concept of competitiveness is nevertheless complex and reflects a number of factors (integration into the international division of production processes, development of a manufacturing network that boosts network effects and innovation, etc.), which also play an important role.

In addition, as is highlighted in a [recent analysis by Eric Heyer](#), Germany's structural reforms were accompanied by a broadly expansionary fiscal policy. Today, the incentive to improve competitiveness, strengthened by the implementation of improved monitoring of macroeconomic imbalances (see [here](#)), is part of a context marked by continued fiscal adjustment and high levels of unemployment. In these conditions, the implementation of structural reforms coupled with a hunt for gains in competitiveness could plunge the entire euro zone into a deflationary situation. In fact, Spain and Greece have already been experiencing deflation, and it is threatening other southern Europe countries, as we show in [our latest forecast](#). This is mainly the result of the deep recession hitting these countries. But the process is also being directly fueled by reductions in public sector wages, as well

as in the minimum wage (in the case of Greece). Moreover, some countries have cut unemployment benefits (Greece, Spain, Portugal) and simplified redundancy procedures (Italy, Greece, Portugal). Reducing job protection and simplifying dismissal procedures increases the likelihood of being unemployed. In a context of under-employment and sluggish demand, the result is further downward pressure on wages, thereby increasing the deflationary risks. Furthermore, there has also been an emphasis on decentralizing the wage bargaining process so that they are more in tune with business realities. This is leading to a loss of bargaining power on the part of trade unions and employees, which in turn is likely to strengthen downward pressure on real wages.

The euro zone countries are pursuing a non-cooperative strategy that is generating gains in market share mainly at the expense of other European trading partners. Thus since 2008 or 2009 Greece, Spain, Portugal and Ireland have improved their competitiveness relative to the other industrialized countries (see graph). The continuation of this strategy of reducing labor costs could plunge the euro zone into a deflationary spiral, as the countries losing market share seek in turn to regain competitiveness by reducing their own labour costs. Indeed, this non-cooperative strategy, initiated by Germany in the 2000s, has already contributed to the crisis in the euro zone (see the box on p.52 of the [ILO report](#) published in 2012). It is of course futile to hope that the continuation of this strategy will provide a solution to the current crisis. On the contrary, new problems will arise, since deflation [\[3\]](#) will make the process of reducing both public and private debt more expensive, since debt expressed in real terms will rise as prices fall: this will keep the euro zone in a state of recession.

Figure 1. Competitiveness measured by unit labour costs (total economy)



[1] The Irish case is somewhat distinct, as the current account deficit seen in 2007 was due not to trade, but a shortfall in income.

[2] These reforms are examined in detail in a report by the Conseil d'analyse économique (no. 102). They are summarized in a special study [La quête de la compétitivité ouvre la voie de la déflation](#) ("The quest for competitiveness opens the door to deflation").

[3] For a more comprehensive view of the dynamics of debt-driven deflation, see [here](#).

Is the euro crisis over?

By [Catherine Mathieu](#) and [Henri Sterdyniak](#)

As of early 2013, it is possible to make two contrasting assessments of the crisis. On the one hand, the euro has survived. Europe's institutions and Member states have of course been slow and hesitant to react, and their reluctance has often fueled speculation. But its institutions have gradually managed to develop solidarity mechanisms, such as the European Financial Stability Facility and then the European Stability Mechanism, and they were able to impose strong fiscal discipline on Member states (strengthening the Stability and Growth Pact, adjustment programs, fiscal treaty).

The Member states have agreed to implement austerity policies and structural reforms. From the beginning of the crisis, the European Central Bank was willing to put in place unconventional policies, and it has supported the public debt of countries in difficulty by intervening in the secondary markets. It then undertook to commit unlimited resources to support countries in trouble that implemented satisfactory policies, which helped to reassure the financial markets and to lower risk premiums.

On the other hand, the euro zone has been unable to regain a satisfactory level of growth or to recover the 9 points of activity lost to the crisis. The Member states have been forced to implement austerity policies during a recession. According to the outlook of the Commission itself, the unemployment rate is expected to stay at about 11.8% in 2013. Imbalances between countries persist, even if they are somewhat mitigated by the deep depression that has engulfed the countries of southern Europe. The rigid standards that have been imposed on the Member states, with no real economic foundation, cannot replace the genuine coordination of

economic policies. The solidarity mechanisms implemented are conditional on the loss of any autonomy and the introduction of drastic austerity policies. In the future, national policies will be paralyzed by European constraints and by the threats of the financial markets. Social Europe is not making progress, and, even worse, Europe is requiring countries in difficulty to call into question universal health care and to cut pension, unemployment and family benefits. Tax competition is continuing, and the crisis has not been seen as a time to challenge tax havens and tax evasion. While Europe is at the forefront of the fight against climate change, it is hesitating to make a robust commitment to the ecological transition. Although many countries in the area are suffering from continuing deindustrialization, no industrial policy has been implemented. A banking union will be established, but its content is not being democratically decided. The European authorities are persisting in a strategy – paralyzing national policies and imposing free market structural reforms – which has so far failed to boost growth and has made Europe unpopular. Europe is sorely lacking a socially unifying project, an economic strategy and a means of functioning democratically.

* [Issue 127 of the “Debates et Politics” collection of the Revue de l’OFCE, which appeared in January](#), contains analyses that provide contrasting insights into the origins of the euro zone crisis and into strategies for resolving the crisis. This issue brings together twelve papers following the 9th EUROFRAME conference [\[1\]](#) in June 2012 on issues concerning the European Union’s economic policy.

[\[1\] EUROFRAME](#) is a network of European economic institutes, which includes: the DIW and IFW (Germany), WIFO (Austria), ETLA (Finland), OFCE (France), ESRI (Ireland), PROMETEIA

(Italy), CPB (Netherlands), CASE (Poland) and NIESR (United Kingdom).

The euro zone in crisis

By [Catherine Mathieu](#) and [Henri Sterdyniak](#)

The 9th EUROFRAME Conference [1], which was held in Kiel on 8 June 2012, focused on economic policy issues in the European Union. The topic was “The euro zone in crisis: Challenges for monetary and fiscal policies”. [Issue 127 of the “Débats et Politiques” collection of the OFCE Revue](#) has published revised versions of twelve papers presented in the Conference[2], gathered in five themes: exchange rate imbalances, indicators of the debt crisis, budget rules, banking and financial issues, and strategies for resolving the crisis.

The analysis of the origins of the euro zone crisis and economic policy recommendations to get out of the crisis have been the subject of great debate among economists, which was illustrated in the EUROFRAME Conference. In the course of these articles, the reader will see several fault-lines:

– For some, it is the irresponsible policies of the South that are the cause of the imbalances: they have allowed the development of wage and property bubbles, while the Northern countries have been implementing virtuous policies of wage austerity and structural reform. The Southern countries thus need to adopt the North’s strategy and undergo a lengthy austerity cure. For others, the single currency has led to the development of twin opposing imbalances: this has led to under-valuing the economies of the North, which enabled them to offset their excessive policies on wage and social

austerity with excessive external surpluses, and it has allowed the persistence of the South's external deficits; this has resulted in the need for a controlled convergence, whereby recovery in the North facilitates the absorption of the South's external imbalances.

– Some argue that each country must implement policies that combine a strong reduction in public spending – to absorb the budget deficits and reduce the public debt burden – with structural reforms (liberalization of the markets for goods and services, deregulation of the labour market) in order to offset the depressive effect on the labour market. The financial markets have to be allowed to impose the necessary discipline on the countries. Others hold that the public deficits have to be tolerated as long as necessary to support economic activity, public debt needs to be guaranteed by the European Central Bank (ECB) to ensure that domestic interest rates converge at low rates, and an EU-wide growth strategy is needed (in particular to finance the investments required for the ecological transition).

– Some even believe that we must avoid any further extension of European solidarity, as it would enable some countries to put off the reforms needed, which would lead to persistent imbalances and thus to money creation and inflation. Others argue that errors have been made on economic policy since the inception of the euro zone, and that these have led to sharp disparities in the zone, which now need to be reduced by means of a coherent solidarity strategy. Europe is one big family and must demonstrate its solidarity and accept compromises to continue to live together.

– For some, ending the debt crisis of the euro zone countries requires the establishment of a fiscal union, which means the establishment of binding rules enshrined in the Fiscal Pact and a certain degree of fiscal federalism; the European Commission and Council should have a say on the fiscal policies of the Member States. Others think that the Member

States should have a degree of autonomy to practice the fiscal policy they choose; this is a matter of both democracy and economic efficiency: the economic situations of the different countries are too diverse to invoke a uniform fiscal policy; what is needed is the open coordination of economic policy, without rigid pre-established standards on public finances, with the aim of ensuring satisfactory growth and the winding down of external imbalances.

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

[2] Ten of which are in English and two in French.

Has monetary policy become ineffective?

By [Christophe Blot](#), [Catherine Mathieu](#) and Christine Riffart

This text summarizes the [special study](#) of the October 2012 forecast.

Since the summer of 2007, the central banks of the industrialized countries have intervened regularly to counter the negative impact of the financial crisis on the functioning

of the banking and financial system and to help kick-start growth. Initially, key interest rates were lowered considerably, and then maintained at a level close to 0 [\[1\]](#). In a second phase, from the beginning of 2009, the central banks implemented what are called unconventional measures. While these policies may differ from one central bank to another, they all result in an increase in the size of their balance sheets as well as a change in the composition of their balance sheet assets. However, three years after the economies in the United States, the euro zone and the United Kingdom hit bottom, it is clear that recovery is still a ways off, with unemployment at a high level everywhere. In Europe, a new recession is threatening [\[2\]](#). Does this call into question the effectiveness of monetary policy and of unconventional measures more specifically?

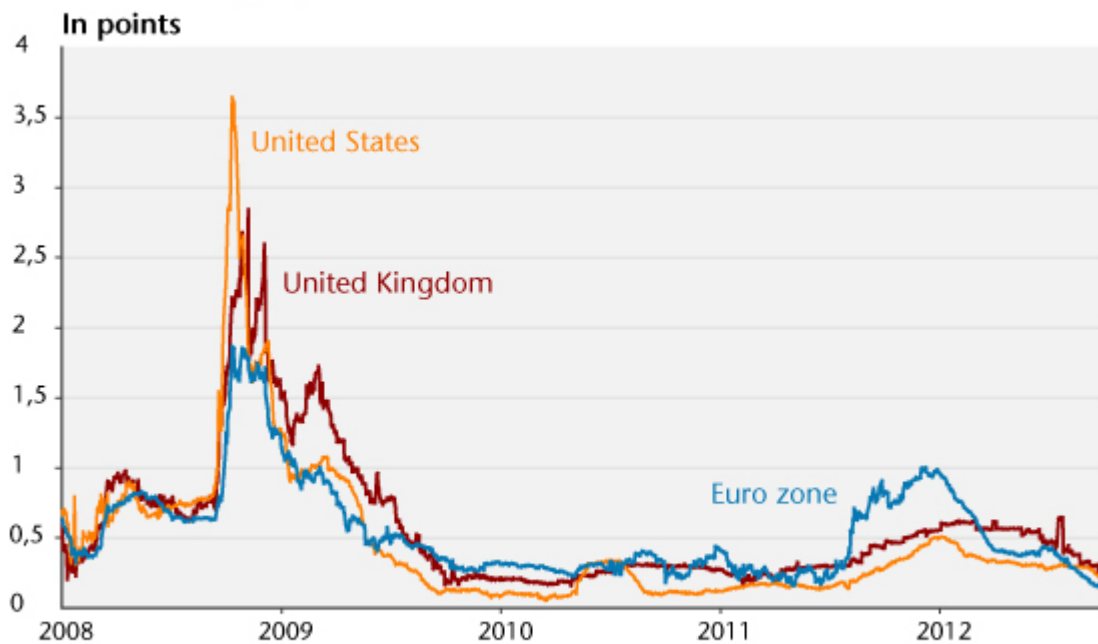
For almost four years, a wealth of research has been conducted on the impact of unconventional monetary policies [\[3\]](#). Cecioni, Ferrero and Sacchi (2011) [\[4\]](#) have presented a review of recent literature on the subject. The majority of these studies focus on the impact of the various measures taken by the central banks on financial variables, in particular on money market rates and bond yields. Given the role of the money market in the transmission of monetary policy, the ability of central banks to ease the pressures that have emerged since the beginning of the financial crisis constitutes a key vector for effective intervention. More recently, this was also one of the reasons motivating the ECB to conduct an exceptional refinancing operation in two stages, with a maturity of 3 years. This intervention has indeed helped to reduce the tensions on the interbank market that had reappeared in late 2011 in the euro zone, and to a lesser extent in the United States and the United Kingdom (see graph). This episode seems to confirm that central bank action can be effective when it is dealing with a liquidity crisis.

Another critical area of debate concerns the ability of

unconventional measures to lower interest rates in the long term and thereby to stimulate activity. This is in fact an important lever for the transmission of monetary policy. The findings on this issue are more mixed. Nevertheless, for the United States, a study by Meaning and Zhu (2012) [\[5\]](#) suggests that Federal Reserve programs to purchase securities have contributed to lowering the rates on 10-year US Treasury bills: by 60 points for the first “Large-scale asset purchase” program (LSAP1) and by 156 points for LSAP2. As for the euro zone, Peersman [\[6\]](#) (2011) shows that the impact of unconventional measures on activity has in general closely resembled the effect of lowering the key interest rate, and Gianone, Lenza, Pill and Reichlin [\[7\]](#) (2012) suggest that the various measures taken by the ECB since the beginning of the crisis have helped offset the rise in the unemployment rate, although the impact is limited to 0.6 point.

Under these conditions, how is it possible to explain the weakness or outright absence of a recovery? One answer evokes the hypothesis of a liquidity trap [\[8\]](#). Uncertainty is still prevalent, and the financial system is still so fragile that agents are continuing to express a preference for liquidity and safety, which explains their reluctance to undertake risky projects. Thus, even if financing conditions are favourable, monetary policy will not be sufficient to stimulate a business recovery. This hypothesis probably explains the timidity of the recovery in the United States. But in the euro zone and the United Kingdom this hypothesis needs to be supplemented with a second explanation that recognizes the impact of restrictive fiscal policies in holding back recovery. The euro zone countries, like the UK, are pursuing a strategy of fiscal consolidation that is undermining demand. While monetary policy is indeed expansionary, it is not able to offset the downward pressure of fiscal policy on growth.

Graphique. Tensions on the interbank markets*



* The tensions are measured by the spread between the interbank rates (Libor ou Euribor) and the overnight interest rate swap (OIS).

Source : Datastream.

[1] One should not, however, forget the exception of the ECB, which prematurely raised its key interest rate twice in 2011. Since then it has reversed these decisions and lowered the key rate, which has stood at 0.75% since July 2012.

[2] The first estimate of UK GDP for the third quarter of 2012 indicates an upturn in growth following three quarters of decline. However, this rebound is due to unusual circumstances (see [Royaume-Uni: l'enlissement](#)), and activity will decline again in the fourth quarter.

[3] Unconventional monetary policies have already been analyzed repeatedly in the case of the Bank of Japan. The implementation of equivalent measures in the United States, the United Kingdom and the euro zone has contributed to greatly amplifying the interest in these issues.

[4] ["Unconventional monetary policy in theory and in practice"](#), *Banca d'Italia Occasional Papers*, no.102.

[5] ["The impact of Federal Reserve asset purchase programmes:](#)

[another twist](#)", *BIS Quarterly Review*, March, pp. 23-30.

[6] "[Macroeconomic effects of unconventional monetary policy in the euro area](#)", ECB Working Paper no.1397.

[7] "[The ECB and the interbank market](#)", CEPR Discussion Paper no. 8844.

[8] See [OFCE](#) (2010) for an analysis of this hypothesis.