

The infinite clumsiness of the French budget

By [Xavier Timbeau](#), @XTimbeau

In the [draft budgetary plan presented to the European Commission](#) on 15 October 2014, it is clear that France fails to comply with the rules on European governance and its previous commitments negotiated in the framework of the European Semester. As France is in an excessive deficit procedure, the Commission, as guardian of the Treaties, has no choice *a priori* but to reject the country's budget plan. If the Commission does not reject the plan, which departs very significantly, at least in appearance, from our previous commitments, then no budget could ever be rejected.

Recall that France, and its current President, have ratified the [Treaty on Stability, Coordination and Growth](#) (the "TSCG" came into force in October 2012), which had been adopted by the Heads of State in March 2012. There was talk during the 2012 presidential campaign of renegotiating it (which raised the hopes of the southern European countries), but the urgency of the sovereign debt crisis in Europe, among other factors, decided otherwise. France has implemented the provisions of the TSCG in [Organic Law 2012-1403](#), for example by setting up a new fiscal council, the [Haut Conseil des Finances Publiques](#), and establishing a multiannual system for tracking the trajectory of public finances based on structural balances (that is to say, adjusted for cyclical effects).

Everything seems to indicate that France had accepted the highly restrictive framework that had been established by the "Six-Pack" (five regulations and one directive, dated 2011, which reinforce the Stability and Growth Pact and which specify a timetable and parameters) and then reinforced by the TSCG and the "Two-Pack". France's good will was also evident

when it presented its [2014 draft budgetary plan](#) in October 2013 and [a stability programme](#) in April 2014, which more than complied. It was at [a press conference in September 2014](#) that the French government announced that the deficit reduction target for 2015 would not be met. Low growth and low inflation were the arguments made there for a serious revision of the economic situation, which was presented as a truthful assessment. The same situation arose in 2013, with the nominal target then being set while underestimating the fiscal multipliers. However, the timing and magnitude of the adjustments had been respected, and a postponement was granted.

So until the press conference, no major difficulty had been posed to the workings of the Treaty. One of the innovations of the TSCG was in fact to no longer aim at a nominal target (3%) but to focus on the structural effort. If the economic situation proves to be worse than expected, then the nominal deficit target is not met (which is the case). In this situation, the objective is the structural effort. In the 2014-2017 Stability Programme of April 2014, the structural effort announced (page 13) is a 0.8 GDP point reduction in the structural deficit in 2015, following 0.8 GDP point in 2014. The [excessive deficit procedure](#) (also set out in a [vade-mecum](#) of the Commission) requires a minimum structural effort of 0.5 GDP point and that the mechanisms for achieving this be set out precisely.

It is here that the [2015 budget bill](#) represents a concrete violation of the treaty. The effort in 2014 is now only 0.1 point, with 0.2 point announced in 2015. These figures are unacceptable to the Commission. How can such a provocative change be explained? Several factors are behind this. The first is a change in the method of booking the CICE tax credit, which means recording in 2015 the expenses generated in 2015 and paid in 2016. As the CICE ramps up, this comes to 0.2 GDP point less in France's fiscal effort. The second is a

change in the hypothesis for potential growth. Instead of 1.5% potential growth in the 2014-2017 stability programme, this is assumed to be 1.2% over the 2014-2017 period. Using a constant percentage method, the effort would have been 0.5 GDP point in 2014 and 0.6 point in 2015. The difference with the April 2014 stability programme is due to the revision downwards of inflation and to several changes in the measurements. A new presentation of the same budget, with a marginal modification of the economic situation, is marked by the absence of structural effort. Not only will the nominal target not be achieved, but furthermore the structural effort for 2014 and 2015 is abandoned – with no change in policy! Worse, this draft budget implies that the nominal target is not being achieved because the structural effort was not made in 2014 and won't be in 2015.

The government, nevertheless, pleads extenuating circumstances. Why change the assumptions for potential growth while not having kept the previous accounting standards for presenting France's 2015 draft budgetary plan? An effort of 0.6 GDP point in 2015 instead of the previously announced effort of 0.8 GDP point would not have posed any problems for the Commission, which itself had made overly high estimates of potential growth (as also in its remarks on the [2014 draft budgetary plan](#), which the Council did not adopt in November 2013). It would have been easy to answer that one does not change assumptions of potential growth every 6 months, and that this is furthermore the purpose of this concept and the reason for its introduction in EU Treaties and guidelines: to avoid a pro-cyclical character in fiscal policy, to avoid tightening up budgets at a time when bad news is piling up. It would have been accepted that the Commission had a lower assessment than France, but potential growth is not observed, and its assessment is based on numerous hypotheses. It is not, for instance, specified in the treaties or regulations whether potential growth is to be assessed in the short term or the medium term. But the Commission considers (in the [2012 Ageing](#)

[Report](#)) that France's medium-term growth potential was 1.7% per year (on average 2010 to 2060) and 1.4% in 2015. Above all, nothing obliges France to adopt the hypothesis of the Commission. EU regulation [473/2011](#) demands that the hypotheses be made explicit, and outside opinions might also be requested. French Organic Law 2012-043 states that, "A report attached to the draft budgetary plan (LPFP) and giving rise to parliamentary approval states: ... 9) The procedures for calculating the structural effort referred to in Article 1, the distribution of this effort among the various sub-sectors of government, and the elements used to establish a correspondence between the notion of the structural effort and the notion of the structural balance; 10) The hypotheses of potential gross domestic product used in planning the public finances. The report presents and justifies any differences from the estimates of the European Commission" – which gives the government good control over the hypothesis for potential growth and makes the parliament sovereign, the final judge.

Does a truth check need to be conducted on potential growth so as to significantly alter this crucial hypothesis in the presentation of the budget? Should a truth process lead to presenting a budget as almost neutral when it reflects crucial, expensive policy choices (to finance business competitiveness by cutting public spending and increasing taxes on households)? Is the Commission's hypothesis more relevant because it has been continuously revised every 6 months for 5 years now? Couldn't it be explained that the French government's ambitious programme of structural reform would help to increase potential growth in the future (unless the government doesn't believe this)? Aren't the CICE and the Responsibility Pact a sufficient pledge of the renewed vitality of a productive system that will lead to boosting potential growth? Would it be better to follow the advice of the [authors of a report for the French Council of Economic Analysis \(CAE\) on potential growth](#) who did not risk producing a new estimate? Isn't it the subject of growth that needs to

be discussed (constructively and technically, in discreet fora) with the Commission, rather than engaging in an explicit breach of EU rules? In the [2015 draft budgetary plan](#), it is written (page 5): “the trajectory is based, out of caution, on a downward revision of potential growth from the previous budgetary plan, by taking the European Commission’s latest estimate of potential growth (spring 2014)”. What kind of caution is this that looks more like a blunder with terrible consequences? Is it the mess that the government was in at end August 2014 that permitted this state of infinite clumsiness?

It is impossible to justify the presentation made: the Commission will rebuke France, which will not react, since it is sure of its rights (as the government has already stated). The Commission will then ramp up the sanctions, and it is unlikely that the Council will stop this process, especially as the decisions are to be taken by a reverse qualified majority vote. There will be a new round of French-bashing, which will merely show the futility of the process, because France will not deviate from the path it has chosen for its public finances. This will undercut France’s persuasiveness and influence at the very time that a 300 billion euro investment plan is being developed, which is sought only by France and Poland (according to rumors), which risks derailing a rare initiative that could get us out of the crisis.

In letting the muffled fury of the technocracy express its dissatisfaction with France, what will come out is the fragility of “European governance”. But this governance relies solely on the denunciation of France and the consequent peer pressure. France could be fined, but neither the Council nor the Commission have any instruments to “force” France to meet Treaty requirements. This is the weakness of “European governance”: it works only if the member states voluntarily adhere to the rules. It is thus governance in name only, but despite this it is the foundation underpinning the path out of the sovereign debt crisis. The European Central Bank

intervened in the summer of 2012 because stronger governance of public finance was intended to solve the “free rider” problem. The (numerous) critics of the European Central Bank’s intervention have broadly denounced the hypocrisy of the Treaty, which guarantees nothing since it is based on the voluntary discipline of the member states. Its violation by France and the impotence of the Commission and the Council will be such a demonstration of this weakness that there is concern that the house of cards might collapse.

France could revise its draft budget and add measures that, in the new accounting system and with a lowered estimate of potential, would enable it to fulfil its April 2014 commitment on its structural effort. This scenario is highly unlikely, and that’s a good thing ([see the post by Henri Sterdyniak](#)). It’s unlikely, because the almost 2 points of VAT at the full rate required to achieve an effort of 0.8% of GDP (and thus without compensating for the delay in 2014) would not be approved by the French Parliament. And it’s good because this would trigger a recession (or serious slowdown) in France and a completely unacceptable rise in unemployment simply to save face for the Commission and diligently apply European legislation.

It would have been more clever to stick to the hypotheses (and methods) of the 2014 stability program, France’s Haut Conseil would have protested, the Commission would have complained, but Europe’s rules of governance would have been saved. They say that statistics are the most advanced form of lying. Between two lies, it’s best to choose the less stupid.

Regulating the financial activities of Europe's banks: a fourth pillar for the banking union

By [Céline Antonin](#), [Henri Sterdyniak](#) and [Vincent Touzé](#)

At the impetus of EU Commissioner Michel Barnier, on 29 January 2014 the European Commission proposed new regulations aimed at limiting and regulating the commercial activities of banks “of systemic importance”, that is to say, the infamous “too big to fail” (TBTF).

Regulating proprietary activities: a need born of the crisis

Due to banks' particular responsibility in the 2008 economic and financial crisis, many voices have been raised demanding stricter regulation of their financial activities. This has led to two approaches: prohibition and separation.

In the United States, the “Volker rule” adopted in late 2013 prohibits banks from engaging in any proprietary trading activities as well as taking holdings of greater than 3% in hedge funds. The banks can nevertheless continue their own market-making and hedging activities. Obviously, this rule does not prohibit banks from investing their own funds in financial assets (equities, government and corporate bonds). The purpose of the rule is to prevent a bank from speculating against its customers and to minimize the use of the leveraging that proved so costly to the financial system (banks using their clients' money to speculate on their own behalf).

The European approach is based on the Vickers Report (2011) for the United Kingdom and the Liikanen Report (2012) for the

European Union. These reports recommend some separation between traditional banking activities on behalf of third parties (management of savings, provision of credit, simple hedging operations) and trading activities that are for the bank's own account or bear significant risk, although the activities can be maintained in a common holding company. The Vickers Report proposes isolating traditional banking activities in a separate structure. In contrast, according to the Liikanen report it is proprietary trading and large-scale financial activities that need to be isolated in a separate legal entity.

The idea of separating banking activities is not new. In the past, many countries enacted legislation to separate commercial banks from investment banks (Glass-Steagall Act in 1933 in the United States, the 1945 Banking Act in France). These laws were revoked in the 1980s due to a growing belief in the superiority of the "universal bank" model, which allows a single bank to offer a full range of financial services to individuals (loans, deposits, simple or complex financial investments) and especially to business (loans, hedging, issuance of securities, market-making activities). The crisis exposed two defects in this model: the losses incurred by a bank on its proprietary trading and other activities on the markets led to a loss in its equity capital, thereby calling into question the bank's lending activities and requiring the State to come to its rescue in order to ensure that bank credit didn't dry up. The universal bank, backed by the State's guarantee and sitting on a mass of deposits, did not have sufficient vigilance over its proprietary trading activities (as was shown by the cases of Kerviel, Picano-Nacci and Dexia).

An ambitious European regulatory proposal

This proposal for bank reform is coming in a situation that is complicated by several factors:

1) The Basel 3 regulations currently being adopted already impose strict rules on the quality of counterparties of the equity capital. Speculative activities must be covered by substantial levels of common equity.

2) The banking union being developed provides that in case of a crisis creditors and large deposit holders could be called upon to save a bank facing bankruptcy (principle of "bail in"), so that taxpayers would not be hit (end of "bail out"). But there are doubts about this mechanism's credibility, which could cause a domino effect in the event that a TBTF bank faces bankruptcy.

3) Some European countries have anticipated reform by adopting a separation law (France and Germany in 2013) or setting prohibitions (Belgium). In the United Kingdom, a separation law inspired by the Vickers Report (2011) is to be adopted by Parliament in early 2014.

The regulatory proposal presented on 29 January is more demanding than the Liikanen Report. Like the "Volker rule" in the US, it prohibits speculation on the bank's own account through the purchase of financial instruments and commodities, as well as investments in hedge funds (which prevents banks from circumventing the regulation by lending to hedge funds while holding significant shares in these funds, thereby taking advantage of the greater leverage).

Moreover, in addition to this prohibition the European legislator provides for the possibility of imposing a separation on an independent subsidiary for operations that are considered too risky, that is to say, that would result in taking positions that are too large. The aim is to address the porous border between proprietary trading and trading for third parties, as bankers could take risks for themselves while not covering the positions sought by their clients. With these new regulations, the legislator hopes that in the event of a bank crisis public support for the banks will benefit

only depositors, not the bankers, with as a consequence an overall reduced cost.

Compared to French regulations, the regulatory proposal is more restrictive than the [law on the separation and regulation of banking activities](#) of 26 July 2013. Indeed, French law provides for the legal compartmentalization only of certain proprietary activities and highly leveraged activities in an independently financed subsidiary; strict prohibition concerns only high-frequency trading activities and speculation in agricultural commodities. And there are numerous exceptions: the provision of services to clients, market-making activities, cash management, and investment transactions and hedging to cover the bank's own risks. In contrary, the prohibitions are broader in the regulatory proposal, as it applies to all proprietary trading. In addition, the regulatory proposal prohibits investment in hedge funds, whereas the French law permits it provided that such activities are compartmentalized.

The regulatory proposal nevertheless concerns only banks of a systemic size, *i.e.* 30 out of the 8000 found in the European Union, representing 65% of banking assets in the EU. It will not be discussed until the election of the new Parliament and the establishment of a new Commission.

A reform that doesn't have a consensus

Michel Barnier's proposed reform has already provoked sharp criticism from certain member countries and the banking community. Some have reproached it for intervening in an area where it has no jurisdiction, which clearly indicates the current complexity of the legislation governing the European banking system.

France, Germany, Belgium could object, "Why are you interfering? We have already enacted our banking reform." But the logic of the banking union is that the same laws apply

everywhere. These countries have chosen to carry out a minimal banking reform in order to pre-empt the content of European law. This is hardly acceptable behaviour at European level. There is also the case of the United Kingdom (for which Barnier's proposal opens the exit door: the regulations will not apply to countries whose legislation is more stringent).

The banking union provides for the European Central Bank to oversee the large European banks and for the European Banking Agency to set the regulations and rules on supervision. The Commission can therefore be reproached for intervening in a field for which it is no longer responsible. On the other hand, the crisis clearly showed that banking concerns more than just the banks. It is legitimate for EU political institutions (Commission, Council, Parliament) to intervene in the matter.

The proposal has encountered two contradictory criticisms. One is that it doesn't organize a genuine separation of deposit-taking banks and investment banks. From this perspective, deposit or retail banks would be entrusted with specific tasks (collecting and managing deposits; managing liquid savings and risk-free savings; lending to local government, households and businesses); they would not have the right to engage in speculative activities or trading activities or to lend to speculators (hedge funds, arranging LBO transactions). These banks would be backed fully by a government guarantee. In contrast, market or investment banks would have no government guarantee for their market interventions and equity and other above-the-line operations. Since these transactions are risky, the absence of a public guarantee would lead them to set aside a greater amount of capital and to bear a high cost for attracting capital. This would reduce their profitability and thus the development of hedging and other speculative activities. A company that was in need of a hedging operation would have to have it carried out by an investment bank and not by its regular bank, so at a higher cost. Conversely, this

would reduce the risk that banks suck their clients (banks and companies) into risky investments and operations. A reform like this would greatly increase the transparency of financial activities, at the cost of diminishing the importance of the banks and financial markets. Michel Barnier did not dare take the principle of separation to this, its logical conclusion. He remains instead within the logic of the universal bank, which uses its massive size as a deposit bank to provide financial intermediary services to its customers (issuance of securities, coverage of risk, investment in the markets, etc.), to intervene in the markets (market-making for foreign exchange and public and private securities) and to underwrite speculative activities.

The reform is nevertheless facing stiff opposition from the banking community, who would have preferred the status quo. Hence Christian Noyer, a member of the ECB Governing Council, has labelled the proposals “irresponsible”, as if the ECB had acted responsibly before 2007 by not warning about the uncontrolled growth of banks’ financial activities.

The European Banking Federation (EBF) as well as the French Banking Federation (FBF) are demanding that the universal banking model be preserved. The banks are criticizing the obligation to spin off their market-making operations (including for corporate debt). According to the FBF, this regulation “would lead to making this operation considerably more expensive,” which “would have a negative impact on the cost of financing companies’ debts and hedging their risks”. However, this obligation may be waived if the banks demonstrate that their market interventions do not require them to take on any risk. The banks could therefore continue to act as market makers provided that they set strict limits on their own positions; they could provide simple hedging operations by covering these themselves.

A fourth pillar for the banking union?

European banks have of course rightly pointed out that this reform comes in addition to the establishment of the SSM (single supervisory mechanism), the SRM (single resolution mechanism), and the ECB exercise assessing the banks (launched in November 2013). The overall system does lack cohesion; a well thought-out schedule should have been set.

However, the separation advocated by the Barnier proposal lends credibility to the banking union and its three pillars (SSM, SRM and deposit insurance). This project does contribute to convergence in banking regulations, from both a functional and a prudential perspective. The establishment of a consistent framework simplifies control by the European supervisor under the SSM (the ECB will monitor the banks' normal activities and ensure that they are not affected by speculative activities). The separation recommended by the Barnier proposal enhances the credibility of the SRM; there will no longer be any banks that are too big to go bankrupt, and investment bank losses will not rebound onto the lending activities of deposit banks and will not have to be borne by the taxpayer. By reducing the risk that deposit banks might fail, the risk of a costly rescue plan for investors (bail-in) is also lowered, as is the risk of needing recourse to deposit insurance. In this sense, the draft regulations can be considered a fourth pillar of the banking union.

For more information:

- Antonin C. and V. Touzé V. (2013), [The law on the separation of banking activities: political symbol or new economic paradigm?](#), OFCE Blog, 26 February 2013.
- Avaro M. and H. Sterdyniak H. (2012), [Banking union: a solution to the euro crisis?](#), OFCE Blog, 10 July 2012.
- Gaffard J.-L. and J.-P. Pollin (2013), [Is it pointless to separate banking activities?](#), OFCE Blog, 19 November 2013.

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.

France: why such zeal?

By Marion Cochard and Danielle Schweisguth

On 29 May, the European Commission sent the members of the European Union its new economic policy recommendations. As part of this, the Commission granted France an additional two years to reach the deficit reduction target of 3%. This target is now set for 2015, and to achieve this the European Commission is calling for fiscal impulses of -1.3 GDP points in 2013 and -0.8 point in 2014 (see [“Austerity in Europe: a change of course?”](#)). This would ease the structural effort needed, since the implementation of the previous commitments would have required impulses of -2.1 and -1.3 GDP points for

2013 and 2014, respectively.

Despite this, the French government has chosen not to relax its austerity policy and is keeping in place all the measures announced in the draft Finance Act (PLF) of autumn 2012. The continuing austerity measures go well beyond the Commission's recommendations: a negative fiscal impulse of -1.8 GDP point, including a 1.4 percentage point increase in the tax burden for the year 2013 alone. Worse, the broad guidelines for the 2014 budget presented by the government to Parliament on 2 July 2013 point to a structural effort of 20 billion euros for 2014, *i.e.* one percentage point of GDP, whereas the Commission required only 0.8 point. The government is thus demanding an additional 0.6 GDP point fiscal cut, which it had already set out in the multi-year spending program in the 2013 Finance Act.

The table below helps to provide an overview of the effort and of its impact on the French economy. It shows the trends in growth, in unemployment and in the government deficit in 2013 and 2014, according to three budget strategies:

1. One using the relaxation recommended by the Commission in May 2013;
2. One based on the budget approved by the government for 2013 and, *a priori*, for 2014;
3. One based on an alternative scenario that takes into account the negative 1.8 GDP point fiscal impulse for 2013 and calculates a fiscal impulse for 2014 that would be sufficient to meet the European Commission's public deficit target of -3.6%.

The different scenarios for deficit reduction in France

In %

| | Relaxation (1) | | Approved budget (2) | | Alternative scenario (3) | |
|-------------------|----------------|------|---------------------|------|--------------------------|------|
| | 2013 | 2014 | 2013 | 2014 | 2013 | 2014 |
| Fiscal impulse | -1.3 | -0.8 | -1.8 | -1.0 | -1.8 | -0.2 |
| Unemployment rate | 10.5 | 10.6 | 10.7 | 11.1 | 10.7 | 10.5 |
| Growth | 0.2 | 1.3 | -0.2 | 1.0 | -0.2 | 1.7 |
| Public deficit | -4.3 | -3.6 | -3.9 | -3.1 | -3.9 | -3.6 |

Source : Authors' calculations based on the iAGS model.

According to our estimates using the iAGS model [\[1\]](#), the public deficit would be cut to 3.1% of GDP in 2014 in scenario (2), whereas the Commission requires only 3.6%. As a consequence of this excess of zeal, the cumulative growth for 2013 and 2014 if the approved budget is applied would be 0.7 percentage point lower than growth in the other two scenarios (0.8 point against 1.5 points). The corollary is an increase in unemployment in 2013 and 2014: the unemployment rate, around 9.9% in 2012, would thus rise to 11.1% in 2014, an increase of more than 350,000 unemployed for the period. In contrast, the more relaxed scenario from the European Commission would see a quasi-stabilization of unemployment in 2013, while the alternative scenario would make it possible to reverse the trend in unemployment in 2014.

While the failure of austerity policy in recent years seems to be gradually impinging on the position of the European Commission, the French government is persisting along its same old path. In the face of the social emergency that the country is facing and the paradigm shift that seems to be taking hold in most international institutions, the French government is choosing to stick to its 3% fetish.

[\[1\]](#) iAGS stands for the Independent Annual Growth Survey. This is a simplified model of the eleven main economies in the euro zone (Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Netherlands, Portugal and Spain). For more

detail, see the working document [Model for euro area medium term projections](#).

The strange forecasts of the European Commission for 2014

By [Mathieu Plane](#)

The figures for French growth for 2014 published by the European Commission (EC) in its last report in May 2013 appear to reflect a relative consensus. Indeed, [the Commission expects GDP to grow by 1.1% in 2014](#), which is relatively close to the forecasts by [the OECD \(1.3%\)](#) and [the IMF \(0.9%\)](#) (Table 1). However, these forecasts of broadly similar growth hide some substantial differences. First, in defining future fiscal policy, the Commission, unlike the other institutions, considers only the measures already approved. While the Commission's growth forecasts for 2013 included the measures enacted by the Finance Act for 2013 (and therefore the austerity measures), the forecasts for 2014 do not include any forthcoming fiscal measure, even though according to [the stability programme submitted to Brussels in April 2013](#) the government plans austerity measures amounting to 20 billion euros in 2014 (a fiscal impulse of -1 GDP point). The exercise carried out by the Commission for 2014 is thus closer to an economic framework than an actual forecast, as it fails to include the most likely fiscal policy for the year. As a result, the French government has no reason to rely on the Commission's growth forecast for 2014 as it makes radically different assumptions about fiscal policy. But beyond this difference, there is also a problem with the overall coherence of the economic framework set out by the Commission for 2014.

It is indeed difficult to understand how for 2014 the Commission can forecast an increase in the unemployment rate with a significantly worsened output gap and a positive fiscal impulse.

Overall, all the institutions share the idea that the output gap in France is currently very wide, lying somewhere between -3.4 percent of GDP (for the EC) and -4.3 percent (for the OECD) in 2013 (Table 1). Everyone thus believes that current GDP is very far from its long-term trajectory, and this deficit in activity should therefore lead, in the absence of an external shock or a constraint on fiscal and monetary policy, to a spontaneous catch-up in growth in the coming years. This should result in a growth rate that is higher than the potential, regardless of the latter's value. So logically, if there is a neutral or positive fiscal stimulus, GDP growth should therefore be much greater than the trend potential. For the IMF, the negative fiscal impulse (-0.2 percent of GDP) is more than offset by the spontaneous catch-up of the economy, resulting in a slight closing of the output gap (0.2) in 2014. For the OECD, the strongly negative fiscal impulse (-0.7 percent of GDP) does not allow closure of the output gap, which continues to widen (-0.3), but less than the negative impact of the impulse due to the spontaneous process of catching up. In both these cases (OECD and IMF), the restrictive fiscal policy holds back growth but leads to an improvement in the public accounts in 2014 (0.5 percent of GDP for the OECD and 0.3 for the IMF).



As for the Commission, its budget forecasts include a positive fiscal impulse for France in 2014 (+0.4 GDP point). As we saw above, the Commission takes into account only the fiscal measures already approved that affect 2014. However, for 2014, if no new fiscal measures are taken, the tax burden should spontaneously decrease due to the fall between 2013 and 2014

[in the yield of certain tax measures or the partial financing of other measures \(such as the CICE Tax credit for competitiveness and jobs\)](#). This could of course result in a positive fiscal impulse in 2014. But despite this impact, which is similar to a stimulus policy (on a small scale), the closure of the output gap (0.1 percent of GDP) is less than the fiscal impulse. This suggests implicitly that fiscal policy has no effect on activity and especially that there is no spontaneous catch-up possible for the French economy despite the very large output gap. But it is not clear why this is the case. Suddenly, the government balance deteriorates in 2014 (-0.3 percent of GDP) and the unemployment rate rises by 0.3 percentage points (which may seem paradoxical with an output gap that doesn't worsen). The French economy is thus losing on all fronts according to the major macroeconomic indicators.

In view of the potential growth, the output gaps and the fiscal impulses adopted by the Commission (the OECD and the IMF), and based on incorporating relatively standard assumptions ([a short-term fiscal multiplier equal to 1](#) and spontaneous closure of the output gap in 5 years), one would have expected the Commission to go for growth in France in 2014 of 2.1% (1.7% for the OECD and 1.2% for the IMF), and thus a steep reduction in unemployment.

Paradoxically, we do not find this same logic in the Commission's forecasts for Germany and the euro zone as a whole (Table 2). In the case of Germany, despite a slight deterioration in the output gap in 2013 (-1 GDP point), which would normally point to some spontaneous catch-up by the German economy in 2014, and an almost neutral fiscal impulse (0.1 GDP point), Germany's growth in 2014 is expected to be 1.8%, thus permitting the output gap to close by 0.5 GDP point, resulting in a fall in the unemployment rate and a reduction in Germany's public deficit in 2014.

In the case of the euro zone, we find the same scenario: a

marginally positive fiscal impulse (0.2 percent of GDP) and a rapid reduction in the output gap (0.7 percent of GDP), which translates both into an improvement in the public accounts despite the positive fiscal impulse and a fall in the unemployment rate (even if we would have expected a greater reduction in the latter in light of the improvement in the output gap).

Given the potential growth, the output gaps and the fiscal impulses adopted for each country by the Commission, the forecast for 2014 could have been for growth of 2.1% in France, 1.6% in Germany and 1.3% for the euro zone.



Finally, why would France, despite a greater output gap than Germany and the euro zone and a stronger positive fiscal impulse, experience an increase in its unemployment rate in 2014 while the rate falls in the other countries? Should we interpret this as reflecting that it is a problem or even impossible for the Commission to include in a forecast that a policy without fiscal consolidation could lead to growth and reduce unemployment spontaneously in France?

Cyprus: a well-conceived plan, a country in ruins...

By [Anne-Laure Delatte](#) and [Henri Sterdyniak](#)

The plan that has just been adopted sounds the death knell for

the banking haven in Cyprus and implements a new principle for crisis resolution in the euro zone: banks must be saved by the shareholders and creditors without using public money. [\[1\]](#) This principle is fair. Nevertheless, the recession in Cyprus will be deep, and the new extension of the Troika's powers further discredits the European project. Once again the latest developments in the crisis are laying bare the deficiencies in euro zone governance. It is necessary to save the euro zone almost every quarter, but every rescue renders the zone's structure even more fragile.

Cyprus never should have been accepted into the euro zone. But Europe privileged expansion over coherence and depth. Cyprus is a banking, tax and regulatory haven, which taxes companies at the rate of only 10%, while the balance sheet of its oversized banking system is nearly eight times its GDP (18 billion euros). Cyprus is in fact a transit hub for Russian capital: the Cypriot banks have about 20 billion euros in deposits from Russia, along with 12 billion euros in deposits of Russian banks. These funds, sometimes of dubious origin, are often reinvested in Russia: Cyprus is the largest foreign investor in Russia, to the tune of about 13 billion euros per year. Thus, by passing through Cyprus, some Russian capital is laundered and legally secured. As Europe is very committed to the principle of the free movement of capital and the freedom of establishment, it has simply let this go.

Having invested in Greek government debt and granted loans to Greek companies that are unable to pay due to the crisis, the island's oversized banking system has lost a lot of money and has fostered a housing bubble that burst, resulting in heavy losses. Given the size of the banking system's balance sheet, these losses represent a significant share of national GDP. The banking system is in trouble, and as a consequence the markets speculated against Cypriot government debt, interest rates rose, the country plunged into a recession, and the deficit deepened. In 2012, growth was negative (-2.5%); the

deficit has reached 5.5% of GDP, the public debt has risen to 87% of GDP, the trade deficit stands at 6% of GDP, and the unemployment rate is 14.7%.

The country needed assistance both to finance itself and to recapitalize its banks. Cyprus requested 17 billion euros, the equivalent of its annual GDP. Ten billion euros of loans were granted, of which nine will be provided by the ESM and one by the IMF. From a financial point of view, the EU certainly did not need that billion, which merely gives the IMF a place at the negotiating table.

In exchange, Cyprus will have to comply with the requirements of the Troika, *i.e.* reductions of 15% in civil servant salaries and 10% in spending on social welfare (pensions, family allowances and unemployment), the introduction of structural reforms, and privatization. It is the fourth country in Europe to be managed by the Troika, which can once again impose its dogmatic recipes.

Cyprus is to lift its tax rate on corporations from 10 to 12.5%, which is low, but Europe could not ask Cyprus to do more than Ireland. Cyprus must increase the tax rate on bank interest from 15 to 30%. This is a timid step in the direction of the necessary tax harmonization.

But what about the banks? The countries of Europe were faced with a difficult choice:

- helping Cyprus to save its banking system amounted to saving Russian capital with European taxpayers' money, and showed that Europe would cover all the abuses of its Member States, which would have poured more fuel on the fire in Germany, Finland and the Netherlands.

- asking Cyprus to recapitalize its banks itself would push its public debt up to more than 150% of GDP, an unsustainable level.

The first plan, released on 16 March, called for a 6.75% contribution from deposits of less than 100,000 euros and applied a levy of only 9.9% on the share of deposits exceeding this amount. In the mind of the Cypriot government, this arrangement had the advantage of not so heavily compromising the future of Cyprus as a base of Russian capital. But it called into question the commitment by the EU (the guarantee of deposits under 100,000 euros), which undermined all the banks in the euro zone.

Europe finally reached the right decision: not to make the people alone pay, to respect the guarantee of 100,000 euros, but to make the banks' shareholders pay, along with their creditors and holders of deposits of over 100,000 euros. It is legitimate to include those with large deposits that had been remunerated at high interest rates. It is the model of Iceland, and not Ireland, that has been adopted: in case of banking difficulties, large deposits remunerated at high rates should not be treated as public debt, at the expense of the taxpayers.

Under the second plan, the country's two largest banks, the Bank of Cyprus (BOC) and Laiki, which together account for 80% of the country's bank assets, are being restructured. Laiki, which was hit hardest by developments in Greece and which was more heavily involved in the collection of Russian deposits, has been closed, with deposits of less than 100,000 euros transferred to the BOC, which takes over Laiki's assets, while it also takes charge of the 9 billion euros that the ECB has lent it. Laiki customers lose the portion of their deposits over 100,000 euros (4.2 billion), while holders of Laiki equities and bonds lose everything. At the BOC, the excesses of deposits above 100,000 euros are placed in a bad bank and frozen until the restructuring of the BOC is completed, and a portion of these (up to 40%) will be converted into BOC shares in order to recapitalize the bank. Hence the 10 billion euro loan from the EU will not be used to resolve the banking

problem. It will instead allow the government to repay its private creditors and avoid a sovereign bankruptcy. Remember that the national and European taxpayers are not called on to repair the excesses of the world of finance.

This is also a first application of the banking union. Deposits are indeed guaranteed up to 100,000 euros. As requested by the German government, the banks must be saved by the shareholders and creditors, without public money. The cost of bailing out the banks should be borne by those who have benefited from the system when it was generating benefits.

From our viewpoint, the great advantage is ending the poorly controlled financial status of Cyprus. It is a healthy precedent that will discourage cross-border investment. It is of course regrettable that Europe is not attacking other countries whose banking and financial systems are also oversized (Malta, Luxembourg, the United Kingdom) and other regulatory and tax havens (the Channel Islands, Ireland, the Netherlands), but it is a first step.

This plan is thus well thought-out. But as was modestly acknowledged by the Vice-President of the European Commission, Olli Rehn, the near future will be very difficult for Cyprus and its people. What are the risks?

Risk of a deposit flight and liquidity crisis: unlike the initial plan, which called for a levy on all deposits, the new plan is consistent with reopening the banks relatively quickly. In fact, the banks are staying closed as long as the authorities fear massive withdrawals by depositors, which would automatically lead to a liquidity crisis for the banks concerned. However, as small depositors are not affected and large depositors have their assets frozen until further notice, it seems that the risk of a bank run can be ruled out. A problem will nevertheless arise when the large deposits are unfrozen. Their almost certain withdrawal will very likely result in a loss of liquidity for the BOC, which will

need to be compensated by specially provided liquidity lines at the ECB. Some small depositors who take fright could also withdraw their funds. Similarly, holders of large deposits in other banks, although in less difficulty and thus not affected, could worry that the levies will be extended in the future and therefore try to move their money abroad. Cyprus remains at the mercy of a liquidity crisis. This is why the authorities have announced exceptional controls on capital movements when the banks reopen, so as to prevent a massive flight of deposits abroad. This is a novelty for the EU. But the transition, which means shrinking the Cypriot banking sector from 8 times the island's GDP to 3.5 times, could well prove difficult and may have some contagion effects on the European markets, since the banks will have to sell a significant amount of assets.

Risk of a long recession: the halving of the size of the banking sector will not take place painlessly, as the entire economy will suffer: bank employees, service partners, attorneys, consultants, auditors, etc. Some Cypriot companies, along with some wealthy households, will lose part of their bank holdings.

However, the plan requires simultaneous fiscal austerity measures (on the order of 4.5% of GDP), structural reforms and the privatizations so dear to Europe's institutions. These austerity measures, coming at a time when key economic activity is being sacrificed, will lead to a lengthy recession. The Cypriots all have in mind the example of Greece, where consumption has fallen by more than 30% and GDP by over 25%. This shrinkage will lead to lower tax revenues, a higher debt ratio, etc. Europe will then demand more austerity measures. Seeing another country trapped in this spiral will further discredit the European project.

Some desire to pull out of the euro zone has been simmering since the beginning of the crisis in Cyprus, and there is little chance that it will die out now.

It is therefore necessary to give new opportunities to Cyprus (and to Greece and Portugal and Spain), not the economic and social ruin imposed by the Troika, but an economic revival involving a plan for industrial reconversion and reconstruction. For example, the exploitation of the gas fields discovered in 2011 on the south of the island could offer a way out of the crisis. It would still be necessary to finance the investment required to exploit them and generate the financial resources the country needs. It is time to mobilize genuine assistance, a new Marshall Plan financed by the countries running a surplus.

Risk of chain reactions in the banking systems of other Member States: the European authorities must make a major effort at communications to explain this plan, and that is not easy. From this point of view, the first plan was a disaster, as it demonstrated that the guarantee of deposits of less than 100,000 euros can be annulled by tax measures. For the second plan, the authorities must simultaneously explain that the plan is consistent with the principle of the banking union – to make the shareholders, creditors and major depositors pay – while clarifying that it has a specific character – to put an end to a bank, fiscal and regulatory haven, and so will not apply to other countries. Let's hope that the shareholders, creditors and major depositors in the banks in the other Member States, particularly Spain, will allow themselves to be convinced. Otherwise significant amounts of capital will flee the euro zone.

Risk of weakening the banking union: the Cypriot banking system was of course poorly managed and controlled. It took unnecessary risks by attracting deposits at high rates that it used to make profitable but risky loans, many of which have failed. But the Cypriot banks are also victims of the default on the Greek debt and of the deep-going recession faced by their neighbours. All of Europe is in danger of falling like dominoes: the recession weakens the banks, which can no longer

lend, which accentuates the recession, and so on.

Europe plans to establish a banking union that will impose strict standards for banks with respect to crisis resolution measures. Each bank will have to write a "living will" requiring that any losses be borne by its shareholders, creditors and major depositors. The handling of the Cyprus crisis is an illustration of this. Also, the banks that need capital, creditors and deposits to comply with the constraints of Basel III will find it harder to attract them and must pay them high rates that incorporate risk premiums.

The banking union will not be a bed of roses. Bank balance sheets will need to be cleaned up before they get a collective guarantee. This will pose a problem in many countries whose banking sector needs to be reduced and restructured, with all the social and economic problems that entails (Spain, Malta, Slovenia, etc.). There will inevitably be conflicts between the ECB and the countries concerned.

Deposit insurance will long remain the responsibility of the individual country. In any event, it will be necessary in the future banking union to distinguish clearly between deposits guaranteed by public money (which must be reimbursed at limited rates and must not be placed on financial markets) and all the rest. This argues for a rapid implementation of the Liikanen report. But will there be an agreement in Europe on the future structure of the banking sector between countries whose banking systems are so very different?

The Cypriot banks lost heavily in Greece. This argues once again for some re-nationalization of banking activities. Banks run great risks when lending on large foreign markets with which they are not familiar. Allowing banks to attract deposits from non-residents by offering high interest rates or tax or regulatory concessions leads to failures. The banking union must choose between the freedom of establishment (any bank can move freely within the EU countries and conduct

whatever activities it chooses) and the principle of liability (countries are responsible for their banking systems, whose size must stay in line with that of the country itself).

In the coming years, the necessary restructuring of the European banking system thus risks undermining the ability of banks to dispense credit at a time when businesses are already reluctant to invest and when countries are being forced to implement drastic austerity plans.

In sum, the principle of making the financial sector pay for its excesses is beginning to take shape in Europe. Unfortunately, the Cyprus crisis shows once again the inconsistencies of European governance: to trigger European solidarity, things had to slide to the very edge, at the risk of going right over the cliff. Furthermore, this solidarity could plunge Cyprus into misery. The lessons of the past three years do not seem to have been fully drawn by Europe's leaders.

[\[1\]](#) The over 50% reduction of the face value of Greek bonds held by private agents in February 2012 already went in this direction.

So far so good ...

By [Christophe Blot](#)

The euro zone is still in recession. According to Eurostat, GDP fell again in the fourth quarter of 2012 (-0.6%). This figure, which was below expectations, is the worst quarterly performance in the euro zone since the first quarter of 2009,

and it is also the fifth consecutive quarter of a decline in activity. For 2012 as a whole, GDP decreased by 0.5%. This annual figure masks substantial heterogeneity in the zone (Figures 1 and 2), since Germany posted annual growth of 0.9% while for the second consecutive year Greece is likely to suffer a recession of more than 6%. Moreover, taking all the countries together, the growth rate will be lower in 2012 than in 2011, and some countries (Spain and Italy to name but two) will sink deeper into depression. This performance is all the more worrying as several months of renewed optimism had aroused hopes that the euro zone was recovering from the crisis. Were there grounds for such hope?

Although it is very cautious about growth for 2012, the European Commission, in its [annual report](#) on growth, noted the return of some good news. In particular, the fall in long-term sovereign rates in Spain and Italy and the success on the financial markets of the public debt issues by Ireland and Portugal reflected renewed confidence. It is clear now however that confidence is not enough. Domestic demand has stalled in France and is in freefall in Spain. All this is hurting trade within the zone, since a decline in imports by one country means a decline in exports from others, which is amplifying the recessive dynamics afflicting the countries in the zone as a whole. As we noted in our [previous forecasting exercise](#) and on the occasion of the publication of the [iAGS](#) (independent Annual Growth Survey), a recovery cannot in any case rely solely on a return of confidence so long as highly restrictive fiscal policies are being carried out synchronously throughout Europe.

Since the third quarter of 2011, the signals have all confirmed our scenario and showed that the euro zone has gradually sunk into a new recession. Unemployment has continued to rise, setting new records every month. In December 2012, according to Eurostat 11.7% of the euro zone working population were jobless. However, neither the European

Commission nor the European governments have adjusted their fiscal strategy, arguing that fiscal efforts were needed to restore credibility and confidence, which would in turn lower interest rates and create a healthy environment for future growth. In doing this, the Commission has systematically underestimated the recessionary impact of the fiscal consolidation measures and has ignored the increasingly abundant literature showing that the multipliers rise in times of crisis and may be substantially higher than one (see the post by [Eric Heyer](#) on this subject). Advocates of fiscal austerity also believe that the costs of such a strategy are inevitable and temporary. They view fiscal consolidation as a prerequisite for a return to growth and downplay the long-term costs of such a strategy.

This dogmatic blindness recalls the final comment in the film *La Haine* (directed by Mathieu Kassovitz): “This is the story of a society that is falling, and to reassure itself as it falls constantly repeats, so far so good, so far so good, so far so good ... what’s important is not the fall, it’s the landing.” It is time to recognize that the economic policy in force since 2011 has been a mistake. It is not creating the conditions for a recovery. Worse, it is directly responsible for the return of recession and for the social catastrophe that is continuing to deepen in Europe. As we have shown, other strategies are possible. They do not neglect the importance of eventually making the public finances sustainable once again. By postponing and reducing the scale of austerity (see the note by [Marion Cochard, Bruno Ducoudré and Danielle Schweisguth](#)), it would be possible to make more rapid progress in restoring growth and cutting unemployment.



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

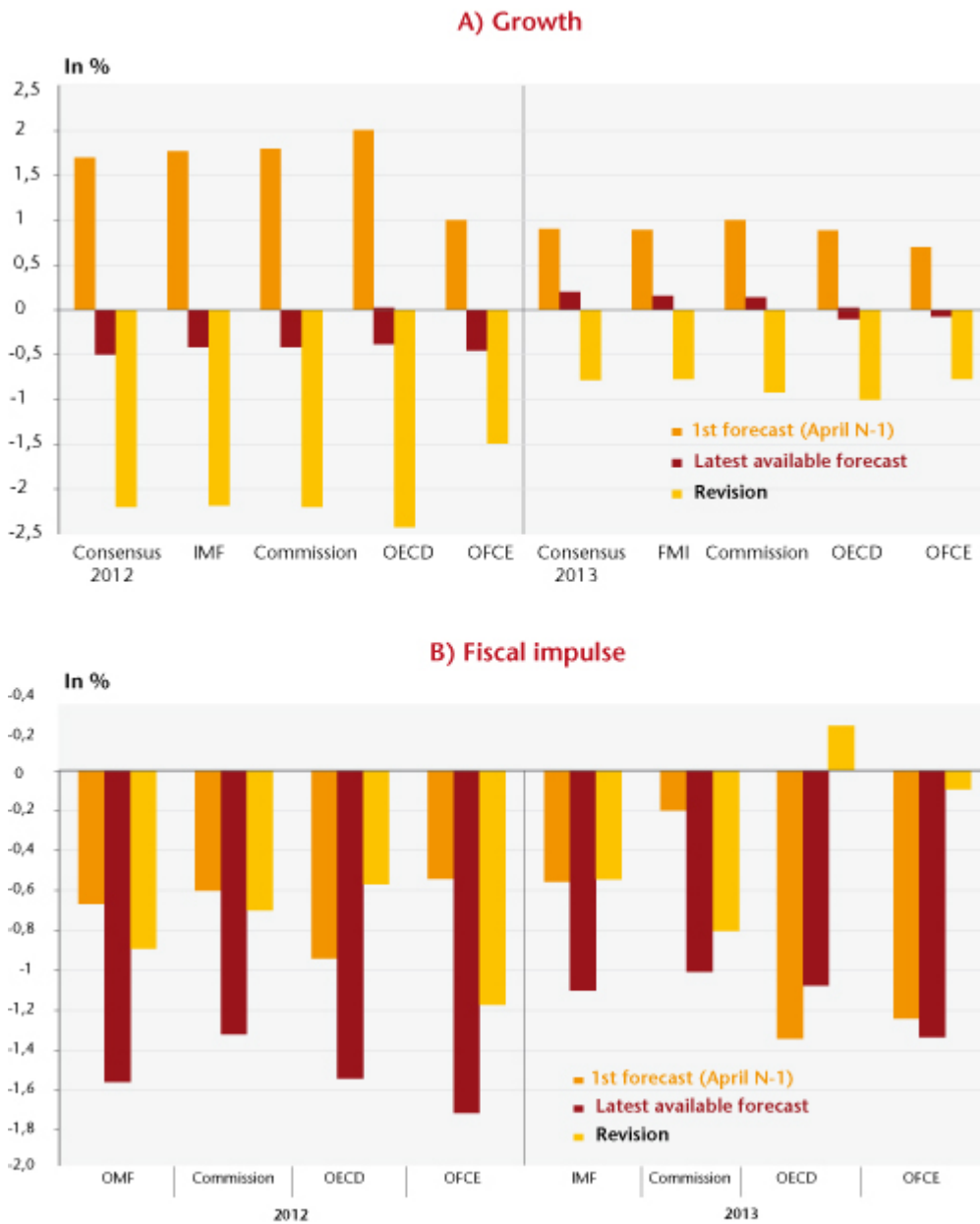
upward revision of the multipliers used in the forecasting exercises? These institutions do not generally specify the size of the multipliers used in their forecasting. An analysis of the revisions to the forecasts for the euro zone in 2012 and 2013 can, however, tell us the extent to which the multipliers 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

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

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 $\Delta e = 0$. 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 | | | | | |
|--|------|--------------------------------|---------------------|---------------------|------------------|-------|-------|
| | | $\Delta \hat{g}$ | $\Delta k \cdot IB$ | $k \cdot \Delta IB$ | $\Delta \hat{e}$ | k_e | k_s |
| 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 | | | | | | | |
| | | $\Delta \hat{g}$ | $\Delta k \cdot IB$ | $k \cdot \Delta IB$ | $\Delta \hat{e}$ | k_e | k_s |
| 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 | | | | | | | |
| | | $\Delta \hat{g}$ | $\Delta k \cdot IB$ | $k \cdot \Delta IB$ | $\Delta \hat{e}$ | k_e | k_s |
| 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 | | | | | | | |
| | | $\Delta \hat{g}$ | $\Delta k \cdot IB$ | $k \cdot \Delta IB$ | $\Delta \hat{e}$ | k_e | k_s |
| 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.

[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.

[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.”

[\[iii\]](#) 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.”

iAGS, independent Annual Growth Survey 2013

by OFCE (Paris), ECLM (Copenhagen) and IMK (Düsseldorf)

The independent Annual Growth Survey (iAGS) brings together a group of internationally competitive economists from three European economic institutes to provide an independent alternative to the Annual Growth Survey (AGS) published by the European Commission. [iAGS 2013](#) focuses on the Eurozone economic outlook and on the sustainability of public finances until 2032. This first report advocates delaying and spreading fiscal consolidation in due respect of current EU fiscal rules.

Four years after the start of the Great Recession, the euro area remains in crisis. GDP and GDP per head are below their pre-crisis level. The unemployment rate has reached a historical record level of 11.6 % of the labour force in September 2012, the most dramatic reflection of the long lasting social despair that the Great Recession produced. The sustainability of public debt is a major concern for national governments, the European Commission and financial markets, but successive and large consolidation programmes have proven unsuccessful in tackling this issue. Up to now, asserting that austerity was the only possible strategy to get out of this dead end has been the cornerstone of policymakers' message to European citizens. But this assertion is based on a fallacious diagnosis according to which the crisis stems from the fiscal profligacy of members states. For the Euro area as a whole, fiscal policy is not the origin of the problem. Higher deficits and debts were a necessary reaction by governments facing the worst recession since WWII. The fiscal response was successful in two respects: it stopped the recession process and dampened the financial crisis. As a consequence, it led to a sharp rise in the public debt of all Euro area countries.

During normal times, sustainability of public debt is a long-term issue whereas unemployment and growth are short-term ones. Yet, fearing an alleged imminent surge in interest rates and constrained by the Stability and Growth Pact, though transition towards more normal times had not been completed, member states and the European Commission reversed priorities. This choice partly reflects well-known pitfalls in the institutional framework of EMU. But it is equally reflecting a dogmatic view in which fiscal policy is incapable of demand management and the scope of public administrations has to be fettered and limited. This ideology has led member states to implement massive fiscal austerity during bad times.

As it is clear now, this strategy is deeply flawed. Eurozone countries and especially Southern European countries have undertaken ill-designed and precipitous consolidation. The austerity measures have reached a dimension that was never observed in the history of fiscal policy. The cumulative change in the fiscal stance for Greece from 2010 to 2012 amounts to 18 points of GDP. For Portugal, Spain and Italy, it has reached respectively 7.5, 6.5 and 4.8 points of GDP. The consolidation has rapidly become synchronized leading to negative spillovers over the whole euro area, amplifying its first-round effects. The reduction in economic growth in turn makes sustainability of public debt ever less likely. Thus austerity has been clearly self-defeating as the path of reduction of public deficits has been by far disappointing regarding the initial targets defined by member states and the Commission.

Since spring 2011 unemployment within the EU-27 and the Euro zone has begun to increase rapidly and in the past year alone unemployment has increased by 2 million people. Youth unemployment has also increased dramatically during the crisis. In the second quarter of 2012 9.2 million young people in the age of 15-29 years were unemployed, which corresponds to 17.7 percent of the 15-29 years old in the workforce and

accounts for 36.7 percent of all unemployed in the EU-27. Youth unemployment has increased more dramatically than the overall unemployment rate within the EU. The same tendencies are seen for the low skilled workers. From past experience it is well known that once unemployment has risen to a high level it has a tendency to remain high the years after. This is known as persistence. Along with the rise in unemployment the first symptoms that unemployment will remain high in the coming years are already visible. In the second quarter of 2012 almost 11 million people in EU had been unemployed for a year or longer. Within the last year long term unemployment has increased with 1.4 million people in the EU-27 and with 1.2 million people within the Euro area.

As a result of long term unemployment the effective size of the workforce is diminished which in the end can lead to a higher structural level in unemployment. This will make more difficult to generate growth and healthy public finances within the EU in the medium term. Besides the effect of long term unemployment on potential growth and public finances one should also add that long term unemployment may cause increased poverty because sooner than expected unemployment benefits will stop. Thus long term unemployment may also become a deep social issue for the European society. Given our forecast for unemployment in EU and the Euro area, we estimate that long term unemployment can reach 12 million in EU and 9 million in the Euro area at the end of 2013.

What is striking is that consequences of ill-designed consolidation could and should have been expected. Instead, they have been largely underestimated. Growing theoretical and empirical evidence according to which the size of multipliers is magnified in a fragile situation has been overlooked. Concretely, whereas in normal times, that is when the output gap is close to zero, a reduction of one point of GDP of the structural deficit reduces activity by a range of 0.5 to 1% (this is the fiscal multiplier), this effect exceeds 1.5% in

bad times and may even reach 2% when the economic climate is strongly deteriorated. All the features (recession, monetary policy at the zero bound, no offsetting devaluation, austerity amongst key trading partners) known to generate higher-than-normal multipliers were in place in the euro area.

The recovery that had been observed from the end of 2009 was brought to a halt. The Euro area entered a new recession in the third quarter of 2011 and the situation is not expected to improve: GDP is forecast to decrease by 0.4 % in 2012 and again by 0.3 % in 2013. Italy, Spain, Portugal and Greece seem to sink in an endless depression. The unemployment soared to a record level in the Eurozone and especially in Spain, Greece, Portugal and Ireland. Confidence of households, non financial companies and financial markets has collapsed again. Interest rates have not receded and governments of Southern countries still face unsustainable risk premium on their interest rate, despite some policy initiatives, while Germany, Austria or France benefit from historically low interest rates.

Rather than focus on public deficits the underlying cause of the crisis needs to be addressed. The euro area suffered primarily from a balance of payments crisis due to the build-up of current account imbalances between its members. When the financial flows needed to finance these imbalances dried up the crisis took hold in the form of a liquidity crisis. Attempts should have been made to adjust nominal wages and prices in a balanced way, with minimal harm to demand, output and employment. Instead salvation was sought in across-the-board austerity, forcing down demand, wages and prices by driving up unemployment.

Even if some fiscal consolidation was almost certainly a necessary part of a rebalancing strategy to curb past excesses in some countries, it was vital that those countries with large surpluses, especially Germany, took symmetrical action to stimulate demand and ensure faster growth of nominal wages and prices. Instead the adjustment burden was thrust on the

deficit countries. Some progress has been made in addressing competitive imbalances, but the cost has been huge. Failure to ensure a balanced response from surplus countries is also increasing the overall trade surplus of the euro area. This is unlikely to be a sustainable solution as it shifts the adjustment on to non-euro countries and will provoke counteractions.

There is a pressing need for a public debate on such vital issues. Policymakers have largely ignored dissenting voices, even as they have grown louder. The decisions on the present macroeconomic strategy for the Euro area should not be seized exclusively by the European Commission at this very moment, for the new EU fiscal framework leaves Euro area countries some leeway. Firstly, countries may invoke exceptional circumstances as they face *“an unusual event outside the control of the (MS) which has a major impact on the financial position of the general government or periods of severe economic downturn as set out in the revised SGP (...)”*. Secondly, the path of consolidation may be eased for countries with excessive deficits, since it is stated that *“in its recommendation, the Council shall request that the MS achieves annual budgetary targets which, on the basis of the forecast underpinning the recommendation, are consistent with a minimum annual improvement of at least 0.5 % of GDP as a benchmark, in its cyclically adjusted balance net of one-off and temporary measures, in order to ensure the correction of the excessive deficit within the deadline set in the recommendation”*. This is of course a minimum, but it would also be seen as a sufficient condition to bring back the deficit to Gdp ratio towards 3 % and the debt ratio towards 60 %.

A four-fold alternative strategy is thus necessary:

First, delaying and spreading the fiscal consolidation in due respect of current EU fiscal rules. Instead of austerity measures of nearly 100 billion euros for the whole euro area, a more balanced fiscal consolidation of 0.5 point of GDP, in

accordance with treaties and fiscal compact, would give for the sole 2013 year a concrete margin for manoeuvre of more than 60 billion euros. This amount would substantially contrast with the vows of the June and October 2012 European Councils to devote (still unbudgeted) 120 billion euros until 2020 within the Employment and Growth Pact. By delaying and capping the path of consolidation, the average growth for the Eurozone between 2013 and 2017 may be improved by 0.7 point per year.

Second, it involves that the ECB fully acts as a lender of last resort for the Euro area countries in order to relieve MS from the panic pressure stemming from financial markets. For panic to cease, EU must have a credible plan made clear to its creditors.

Third, significantly increasing lending by the European Investment Bank as well as other measures (notably the use of structural funds and project bonds), so as to meaningfully advance the European Union growth agenda. Vows reported above have to be transformed into concrete investments.

Fourth, a close coordination of economic policies should aim at reducing current accounts imbalances. The adjustment should not only rely on deficit countries. Germany and the Netherlands should also take measures to reduce their surpluses.