

France: Recovery ... at last!

By [Mathieu Plane](#), [Bruno Ducoudré](#), [Pierre Madec](#), Hervé Péléraux and Raul Sampognaro

[The OFCE's forecast for the French economy in 2015-2016 is now available.](#)

Not since the beginning of the subprime crisis has the French economy been in such a favourable situation for a recovery. The fall in oil prices, the ECB's proactive and innovative policy, the easing of fiscal consolidation in France and the euro zone, the gathering impact of the CICE tax and the implementation of the Responsibility Pact (representing a tax transfer to business of 23 billion euros in 2015 and nearly 33 billion in 2016) all point in the same direction. The main obstacles that have held back French activity over the last four years (over-calibrated fiscal austerity, a strong euro, tight financial conditions, and high oil prices) should all be out of the way in 2015 and 2016, with pent-up growth finally released. The supply policy being pushed by the government, whose impact on business is still pending, will be all the more effective thanks to the positive demand shock from foreign trade, which will allow the economic rebalancing that was lacking up to now.

French GDP will grow by 1.4% in 2015, with the pace accelerating in the course of the year (to 2% yoy). The second half of 2015 will mark the turning point in the recovery, with the corporate investment rate picking up and the unemployment rate beginning to fall, ending the year at 9.8% (after 10% in late 2014). 2016 will then be the year of recovery, with GDP growth of 2.1%, a 4% increase in productive investment and the creation of nearly 200,000 private sector jobs, pushing the unemployment rate down to 9.5% by end 2016. In this positive context, the public deficit will fall significantly, and is expected to be 3.1% of GDP in 2016 (after 3.7% in 2015).

Obviously this virtuous cycle will only take effect if the macroeconomic environment remains favourable (low oil prices, a competitive euro, no new financial tensions in the euro zone, etc.) and if the government limits itself to the budget savings already announced.

France: gradual adjustments (forecasts)

[2014-2015 outlook for the French economy](#)

By [Éric Heyer](#), Marion Cochard, [Bruno Ducoudré](#) and Hervé Péléraux

In 2013, the French economy grew at an annual average rate of 0.3%, which enabled it to return to the level it had reached six years ago, in early 2008. Between 2008 and early 2011, the economy had shown resilience in comparison with the performance of France's main partners. In the first quarter of 2011, the country's GDP had even come close to regaining its pre-crisis level, and lagged only slightly behind Germany and the United States. But the situation changed in the second quarter of 2011 as the austerity measures introduced in 2010 began to have an impact. The initial spurts of recovery seen after the recession were cut off. While the country did experience positive annual GDP growth, until 2013 this was close to zero. Ultimately, France is leaving this six-year period behind with an increased deficit that is still greater than the threshold of 3 GDP points. Fiscal consolidation has not proved very effective: the cost in terms of activity, unemployment and the financial situation for business has been

disproportionate to the results.

In recent months, the economic situation in Europe has clarified considerably, with a return to growth and a strengthening of the main economic indicators. Business surveys also show a return of confidence in the productive sectors in France.

The relaxation of austerity should enable the French economy to continue along this path, with growth in GDP gradually picking up pace in 2014 and 2015.

For 2014, if we consider only the measures already approved, the French economy would grow by 1.2%, a level that is insufficient to bring down unemployment or to hit the 3.6% deficit target. The announcement by Manuel Valls in his general policy ("DPG") speech on 8 April 2014 of additional austerity measures of 4 billion euros through a supplementary budget prior to the summer should allow the government to meet its deficit commitment. But this will inevitably hurt activity and reduce the growth expected for the French economy to 1%, bringing the unemployment rate to 10.2% of the workforce by year-end.

Table 1. Measures announced in the General Policy (DPG) speech by Manuel Valls on 8 April 2014

		Date implemented	Amount in bn euros	Multiplier	Impact on growth (%)
	CICE tax credit yr 1	1 Jan 2014	9	1,0	0,5
	CICE yr 2	1 Jan 2015	7	0,8	0,3
	CICE yr 3	1 Jan 2016	1	0,8	0,0
	CICE yr 4	1 Jan 2017	2	0,8	0,1
	CICE yr 5	1 Jan 2018	1	0,8	0,0
Responsibility Pact	Reductions on low wages	1 Jan 2015	4,5	0,9	0,2
	Reductions wages > 1.6 SMIC	1 Jan 2016	4,5	0,8	0,2
	Reductions free-lancers and artisans	1 Jan 2015	1	0,8	0,04
	TOTAL		30		1,4
Solidarity Pact	Reductions social contributions < 1.3 SMIC	1 Jan 2015	2,3	0,8	0,1
	Income tax reductions	2016-2017	2,7	0,7	0,1
	TOTAL		5		0,2
Tax base	Elimination of the C3S tax	2015	1		0,04
		2016-2017	4	0,8	0,16
	Elimination of the IS corporation surtax	2016	2,3	0,9	0,1
	Reduction in the IS corporation tax rate	Around 2020			

CICE = "Crédit d'impôt pour la compétitivité et l'emploi" (Tax credit for competitiveness and employment)

SMIC = French minimum wage

Sources: DPG speech, authors' calculations.

The DPG speech is also upsetting expectations for 2015: prior to this announcement we had forecast GDP growth of 1.6%. Companies would benefit from this renewed growth to gradually restore their financial positions. This strategy is based primarily on increasing productivity, which would help to reabsorb marginal production capacity and restore business margins. In this scenario, the public finances would also continue their gradual adjustment and the government deficit would come to 3% of GDP. As a corollary to the announced adjustment, the unemployment rate will continue to rise in 2015. The acceleration of the implementation of the Responsibility and Solidarity Pact promised in the DPG speech and the vagueness about how it will be funded may well affect the scenario set out above. Without new measures to cut public spending other than the 12 billion euros already included in our central scenario, the injection of 8.8 billion euros in

new measures (Table 1) would allow the French economy to achieve 2% growth in 2015, as it did in 2011. This growth, combined with the impact of reductions in social security contributions on low wages, would by the end of 2015 push the unemployment rate down to its end 2013 level of 9.8% of the labor force. The reduction in the fiscal stimulus to -0.1% of GDP, although partly offset by the impact of growth on tax revenues, will nevertheless take the scenario off the path set out by Brussels, with a public deficit of 3.2% of GDP. If new cost-cutting measures are taken to finance these new measures *ex ante* in 2015, then, given the higher fiscal multipliers for government spending, the positive impact on growth would vanish, and the general government deficit would surpass 3% (3.1% of GDP) and the unemployment rate would hit 10% at end 2015. This scenario appears worse than the central scenario with respect to public finances and growth, with the slight fall in the unemployment rate being due simply to the impact of reducing social contributions on low wages, leading to a larger proportion of low-wage jobs in total employment (Table 2).

Table 2. Summary of the forecast for 2014 and 2015

	2013	2014		2015		
		Before DPG	After DPG	Before DPG	After DPG	
					Not funded	Funded*
GDP (%)	0,3	1,2	1,0	1,6	2,0	1,5
Public deficit (% of GDP)	-4,3	-3,7	-3,6	-3,0	-3,2	-3,1
Unemployment rate*	9,8	10,0	10,1	10,1	9,8	10,0
Fiscal impulse	-1,2	-0,7	-0,9	-0,6	-0,1	-0,6

* It is assumed that the 9.3 billion euros in measures to reduce social contributions and income tax are financed by a reduction by the same amount in public spending, which would be added to the 50 billion already announced by the government.

Sources: INSEE, national accounts, authors' calculations.

Euro zone: Recovery or deflation?

By [Céline Antonin](#), [Christophe Blot](#), Sabine Le Bayon and Danielle Schweisguth

This text summarizes the [OFCE's forecast for 2014-2015 for the euro zone economy](#)

Will the euro zone embark on the road to recovery, or will it sink into a deflationary spiral? The latest macroeconomic indicators are sending out conflicting signals. A return to growth is being confirmed, with three consecutive quarters of rising GDP. However, the level of unemployment in the euro zone remains at a historically high level (11.9% for the month of February 2014), which is fuelling deflationary pressures, as is confirmed by the latest figures on inflation (0.5% yoy for March 2014). While this reduction in inflation is partly due to changes in energy prices, the fact remains that underlying inflation has fallen under 1% (Figure 1). In these conditions, a turnaround in inflationary expectations cannot be excluded, which would undoubtedly push the euro zone into deflation. The ECB has been concerned about this situation for several weeks and says it is ready to act (see [here](#)). However, no concrete proposal for a way to ease monetary policy and ensure that expectations are not anchored on a deflationary trajectory has been set out.

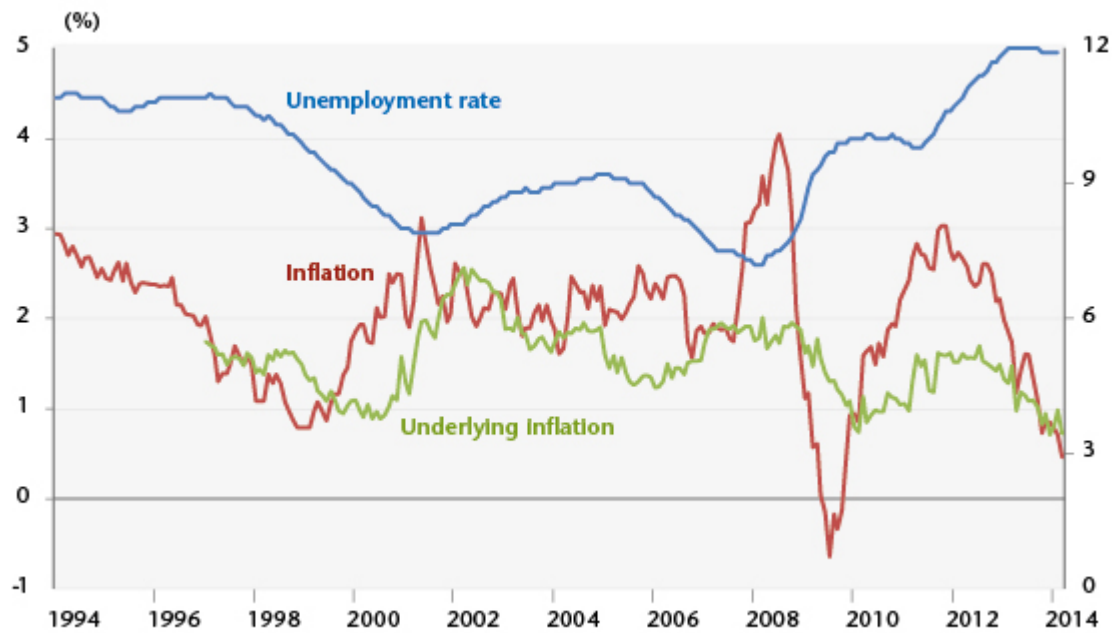
After a fall in GDP of 0.4% in 2013, the euro zone will return to positive growth: 1.3% in 2014 and 1.6% in 2015. Even so, at this rate of growth, there will still be an open output gap in most of the euro zone countries, reflecting the idea that the euro zone is only slowly pulling out of the crisis. Indeed, although efforts to reduce deficits will be curtailed, fiscal policies will still be pro-cyclical. Furthermore, financing conditions will continue to improve. The end of the sovereign

debt crisis, thanks in particular to the announcements by the ECB in July and September 2012 [\[1\]](#), has reduced the risk premiums on the market for government bonds. The impact of lower long-term market rates has been partly reflected in bank interest rates, and credit supply conditions are generally less restrictive than they were between early 2012 and mid-2013. But there will still not be sufficient growth to trigger a recovery strong enough to lead to a rapid and significant reduction in unemployment. Indeed, the level will fall only very moderately, from 11.9% in the first quarter of 2014 to 11.3% at year end 2015. While Germany will enjoy almost full employment, mass joblessness in Spain and the other countries of southern Europe will persist (Figure 2). Unemployment should stabilize in Italy and continue to grow in France.

However, this continuing underemployment is giving rise to the risk of deflation. It is holding back growth in wages and contributing to the weakness of underlying inflation, which was in fact zero in Spain in March 2013 and negative in Greece and Portugal. For the euro zone as a whole, we do not expect deflation in the short term, but the weakness of growth is increasing the likelihood that private agents' expectations are not anchored in a deflationary scenario.

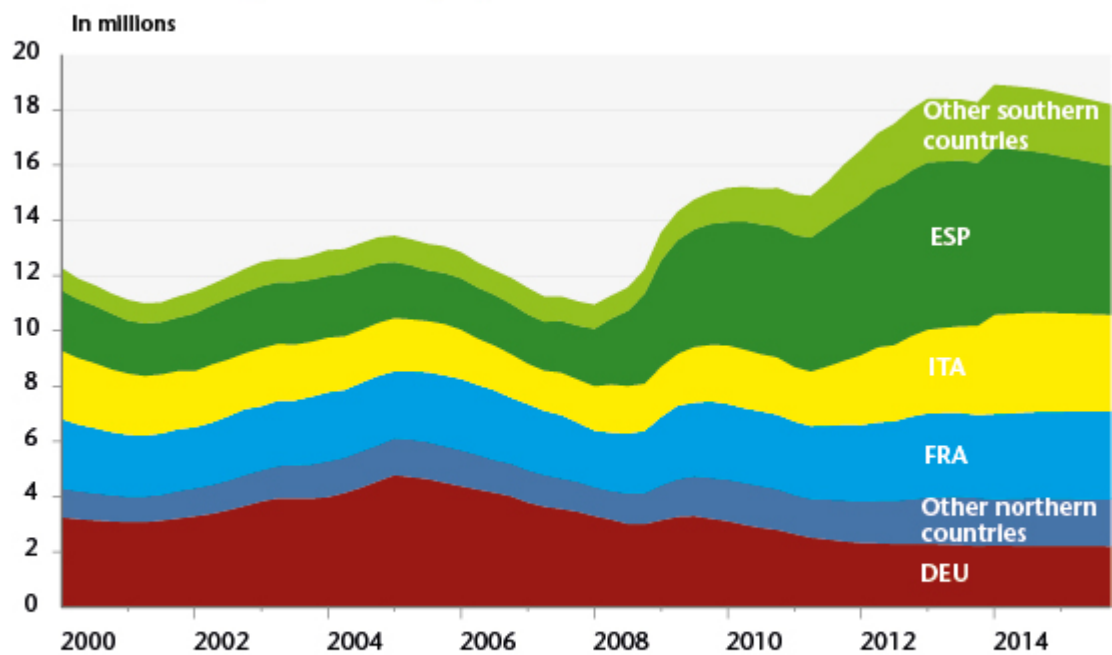
The situation in the euro zone is reminiscent of Japan in the 2000s. The country began to experience deflation in 1999 [\[2\]](#) following the recession associated with the Asian crisis. At that point, despite average growth of 1.4% between 2000 and 2006, prices failed to pick up, and the country's central bank did not find a way out of this trap, despite trying expansionary monetary policies. This is precisely the dynamic threatening the euro zone today, making it crucial to use all possible means to avoid this (monetary policy, fiscal policy and the coordination of wage policy [\[3\]](#)).

Figure 1. Unemployment rate and inflation rate in the euro zone



Source : Eurostat.

Figure 2. Unemployment in the euro zone countries



Note : The other southern countries are Portugal and Greece. The other northern countries are the Netherlands, Belgium, Ireland, Austria and Finland.

Sources : Eurostat, OFCE forecast April 2014.

[1] In July, ECB President Mario Draghi declared that the central bank would save the euro “whatever it takes”. In

September, the ECB announced the creation of a new mechanism called Outright Monetary Transactions (see the post by [Jérôme Creel and Xavier Timbeau](#)), which enables it to engage in unlimited purchases of sovereign debt.

[2] It should be pointed out that there was an initial period of deflation in 1995 following three years of economic stagnation.

[3] All these elements are discussed in detail in the previous [iAGS](#) report (2014).

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

By [Christophe Blot](#), [Jérôme Creel](#), and [Xavier Timbeau](#)

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

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

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

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

the multiplier effect during a period of austerity.

Table. Fiscal impulses in the euro area

In GDP points

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

Sources: Eurostat, National accounts.

If the fiscal multipliers are higher in times of crisis, then a rational reduction in the public debt implies the postponement of restrictive fiscal policies. We must first get out of the situation that is causing the increase in the multiplier, and once we are back into a “normal” situation then reduce the public debt through tighter fiscal policy. This is especially important as the reduction in activity induced by tightening fiscal policy may outweigh the fiscal effort. For a multiplier higher than 2, the budget deficit and public debt, instead of falling, could continue to grow, despite austerity. The case of Greece is instructive in this respect: despite *real* tax hikes and *real* spending cuts, and despite a partial restructuring of its public debt, the Greek government is facing a public debt that is not decreasing at the pace of the budgetary efforts – far from it. The “fault” lies in the steep fall in GDP. The debate on the value of the multiplier is old but took on new life at the beginning of the crisis.[\[4\]](#) It received a lot of publicity at the end of 2012 and in early 2013, when the IMF (through the voice of [O. Blanchard and D. Leigh](#)) challenged the European Commission and demonstrated that these two institutions had, since 2008, systematically underestimated the impact of austerity on the

euro zone countries. The European Commission recommended remedies that failed to work and then with each setback called for strengthening them. This is why the fiscal policies pursued in the euro zone reflected a considerable error of judgment and are the main cause of the prolonged recession we are experiencing. The magnitude of this error can be estimated at almost 3 percentage points of GDP for 2013 (or almost 3 points of unemployment): If austerity had been postponed until more favourable times, we would have reached the same ratio of debt-to-GDP by the deadline imposed by treaty (in 2032), but with the benefit of additional economic activity. The cost of austerity since 2011 is thus almost 500 billion euros (the total of what was lost in 2011, 2012 and 2013). The nearly 3 additional points of unemployment in the euro zone are now exposing us to the risk of deflation, which will be very difficult to avoid.

Although the European Commission follows these debates on the value of the multiplier, it (and to some extent the IMF) developed another analysis to justify its choice of economic policy in the euro zone. This analysis holds that the fiscal multipliers are *negative* in times of crisis *for the euro zone*, and for the euro zone alone. Based on this analysis, austerity should *reduce* unemployment. To arrive at what seems to be a paradox, we must accept a particular counterfactual (what would have happened if we had not implemented austerity policies). For example, in the case of Spain, without an immediate fiscal effort, the financial markets would have threatened to stop lending to finance the Spanish public debt. The rise in interest rates charged by the financial markets to Spain would have pushed its government into brutal fiscal restraint, the banking sector would not have survived the collapse of the value of Spain's sovereign notes, and the increased cost of credit due to the fragmentation of the financial markets in Europe would have led to a crisis that spiralled way beyond what the country actually experienced. In this analytical model, the austerity recommended is not the

result of dogmatic blindness but an acknowledgement of a lack of choice. There was no other solution, and in any case, delaying austerity was not a credible option.

Accepting the European Commission's counterfactual amounts to accepting the idea that the fiscal multipliers are negative. It also means accepting the notion that finance dominates the economy, or at least that judgments on the sustainability of the public debt must be entrusted to the financial markets. According to this counterfactual, quick straightforward austerity would regain the confidence of the markets and would therefore avoid a deep depression. Compared to a situation of postponed austerity, the recession induced by the early straightforward budget cuts should lead to less unemployment and more activity. This counterfactual thesis was raised against us in a seminar held to discuss the iAGS 2014 report organized by the European Commission (DGECFIN) on 23 January 2014. Simulations presented on this occasion illustrated these remarks and concluded that the austerity policy pursued had been beneficial for the euro zone, thereby justifying the policy *a posteriori*. The efforts undertaken put an end to the sovereign debt crisis in the euro zone, a prerequisite for hoping one day to get out of the depression that began in 2008.

In the [iAGS 2014](#) report, publically released in November 2013, we responded (in advance) to this objection based on a very different analysis: massive austerity did not lead to an end to the recession, contrary to what had been anticipated by the European Commission following its various forecasting exercises. The announcement of austerity measures in 2009, their implementation in 2010 and their reinforcement in 2011 never convinced the financial markets and failed to prevent Spain and Italy from having to face higher and higher sovereign rates. Greece, which went through an unprecedented fiscal tightening, plunged its economy into a deeper depression than the Great Depression, without reassuring

anyone. Like the rest of the informed observers, the financial market understood clearly that this drastic remedy would wind up killing the patient *before* any cure. The continuation of high government deficits is due largely to a collapse in activity. Faced with debt that was out of control, the financial markets panicked and raised interest charges, further contributing to the collapse.

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

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

Contrary to our analysis, the counterfactual envisaged by the European Commission, which denies the possibility of an alternative, assumes an unchanged institutional framework [5]. Why pretend that the macroeconomic strategy should be strictly conditioned on institutional constraints? If institutional compromises are needed in order to improve the orientation of economic policies and ultimately to achieve a better result in terms of employment and growth, then this strategy must be followed. Since the Commission does not question the rules of the game in political terms, it can only submit to the imperatives of austerity. This form of apolitical stubbornness was an error, and in the absence of the ECB's "political" step, the Commission was leading us into an impasse. The implicit pooling of the public debt embodied in the ECB's commitment to take all the measures necessary to support the euro (the "Draghi put") changed the relationship between the public debt and sovereign interest rates for every country in the euro zone. It is always possible to say that the ECB would never have made this commitment if the countries had not undertaken their forced march towards consolidation. But such an argument does not preclude discussing the price to be paid in order to achieve the institutional compromise. The fiscal multipliers are clearly (and strongly) positive, and it would have been good policy to defer austerity. There was an alternative, and the policy pursued was a mistake. It is perhaps the magnitude of this error that makes it difficult to recognize.

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

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

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

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

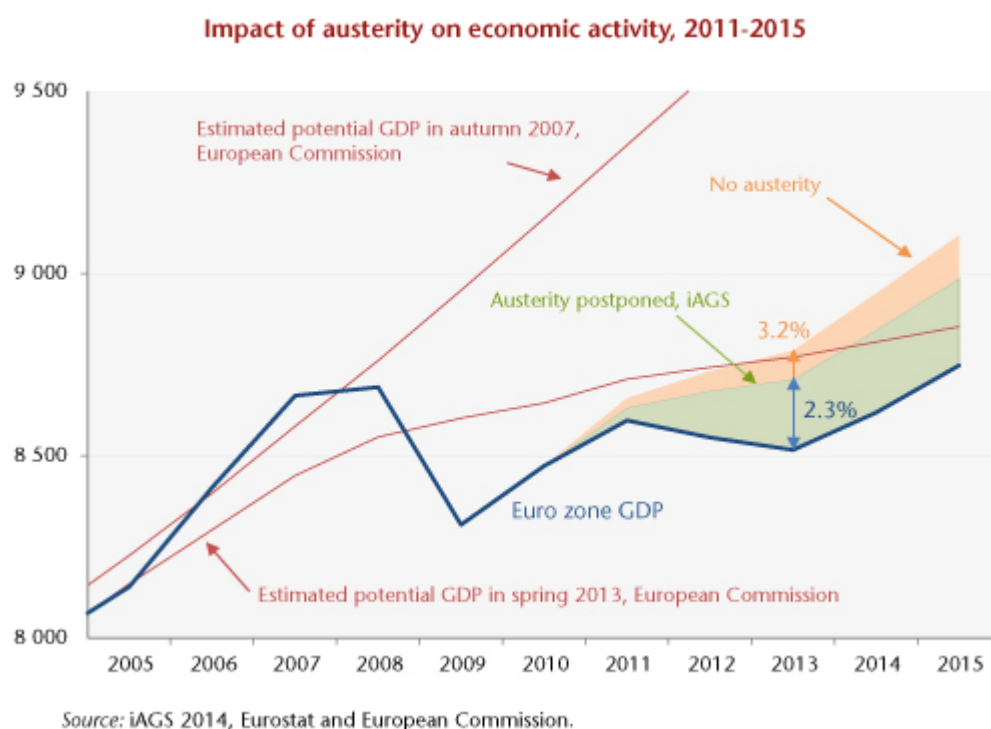
[5] The institutional framework is here understood broadly. It refers not only to the institutions in charge of economic policy decisions but also to the rules adopted by these institutions. The OMT is an example of a rule change adopted by an institution. Strengthening the fiscal rules is another element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

From austerity to stagnation

By [Xavier Timbeau](#)

Since 2010, the European Commission has published the Annual Growth Survey to stimulate discussion on the occasion of the European semester, during which the governments and parliaments of the Member States, the Commission, and civil society discuss and develop the economic strategies of the various European countries. We considered it important to participate in this debate by publishing simultaneously with the Commission an independent Annual Growth Survey (iAGS), in collaboration with the IMK, a German institute, and the ECLM, a Danish institute. In the 2014 iAGS, for instance, we estimate the cost of the austerity measures enacted since 2011. This austerity policy, which was implemented while the fiscal multipliers were very high and on a scale unprecedented since the Second World War, was followed simultaneously by most euro zone countries. This resulted in lopping 3.2% off

euro zone GDP for 2013. An alternative strategy, resulting after 20 years in the same GDP-to-debt ratios (*i.e.* 60% in most countries), would have been possible by not seeking to reduce public deficits in the short term when the multipliers are high. In order to lower the fiscal multipliers again, it's necessary to reduce unemployment, build up agents' balance sheets and get out of the liquidity trap. A more limited but ongoing adjustment strategy, just as fiscally rigorous but more suited to the economic situation, would have led to 2.3 additional points of GDP in 2013, which would have been much better than under the brutal austerity we find ourselves in today. This means there would not have been a recession in 2012 or 2013 for the euro zone as a whole (see the figure below: GDP in million euros).



It is often argued that the state of euro zone public finances left no choice. In particular, market pressure was so great that certain countries, like Greece for example, were concerned that they would lose access to private financing of their public debt. The amounts involved and the state of the primary deficit are advanced to justify this brutal strategy and convince both the markets and the European partners.

However, the sovereign debt crisis, and hence market pressure, ended when the European Central Bank announced that no country would leave the euro and set up an instrument, Outright Monetary Transactions, which makes it possible under certain conditions to buy back public debt securities of euro zone countries and therefore to intervene to counter the distrust of the markets ([see an analysis here](#)). From that point on, what matters is the sustainability of the public debt in the medium term rather than demonstrating that in an emergency the populace can be compelled to accept just any old policy. Sustainability does however require an adjustment policy that is ongoing (because the deficits are high) and moderate (because fiscal policy has a major impact on activity). By choosing the difficult path of austerity, we paid a high price for the institutional incoherence of the euro zone, which was exposed by the crisis. In the 2014 iAGS, we point out costs due to austerity that go beyond the loss of activity. On the one hand, inequality is increasing, and “anchored poverty”, *i.e.* as measured from the median incomes of 2008, is increasing dramatically in most countries affected by the recession. The high level of unemployment is leading to wage deflation in some countries (Spain, Portugal and Greece). This wage deflation will result in gains in cost competitiveness but, in return, will lead the countries’ partners to also take the path of wage deflation or fiscal devaluation. Ultimately, the adjustment of effective exchange rates either will not take place or will occur at such a slow pace that the effects of deflation will wind up dominant, especially as the appreciation of the euro will ruin the hopes of boosting competitiveness relative to the rest of the world. The main effect of wage deflation will be a greater real burden (*i.e.* relative to income) of private and public debt. This will mean a return to centre stage of massive public and private defaults, as well as the risk of the euro zone’s collapse. It is possible nevertheless to escape the trap of deflation. Possible methods are explored and calculated in the 2014 iAGS. By reducing sovereign spreads, the countries in crisis can be

given significant maneuvering room. The levers for this include the continuation of the ECB's efforts, but also a credible commitment by the Member states to stabilizing their public finances. Public investment has been cut by more than 2 points of potential GDP since 2007. Re-investing in the future is a necessity, especially as infrastructure that is not maintained and is allowed to collapse will be extremely expensive to rebuild. But it is also a way to stimulate activity without compromising fiscal discipline, since the latter must be assessed by trends not in the gross debt but in the net debt. Finally, the minimum wage should be used as an instrument of coordination. Our simulations show that there is a way to curb deflationary trends and reduce current account imbalances if surplus countries would increase their minimum wage faster in real terms than their productivity while deficit countries would increase their minimum wage slower than their productivity. Such a rule, which would respect both national practices in wage bargaining as well as productivity levels and the specific features of labour markets, would lead to gradually reducing macroeconomic imbalances in the euro zone.

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

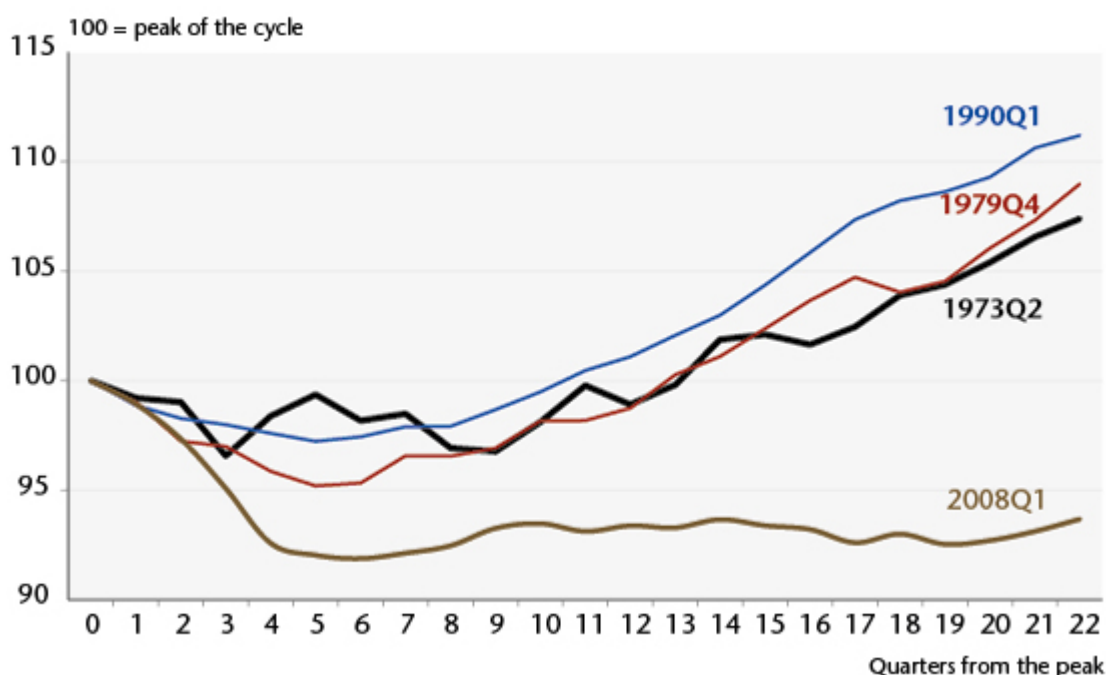
By [Catherine Mathieu](#)

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



Source: Office for National Statistics (ONS).

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.

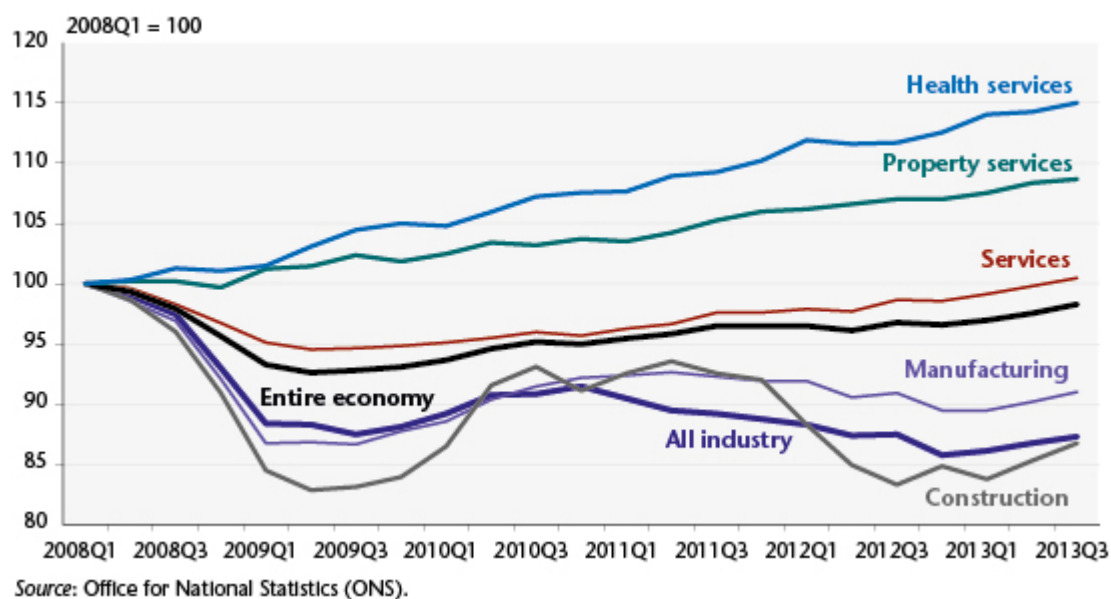
Table 1. Growth and fiscal Impulses in the United Kingdom since 2008

	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	
	1 st half	2 nd half	1 st half	2 nd half	1 st half	2 nd half	1 st half	2 nd 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.

What factors have put the brakes on growth since 2010?

By [Eric Heyer](#) and Hervé Péléraux

At the end of 2012, five years after the start of the crisis, France's GDP has still not returned to its earlier level (Figure 1). At the same time, the labour force in France has grown steadily and technical progress has constantly raised workers' productivity. We are therefore more numerous and more productive than 5 years ago when output was lower: the explosion in unemployment is a symptom of this mismatch. Why had the shoots of recovery seen in 2009 been choked off by mid-2010?



The main factor stifling the recovery has been the austerity

measures that were enacted in France and Europe in 2010 and then intensified in 2011 and 2012 (Table 1). The impact of austerity has been all the more marked as it has been generalized throughout the euro zone. The effects of domestic cutbacks have combined with the effects of undercutting demand from other European partners. Given that 60% of France's exports are to the European Union, any external stimulus had virtually vanished by mid-2012, less due to the slowdown in global growth, which is still almost 3%, than to the consequence of the poor performance of the euro zone, which is on the brink of recession.

It is austerity that is at the root of the lack of growth: after shaving -0.7 GDP point off growth in 2010, its effects increased in 2011 and 2012 (respectively -1.5 and -2.1 points) because of the stepped-up measures and the existence of high fiscal multipliers. Indeed, in a period of low economic activity simultaneously tightening fiscal policy in all the European countries while there is very little manoeuvring room for monetary policy (real interest rates close to zero) has led to raising the value of the multiplier. There is now a broad consensus that the short-term fiscal multipliers are high, especially as full employment is still out of reach (see [Heyer \(2012\)](#) for a review of the literature on multipliers). The theoretical debate about the value of the multiplier and the role of agents' expectations must give way to empirical observation: the multipliers are positive and greater than 1.



In addition to the fiscal drag, there is the effect of tight monetary conditions: the easing of monetary policy – seen in particular in the lower key interest rates – is far from enough to offset the negative effect on the economy of tighter borrowing conditions and the widening of the spread between private investment and risk-free public investment.

All things considered, including taking into account the

impact of the resurgence in oil prices after the onset of the recession, the spontaneous growth of the French economy would have averaged 2.6% over the past three years. The realization of this potential would have led to a further reduction in excess production capacity and would ultimately have cut short the downturn in the economy that actually took place.

Holding to the required course

By [Eric Heyer](#)

[This text summarizes the OFCE's 2013-2014 forecasts for the French economy.](#)

In 2013, the French economy should see negative annual average growth, with a fall in GDP of 0.2%, before a modest recovery in 2014, with growth of 0.6 % (Table 1). This particularly mediocre performance is far from the path that an economy pulling out of a crisis should be taking.

Table 1. Summary of the forecast for 2013 and 2014

In %, annual average

	2010	2011	2012	2013*	2014*
Taux de croissance du PIB	1,6	1,7	0,0	-0,2	0,6
Imports	8,4	5,2	-0,3	0,1	1,7
Household consumption	1,4	0,2	-0,1	0,0	0,8
Government consumption	1,7	0,2	1,4	1,2	0,2
Total investment	1,0	3,5	0,0	-1,9	-0,5
Exports	9,2	5,5	2,5	0,9	2,2
Contribution to growth					
Domestic demand excl. inventory	1,5	0,9	0,3	-0,1	0,5
Change in inventory	0,0	0,8	-1,0	-0,3	0,0
Trade balance	0,0	0,0	0,7	0,2	0,1
GDP growth rate, euro zone	2,0	1,1	-0,5	0,4	0,9
Other indicators					
Inflation (consumption deflator)	1,1	2,1	1,9	1,6	1,6
Savings rate (% of GDI)	15,9	16,2	16,0	15,6	15,2
Unemployment rate	9,3	9,2	9,9	10,7	11,4
Public deficit (GDP points)	7,1	5,2	4,8	3,9	3,0
Public debt (GDP points)	82,4	85,8	90,2	93,3	94,8
GDP growth rate (year-on-year)	1,8	1,1	-0,3	0,3	0,7

Sources : INSEE, quarterly accounts; OFCE *e-mod.fr* forecast for 2013 and 2014.

Four years after the start of the crisis, the French economy has a substantial potential for recovery: this should have led to average spontaneous growth of about 2.6% per year in 2013 and 2014, making up some of the output gap accumulated since the onset of the crisis. But this spontaneous recovery is being hampered mainly by the introduction of fiscal savings plans in France and across Europe. To meet its commitment to cut the public deficit to 3% by 2014, the French government will have to hold to the course of fiscal consolidation it adopted in 2010, which was imposed by the European Commission in all the euro zone countries. This budget strategy should slash 2.6 percentage points off GDP growth in France in 2013 and 2.0 percentage points off GDP in 2014 (Table 2).

Table 2. The obstacles to growth in France during the years 2013 and 2014

In GDP points

	2013	2014
GDP growth	-0,2	0,6
Impact on GDP due to ...		
... oil changes	-0,2	0,0
<i>Direct impact on the French economy</i>	-0,1	0,0
<i>Impact via addressed demand</i>	0,0	0,0
... austerity measures	-2,6	-2,0
<i>Direct impact on the French economy</i>	-1,8	-1,4
<i>Impact via addressed demand</i>	-0,8	-0,6
... monetary conditions	0,0	0,0
<i>Direct impact on the French economy</i>	0,0	0,0
<i>Impact via addressed demand</i>	0,0	0,0
... policies on competition	0,1	-0,1
<i>Direct impact on the French economy</i>	0,2	0,0
<i>Impact via addressed demand</i>	-0,1	-0,1
Achievement	-0,2	0,1
Spontaneous growth rate	2,6	2,6

Sources : INSEE, OFCE calculations.

By setting a pace far from its potential, the expected growth will aggravate the output gap built up since 2008, with the labour market thus continuing to worsen. The unemployment rate will rise steadily to 11.6% in late 2014.

Only a shift in European fiscal strategy could halt the rise in unemployment. This would mean limiting the negative fiscal stimulus to 0.5 percent of GDP instead of the total of 1.0 points planned in the euro zone in 2014. This reduced fiscal effort could be repeated until the public deficit or debt reaches a defined goal. Compared to current plans, because the effort would be measured the burden of adjustment would be spread more fairly over the taxpayers in each country, avoiding the pitfall of drastic cuts in the public budgets. This new strategy would lead to a slower reduction in the public deficit (-3.4% in 2014 against -3.0% in our central scenario), but also and especially to higher economic growth (1.6% against 0.6%). This “less austerity” scenario would allow the French economy to create 119,000 jobs in 2014, *i.e.*

232,000 more than in our central forecast, and unemployment would fall instead of continuing to increase.

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

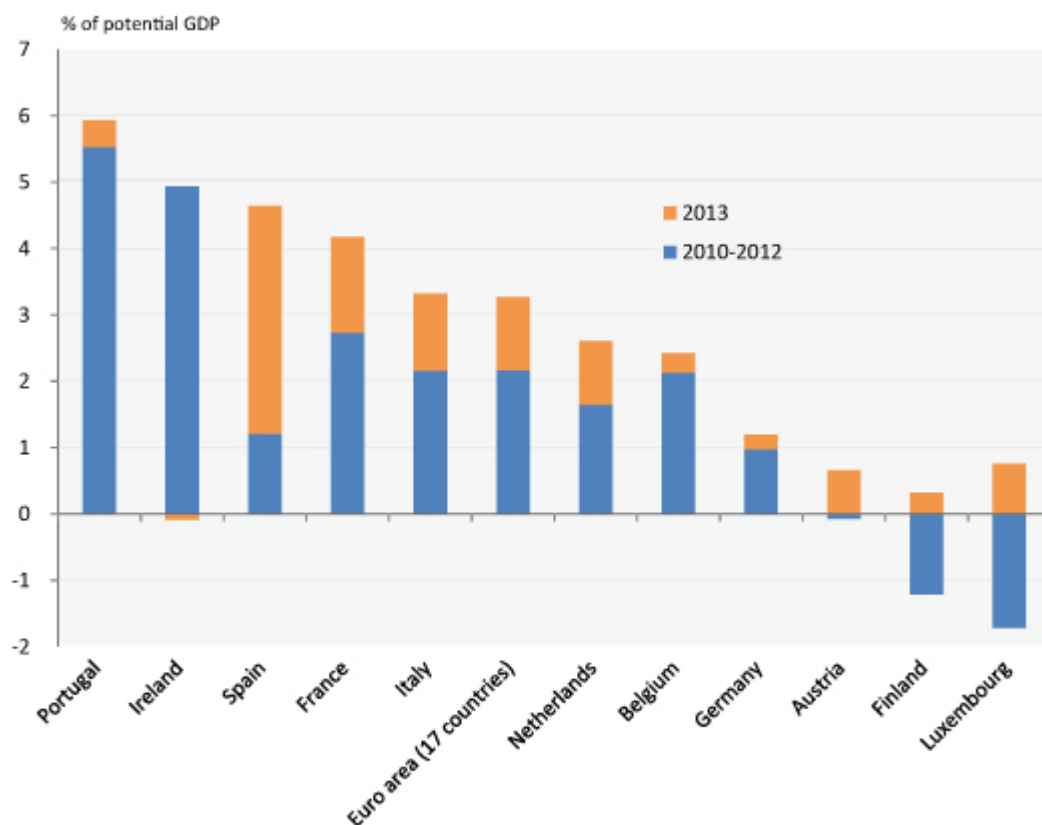
By [Mathieu Plane](#)

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

1 – According to the latest figures from the European Commission on 22 February 2013^[1], of the euro zone countries making the greatest fiscal adjustment in 2013 from a structural viewpoint, France, with 1.4 GDP points, comes behind only Spain (3.4) and Greece (2.6). For the 2010-2013 period, the reduction in France’s structural deficit

represents 4.2 GDP points, which makes France the euro zone country which, alongside Spain (4.6 GDP points), has carried out the largest budget cutbacks of the major countries in the zone, ahead of Italy (3.3 GDP points), the Netherlands (2.6) and of course Germany (1.2) (Figure 1).

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



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

Sources: European Commission, OFCE calculations.

2 – In 2007, before the crisis, according to the European Commission France had a structural public deficit of -4.4 GDP points, compared with an average of -2.1 for the euro zone and -0.9 for Germany. In 2013, this came to -1.9 GDP points in France, -1.3 for the euro zone, and +0.4 for Germany, which represents an improvement of the structural deficit of 2.5 GDP points for France since the start of the crisis, *i.e.* three times the average for the euro zone and twice that for Germany (Table 1). Leaving aside public investment, France's structural public deficit in 2013 was positive and higher than

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

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

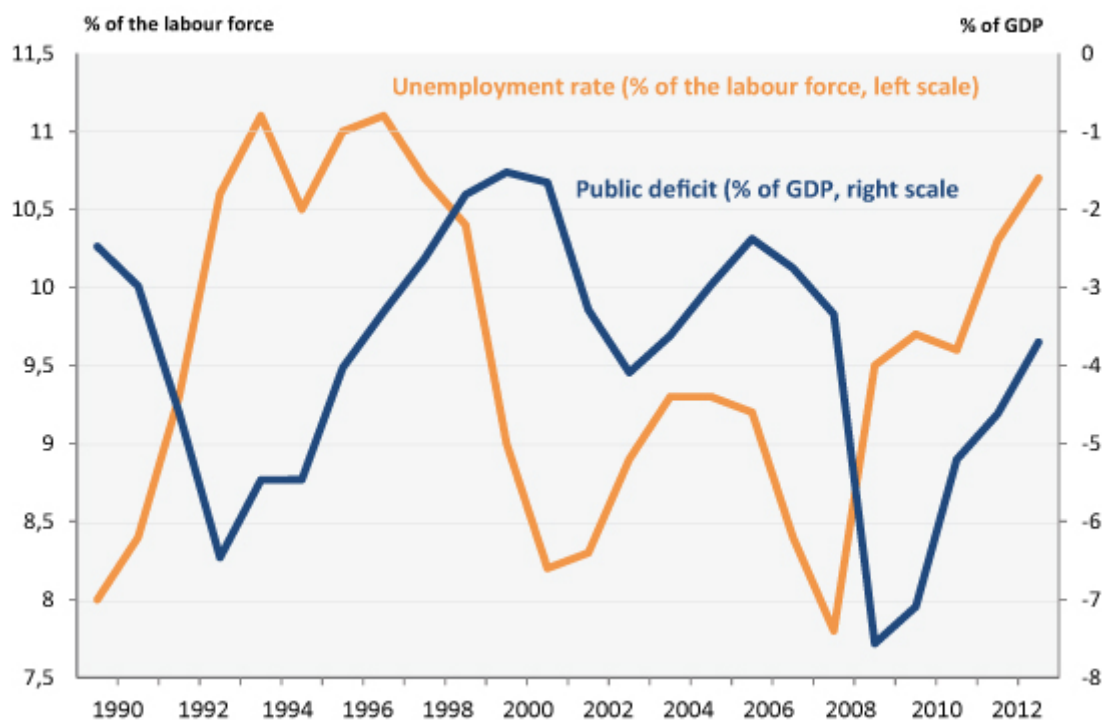
In GDP points	Public balance				Structural public balance				SPB w/o public investment			
	FRA	DEU	EZ	FRA-EZ diff.	FRA	DEU	ZE	FRA-EZ diff.	FRA	DEU	EZ	FRA-EZ diff.
2007	-2.8	0.2	-0.7	-2.1	-4.4	-0.9	-2.1	-2.3	-1.1	0.6	0.5	-1.6
2013	-3.7	-0.2	-2.8	-0.9	-1.9	0.4	-1.3	-0.6	1.2	1.9	0.8	0.4
Change 2007-2013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

Sources : European Commission, OFCE calculations.

3 – In 2013, the public deficit, even at 3.7% of GDP according to the European Commission, is once again at a level close to that of 2008, similar to that of 2005, and below that of 2004 and of the entire 1992-1996 period. The public deficit figure expected for 2013 corresponds to the average over the past thirty years, and thus no longer seems so exceptional, which is easing the pressure that France could experience on the financial markets. In contrast, according to the European Commission the unemployment rate in France in 2013 will reach 10.7% of the workforce, which is very close to its historic peak in 1997 (Figure 2). With an unemployment rate in 2013 that is 1.3 percentage points higher than the average over the last thirty years, an exceptional situation now characterizes the labour market more than it does the government deficit. While new austerity measures would help to reduce the deficit,

however painfully, due to the [high value of the fiscal multiplier in the short term](#) they will lead on the other hand to going well beyond our historic unemployment peak. Indeed, as we showed in our [latest forecast in October 2012](#), if France really tries to meet its budget commitment for 2013 “whatever the cost”, this will require a new fiscal tightening of over 20 billion euros, in addition to the [36 billion euros already planned](#). This would lead to a recession, with GDP down -1.2% and 360,000 job losses (instead of expected growth of 0% and the loss of about 160,000 jobs), with the unemployment rate reaching 11.7% of the labour force by late 2013.

Figure 2. Public deficit and unemployment rate



Source: European Commission.

To restore its public accounts since 2010, France has undertaken a historic fiscal effort, well beyond the average of its European partners, which has cost it in terms of growth and employment. Adding another layer of austerity in 2013 to the already historic build-up of austerity would lead us this

year straight into a recession and an unprecedented worsening in the labour market. If there is a choice, are a few tenths of a point in the public deficit worth such a sacrifice? Nothing is less certain. It is thus essential to put off the goal of reducing the deficit to 3% of GDP to at least 2014.

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

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.

