He who sows austerity reaps recession

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This article summarizes OFCE note no.16 that gives the outlook on the global economy for 2012-2013.

The sovereign debt crisis has passed its peak. Greece's public debt has been restructured and, at the cost of a default, will fall from 160% of GDP to 120%. This restructuring has permitted the release of financial support from the Troika to Greece, which for the time being solves the problem of financing the renewal of the country's public debt. The contagion that hit most euro zone countries, and which was reflected in higher sovereign rates, has been stopped. Tension has eased considerably since the beginning of 2012, and the risk that the euro zone will break up has been greatly reduced, at least in the short term. Nevertheless, the process of the Great Recession that began in 2008 being transformed into a very Great Recession has not been interrupted by the temporary relief of the Greek crisis.
First, the global economy, and especially the euro zone, remains a high-risk zone where a systemic crisis is looming once again. Second, the strategy adopted by Europe, namely the rapid reduction of public debt (which involves cutting public deficits and maintaining them below the level needed to stabilize debt), is jeopardizing the stated objective. However, since the credibility of this strategy is perceived, rightly or wrongly, as a necessary step in the euro zone to reassure the financial markets and make it possible to finance the public debt at acceptable rates (between 10% and 20% of this debt is refinanced each year), the difficulty of reaching the goal is demanding ever greater rigor. The euro zone seems to be pursuing a strategy for which it does not hold the

reins, which can only fuel speculation and uncertainty.
Our forecast for the euro zone points to a recession of 0.4 percentage point in 2012 and growth of 0.3 point in 2013 (Table 1). GDP per capita in the euro zone should decline in 2012 and stabilize in 2013. The UK will escape recession in 2012, but in 2012 and 2013 annual GDP growth will remain below 1%. In the US, GDP growth will accelerate from 1.7% per year in 2011 to 2.3% in 2012. Although this growth rate is higher than in the euro zone, it is barely enough to trigger an increase in GDP per capita and will not lead to any significant fall in unemployment.
The epicenter of the crisis is thus shifting to the Old Continent and undermining the recovery in the developed countries. The United States and United Kingdom, which are faced even more than the euro zone with deteriorating fiscal positions, and thus mounting debt, are worried about the sustainability of their public debts. But because growth is just as important for the stability of the debt, the budget cuts in the euro zone that are weighing on their activity are only adding to difficulties of the US and UK.
By emphasizing the rapid reduction of deficits and public debt, euro zone policymakers are showing that they are anticipating a worst case scenario for the future. Relying on so-called market discipline to rein in countries whose public finances have deteriorated only aggravates the problem of sustainability by pushing interest rates up. Through the interplay of the fiscal multiplier, which is always underestimated in the development of strategies and forecasts, fiscal adjustment policies are leading to a reduction in activity, which validates the resignation to a worse “new normal”. Ultimately, this is simply a self-fulfilling process.

Outlook for global growth

Annual growth rate (%)

	Weight in the total (1)	GDP in volume 2011	2012	2013
DEU	4,2	3,1	0,1	0,8
FRA	3,1	1,7	0,2	0,7
ITA	2,6	0,6	-1,7	-0,9
ESP	2,0	0,7	-1,5	-0,6
NLD	1,0	1,5	-1,1	0,5
BEL	0,6	1,9	0,1	0,9
AUT	0,5	3,1	0,4	0,8
FIN	0,3	2,7	0,7	1,1
PRT	0,3	-1,5	-2,9	0,2
GRE	0,3	-6,3	-5,3	-0,5
IRL	0,2	0,8	-0,6	0,9
EUZ	15,5	1,5	-0,4	0,3
GBR	3,2	0,9	0,7	0,9
SWE	0,5	4,0	0,8	1,6
DNK	0,3	1,1	0,6	1,1
EU-15	19,4	1,5	-0,2	0,4
12 new member states	2,7	3,1	1,1	2,1
EU-27	22,0	1,7	-0,1	0,6
CHE	0,5	1,9	0,2	1,0
NOR	0,4	2,5	2,1	2,0
Europe	22,9	1,6	0,0	0,6
USA	20,0	1,7	2,1	2,4
JPN	6,3	-0,6	1,9	1,5
CAN	1,9	2,5	2,0	2,3
Industrialized countries	50,5	1,4	1,2	1,5
EU candidate countries (2)	1,5	7,6	1,7	4,3
RUS	3,3	4,5	3,5	3,8
Other CIS (3)	1,3	3,9	3,7	4,2
CHN	11,3	9,2	8,1	8,1
Other Asian countries	13,2	5,6	5,0	6,3
Latin America	8,7	4,3	3,1	3,5
Sub-Saharan Africa	2,5	4,9	5,5	5,3
Middle East and North Africa	4,8	3,1	3,2	3,6
World	100	3,5	3,1	3,4

1) Weighted according to GDP and 2006 PPPs estimated by the IMF.
2) Croatia, Republic of Macedonia and Turkey.
3) Commonwealth of Independent States.
Sources: IMF, OECD, national sources, March 2012 OFCE calculations and forecasts.

Yes, the national accounts will be revised after the election

By Hervé Péléraux and Lionel Persyn[1]

In a Europe that is heading more and more clearly towards a recession, in mid-February the INSEE reported a 0.2% rise in France's GDP. This fourth-quarter performance was surprising, as it contrasts sharply with the deterioration in the economic climate since summer 2011, which indicated that GDP growth would be less favourable than that announced.

The current figures from the national accounts are, however, not set in stone. [A note from the OFCE](#)describes the procedure since the release of the provisional results that marks the starting point in the process of revising the accounts. This revision is spread over several years, first involving the tuning of the quarterly accounts with the annual accounts, then the revision of the annual accounts (the final version for 2011 will be announced in May 2014). The final changes are to the database for the national accounts, which will provide an opportunity to introduce methodological innovations that aim at greater accuracy on past estimates.

The enigma of the fourth quarter of 2011 may be resolved in the future as the revisions are worked out. It is useful to refer to past experience to try to identify the profile of the coming adjustments and to draw the likely implications for the current period. Since 1987, the revisions to the accounts seem to have been pro-cyclical, that is to say, the preliminary figures are mostly revised upwards in periods of recovery or rapid growth, and downwards in periods of downswings in the economic cycle. In some major cyclical episodes, the average revisions are significant and could affect the economic diagnosis.

This was what happened in 2008. After the INSEE announced a negative result for the second quarter of -0.3%, the initial estimate for the third quarter was a positive 0.1%, which for a while put off the prospect that the French economy was entering a recession. The subsequent assessments gave a more dramatic turn to the GDP’s trajectory, with the current respective estimates for the two quarters being -0.7% and -0.3%. Had these been known at the time, this would probably have pushed forecasts downwards by fully revealing the severity of the impact of the financial crisis on the real economy.

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[1] At the time this note was written, Lionel Persyn was an intern at OFCE and a doctoral candidate at the University of

Nice at Sophia Antipolis.

Should the Stability and Growth Pact be strengthened?

By Jérôme Creel, Paul Hubert and Francesco Saraceno

The European fiscal crisis and the ensuing need to reduce the levels of public debt accelerated the adoption of a series of reforms of European fiscal rules in late 2011. Two rules were introduced to strengthen the Stability and Growth Pact (SGP). Given that many Member States in the euro zone have structural deficits and public debts that exceed the thresholds under consideration, it seemed worthwhile to assess the macroeconomic implications of compliance with these fiscal rules by four countries, including France.

The current limit of the public deficit to 3% of GDP was supplemented by a limit on the structural deficit equivalent to 0.5% of GDP, and by a rule on debt reduction requiring heavily indebted countries to reduce their level of public debt every year by 1/20th of the difference with the reference level of 60% of GDP. Moreover, the limit on the structural deficit goes beyond the 3% rule because it is associated with a requirement to incorporate a balanced budget rule and automatic mechanisms for returning to balanced budgets in the constitution of each Member State in the euro zone. Due to an unfortunate misnomer, this is now often called the "golden rule" [1]. To distinguish this from the "golden rule of public finance" applied by the French regions, the German Länder and, from 1997 to 2009, the UK, we will henceforth call this “balanced budget rule” the “new golden rule “.

Because of the international financial crisis raging since 2007, the euro zone States often fall far short of the demands of the new rules. This raises the question of the consequences that flow from imposing these rules on the Members. To this end, we decided to study the paths of convergence with the different rules of four countries that are representative of the euro zone, using a standard theoretical model.

We chose a large country with an average level of public debt (France), a small country with a somewhat larger debt (Belgium), a large country with a large debt (Italy) and a small country with a relatively low level of debt (Netherlands). The size of the country, large or small, is associated with the size of their fiscal multiplier, i.e. the impact of public spending on growth: large countries that are less open than the small countries to international trade have a greater multiplier effect than the small countries. The four countries also differed with respect to the size and sign of their structural primary balance in 2010: France and the Netherlands ran a deficit, while Belgium and Italy had a surplus.

In the model, the evolution of the public deficit is countercyclical and the impact of an increase in the public deficit on GDP is positive, but excessive indebtedness increases the risk premium on the long-term interest rates paid to finance this debt, which ultimately undermines the effectiveness of fiscal policy.

The rules that we simulated are: (a) a balanced (at 0.5% of GDP) budget or the “new golden rule”; (b) the 5% per year rule on debt reduction; (c) the 3% ceiling on the total deficit (status quo). We also evaluated: (d) the impact of adopting an investment rule along the lines of the golden rule of public finance which, in general, requires a balanced budget for current expenditure over the cycle, while allowing the debt to finance public investment.

We simulated over 20 years, i.e. the horizon for implementing the 1/20th rule, the impact of the rules on growth, on the inflation rate and the structural public deficit and on the level of public debt. First, we analyzed the path followed by the four economies after the adoption of each fiscal rule in 2010. In other words, we asked how the rules work in the context of the fiscal austerity that Europe is currently experiencing. Second, we simulated the dynamics of the economy after a demand shock and a supply shock, starting from the base situation of the Maastricht Treaty, with the economy growing at a nominal rate of 5% (growth potential of 3% and inflation rate of 2%), and a debt level of 60%. It is interesting to note that the real growth potential in the euro zone countries has been consistently below 3% since 1992, which has helped to make the rule limiting public finances even more restrictive than originally planned.

Our simulations led to a number of results. First, in every case the adoption of the rules produced a short-term recession, even in small countries with a small fiscal multiplier and a small initial public debt, such as the Netherlands. This complements the analysis that the widespread implementation of austerity in Europe is inevitably undermining growth (see The very great recession, 2011) by showing that there is no fiscal rule that, strictly applied in the short term, makes it possible to avoid a recession. This finding points to an incentive on the part of government to dissociate the use of the fiscal rules de facto and de jure: in other words, if the ultimate goal of economic policy is the preservation and stability of economic growth, then it is wise not to act on the pronouncements.

Second, recessions can lead to deflation. Under the constraint of zero nominal interest rates, deflation is very difficult to reverse with fiscal austerity.

Third, the investment rule leads to a better macroeconomic performance than the other three rules: the recessions are shorter, less pronounced and less inflationary over the time period considered. Ultimately, the levels of public debt decreased admittedly less than with the 1/20th rule but, as a result of the growth generated, France’s public debt shrinks by 10 GDP points from its 2010 level, while the Belgian and Italian debt are reduced by 30 and 50 GDP points, respectively. Only the country that was least indebted initially, the Netherlands, saw its debt stagnate.

Fourth, while ignoring the investment rule, which is not part of European plans, it appears that, in terms of growth, the status quo is more favorable than the “new golden rule” or the rule on debt reduction; it is, however, more inflationary for the large countries. This indicates that, in terms of growth, the strengthening of the Stability and Growth Pact, brutally applied, would be detrimental to the four economies.

Fifth, when the economy in equilibrium is hit by demand and supply shocks, the status quo seems appropriate. This confirms the idea that the current Pact provides room for fiscal maneuvering. The simulations nevertheless suggest that the status quo remains expensive compared with the investment rule.

To conclude, it is difficult not to notice a paradox: the rules designed to prevent governments from intervening in the economy are being discussed precisely after the global financial crisis that required governments to intervene to help cushion the shocks resulting from market failures. This work aims to shift the debate: from the goal of fiscal stabilization to the goal of macroeconomic stabilization. The European authorities – the governments, the ECB and the Commission – seem to consider the public debt and deficit as policy objectives in their own right, rather than as instruments to achieve the ultimate objectives of growth and inflation. This reversal of objectives and instruments is tantamount to denying a priori any role for macroeconomic policy. Many studies [2], including the one we have conducted here, adopt the opposite position: economic policy definitely plays a role in stabilizing economies.

[1] This misnomer has been criticised in particular by Catherine Mathieu and Henri Sterdyniak in 2011, and by Bernard Schwengler in 2012.
[2] See, for example, the cross-disciplinary study that appeared in English in 2012 in the American Economic Journal, Macroeconomics, and the bibliography that it contains, or in French, the study that appeared in 2011 by Creel, Heyer and Plane on the multiplier effects of temporary fiscal stimulus policies.

The irresistible attraction to recession

By Hervé Péléraux

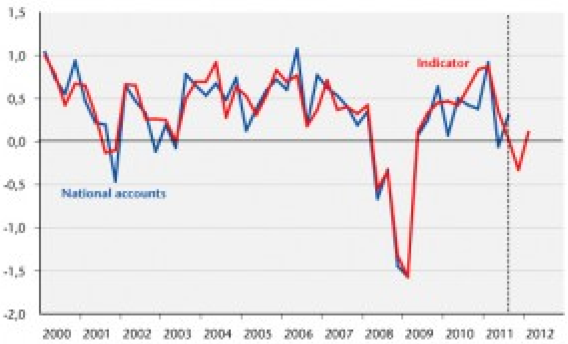
Here is the leading indicator for the French economy, updated to 30 January 2011.

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

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

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

The GDP growth rate based on the national accounts and the leading indicator *



* Estimation is implemented with a dummy variable equal to 1 on quarter 1, 2009.

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

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

Sources : INSEE, OFCE forecasts and calculations.

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