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.

Concerning the Macron law "to promote growth, activity and equal economic opportunity"

By Henri Sterdyniak

The Macron Law is certainly not the "law of the century". It is a patchwork of about 240 provisions of varying importance. It is not some "great turn to the free market" nor does it represent a uniquely French strategy. It does nevertheless raise interesting questions about France's economic strategy and the way the legislature works.

The latest issue of the *Note de l'OFCE (no. 43 of 13 March 2015)* examines the law's major provisions, which oscillate between free market liberalization (let competition and the market do their work), social liberalism (certain categories of the population must be protected), economic interventionism (the state must regulate the functioning of the markets), and social democracy (the social partners must play an important role), without a clear victory for any of these. It is a compromise text that by definition cannot really satisfy anyone.

In our view, despite its title, there are few provisions in the law that will promote activity or that are beneficial to industry, to “Made in France”, to urban renewal, to the habitat, to the production of sustainable recyclable goods, or to greater employee participation in the decision-making process in their business. The law is instead in line with the myth of an economy driven by innovative start-ups, and ignores the need for industrial restructuring and an ecological transition.

Recovery aborted

By Christophe Blot

This text draws on the article “Le piège de la déflation: perspectives 2014-2015 pour l’économie mondiale” [The deflation trap: the 2014-2015 outlook for the world economy], written by Céline Antonin, Christophe Blot, Amel Falah, Sabine Le Bayon, Hervé Péléraux, Christine Rifflart and Xavier Timbeau.

According to a Eurostat press release published on 14 November 2014, euro zone GDP grew by 0.2% in the third quarter of 2014, and inflation stabilized in October at the very low level of 0.4%. Although the prospects of a new recession have receded for now, the IMF evaluates the likelihood of a recession in the euro zone at between 35% and 40%. This dismal prospect reflects the absence of a recovery in the euro zone, which is preventing a rapid reduction in unemployment. What lessons can be drawn?

In the short term, this sluggishness is due to three factors that have held back growth. First, fiscal consolidation, although less extensive than in 2013, has been continued in 2014 in a context where the multipliers remain high. Second, despite the reduction in long-term public interest rates due to the easing of pressure on sovereign debt, financing conditions for households and businesses in the euro zone have worsened, as the banks have not consistently passed on the reduction in long-term rates and lower inflation is leading to a tightening of real monetary conditions. Finally, the euro appreciated by more than 10% between July 2012 and early 2014. Even though the currency's rise reflects the winding down of pressure on euro zone bond markets, this has hurt exports. In addition to these short-term factors, recent data could herald the beginnings of a long phase of moderate growth and low inflation or even deflation in the euro zone.

Indeed, after a period of sharply increasing debt (see Figures), the financial situation of households and firms in the euro zone has deteriorated since 2008 due to a series of crises – financial, fiscal, banking and economic. This deterioration in the financial health of the non-financial sector has weakened its thirst for credit. Furthermore, households may be forced to cut down on their spending on consumption, and firms investment and their need for employment in order to reduce their debt. Adding to this is the fragility of certain banks, which need to absorb a high amount of bad debt; this is leading them to restrict the supply of credit, as is evidenced by the latest SAFE survey conducted by the ECB on SMEs. In a context like this where private agents prefer deleveraging, fiscal policy should play a crucial role. But this is not happening in the euro zone due to the desire to consolidate the trajectory of public finances at the expense of the goal of growth[1]. Furthermore, while many countries could get out of the excessive deficit procedure in 2015 [2], fiscal consolidation is expected to continue because of the rules in the Treaty on Stability, Coordination and Governance

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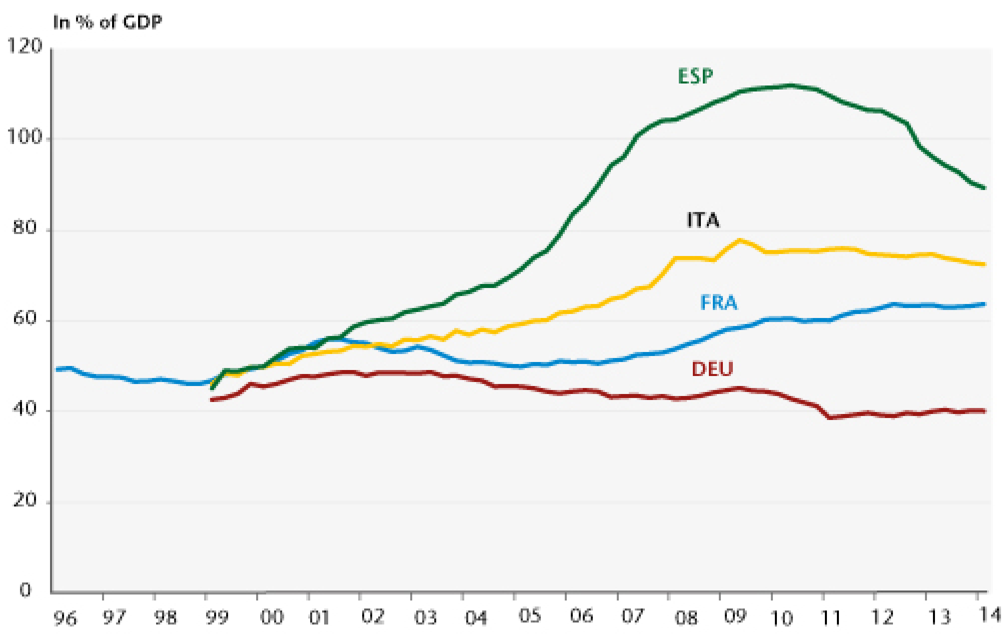
(TSCG) requiring Member countries to make fiscal adjustments to bring public debt down to the 60% threshold within 20 years[3].

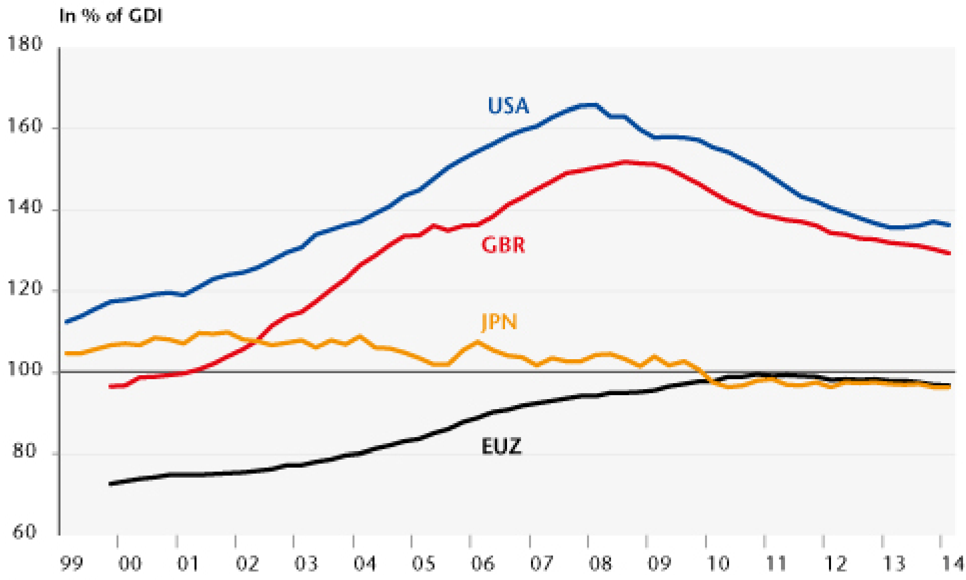
These conditions could push a recovery further down the road, and the euro zone could wind up locked in the trap of deflation. A lack of growth and high unemployment are creating downward pressure on prices and wages, pressure that is being exacerbated by internal devaluations, which are the only solutions being adopted to improve competitiveness and regain market share. This reduction in inflation is making the deleveraging process even more protracted and difficult, thus undercutting demand and strengthening the deflationary process. The Japanese experience of the 1990s shows that it is not easy to pull out of this kind of situation.

Figure 1. Debt of non-financial corporations



Source: Banque de France.

Figure 2. Household debt



Source: Banque de France.

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[1] The costs of this strategy were evaluated in the two preceding iAGS reports (see here).

[2] France and Spain would, however, constitute two major exceptions, with budget deficits of, respectively, 4% and 4.2% in 2015.

[3] See the post by Raul Sampognaro for more on the specific case of Italy.

Does growth in the euro zone really depend on a hypothetical German fiscal stimulus?

By Christophe Blot and Jérôme Creel

The debate on economic policy in Europe was re-ignited this summer by Mario Draghi during the now traditional symposium at Jackson Hole, which brings together the world's main central bankers. Despite this, it seems that both the one side (Wolfgang Schaüble, Germany's finance minister) and the other (Christine Lagarde, head of the IMF) are holding to their positions: fiscal discipline plus structural reforms, or demand stimulus plus structural reforms. Although the difference can seem tenuous, the way is now open for what Ms. Lagarde called "fiscal manoeuvring room to support a European recovery". She is targeting Germany in particular, but is she really right?

In an interview with the newspaper *Les Echos*, Christine Lagarde said that Germany "very likely has the fiscal manoeuvring room necessary to support a recovery in Europe". It is clear that the euro zone continues to need growth (in second quarter 2014, GDP was still 2.4% below its pre-crisis level in first quarter 2008). Despite the interest rate cuts decided by the ECB and its ongoing programme of exceptional measures, a lack of short-term demand is still holding back the engine of European growth, mainly due to the generally tight fiscal policy being pursued across the euro zone. In today's context, support for growth through more expansionary fiscal policy is being constrained by tight budgets and by a political determination to continue to cut deficits. Fiscal constraints may be real for countries that are heavily in debt and have lost market access, such as Greece, but they are more of an institutional nature for countries able to issue government debt at historically very low levels, such as France. For Ms. Lagarde, Germany has the manoeuvring room that makes it the only potential economic engine for powering a European recovery. A more detailed analysis of the effects of its fiscal policy – both internally and spillovers to European partners – nevertheless calls for tempering this optimism.

The mechanisms that underlie the hypothesis of Germany driving growth are fairly simple. An expansionary fiscal policy in Germany would boost the country's domestic demand, which would increase imports and create additional opportunities for companies in other countries in the euro zone. In return, however, the impact could be tempered by a slightly less expansionary monetary policy: as Martin Wolf argues, didn't Mario Draghi ensure that the ECB would do everything in its power to ensure price stability over the medium term?

In a recent OFCE working document, we have tried to capture these various commercial and monetary policy effects in a dynamic model of the euro zone. The result is that a positive fiscal impulse of 1 GDP point in Germany for three consecutive years (a plan involving 27.5 billion euros per year [1]) would boost growth in the euro zone by 0.2 point in the first year. This impact is certainly not negligible. However, this is due solely to the stimulation that would benefit German growth and not to spillovers to Germany's European partners. Indeed, and as an example, the increase in Spain's growth would be insignificant (0.03 point of growth in the first year). The weakness of the spillover effects can be explained simply by the moderate value of Germany's fiscal multiplier [2]. Indeed, the recent literature on multipliers suggests that they rise as the economy goes deeper into a slump. But based on the estimates of the output gap retained in our model, Germany is not in this situation, and indeed the multiplier has dropped to 0.5 according to the calibration of the multiplier effects selected for our simulations. For an increase in German growth of 0.5 percentage points, the effect of the stimulation on the rest of the euro zone is therefore low, and depends on Germany's share of exports to Spain and the weight of Spanish exports in Spanish GDP. Ultimately, a German recovery would undoubtedly be good news for Germany, but the other euro zone countries may be disappointed, just as they undoubtedly will be from the implementation of the minimum wage, at least in the short term, as is suggested by Odile Chagny and Sabine Le Bayon in a recent post. We can also assume that in the longer term the German recovery would help to raise prices in Germany, thereby degrading competitiveness and providing an additional channel through which other countries in the euro zone could benefit from stronger growth.

And what would happen if the same level of fiscal stimulus were applied not in Germany, but rather in Spain, where the output gap is more substantial? In fact, the simulation of an equivalent fiscal shock (27.5 billion euros a year for three years, or 2.6 points of Spanish GDP) in Spain would be much more beneficial for Spain but also for the euro zone. While in the case of a German stimulus, growth in the euro zone would increase by 0.2 percentage points over the first three years, it would increase by an average of 0.5 points per year for three years in the event of a stimulus implemented in Spain. These simulations suggest that if we are to boost growth in the euro zone, it would be best to do this in the countries with the largest output gap. It is more effective to spend public funds in Spain than in Germany.

In the absence of any relaxation of the fiscal constraints on Spain, a stimulus plan funded by a European loan, whose main beneficiaries would be the countries most heavily affected by the crisis, would undoubtedly be the best solution for finally putting the euro zone on a path towards a dynamic and sustainable recovery. The French and German discussions of an investment initiative are therefore welcome. Hopefully, they will lead to the adoption of an ambitious plan to boost growth in Europe.

Table. Impact of a fiscal expansion in Germany and in Spain

In percentage points

	Fiscal expansion in Germany			Fiscal expansion in Spain		
	German growth	Spanish growth	Euro zone growth	German growth	Spanish growth	Euro zone growth
2013	0,5	0,0	0,2	0,0	4,9	0,5
2014	0,6	0,0	0,2	0,0	5,8	0,7
2015	0,5	0,0	0,2	0,0	2,8	0,4
2016	0,0	0,0	0,0	0,0	-0,7	-0,1
2017	-0,6	0,0	-0,2	0,0	-2,6	-0,3
2018	-0,8	0,0	-0,2	0,0	-3,0	-0,3
2019	-0,7	0,0	-0,2	0,0	-2,9	-0,3

Source: iAGS model.

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[1] The measure is then compensated in a strictly equivalent way so that the shock amounts to a transient fiscal shock.

[2] Recall that the fiscal multiplier reflects the impact of fiscal policy on economic activity. Thus, for one GDP point of fiscal stimulus (or respectively, tightening), the level of activity increases (respectively, decreases) by k points.

Dealing with the ECB's triple mandate

By Christophe Blot, Jérôme Creel, Paul Hubert and Fabien Labondance

The financial crisis has sparked debate about the role of the central banks and monetary policy before, during and after the economic crisis. The prevailing consensus on the role of the central banks is eroding. Having price stability as the sole objective is giving way to the conception of a triple mandate that includes inflation, growth and financial stability. This is *de facto* the orientation that is being set for the ECB. We delve into this situation in one of the articles of the OFCE issue entitled *Reforming Europe* [1], in which we discuss the implementation of these three objectives.

The exclusive pursuit of the goal of price stability is now insufficient to ensure macroeconomic and financial stability. [2] A new paradigm is emerging in which the central banks need to simultaneously ensure price stability, growth and financial stability. This has been the orientation of recent institutional changes in the ECB, including its new responsibility for micro-prudential supervision. [3] Furthermore, the conduct of the euro zone's monetary policy shows that the ECB has also remained attentive to trends in growth[4]. But if the ECB is indeed pursuing a triple mandate, what then is the proper relationship between these missions?

The crucial need for coordination between the different actors in charge of monetary policy, financial regulation and fiscal policy is lacking in the current architecture. Furthermore, certain practices need to be clarified. The ECB has played the role of lender of last resort (with banks and to a lesser extent States) even though it has not specifically been assigned this role. Finally, in a new framework in which the ECB plays a greater role in determining the euro zone's macroeconomic and financial balance, we believe it is necessary to strengthen the democratic accountability of the Bank. The definition of its objectives in the Maastricht Treaty in fact gives it strong autonomy in interpretation (see in particular the discussion by Christophe Blot, here). Moreover, while the ECB regularly reports on its work to the

European Parliament, the latter does not have any way to direct this [5].

Based on these observations, we discuss several proposals for coordinating the ECB’s three objectives more effectively henceforth:

1 – Even without modifying the treaties in force, it is important that the heads of the ECB be more explicit about the different objectives being pursued [6]. The declared priority of price stability no longer corresponds to the practice of monetary policy: growth seems to be an essential objective, as is financial stability. More transparency would make monetary policy more credible and certainly more effective in preventing another financial and banking crisis in particular. The use of exchange rate policy [7] should not be overlooked, as it can play a role in reducing macroeconomic imbalances within the euro zone.

2 – In the absence of such clarification, the ECB’s extensive independence needs to be challenged so that it comes up to international standards in this area. Central banks rarely have independence in deciding their objectives: for example, the US Federal Reserve pursues an explicit dual mandate, while the Bank of England’s actions target institutionalized inflation. An explicit triple mandate could be imposed on the ECB by the governments, with the heads of the ECB then needing to make effective tradeoffs between these objectives.

3 – The increase in the number of objectives pursued has made it more difficult to deal with tradeoffs between them. This is particularly so given that the ECB has *de facto* embarked on a policy of managing the public debt, which now exposes it to the problem of the sustainability of Europe’s public finances. The ECB’s mandate should therefore explicitly spell out its role as lender of last resort, a normal task of central banks, which would clarify the need for closer coordination between governments and the ECB.

4 – Rather than calling the ECB's independence completely into question, which would never win unanimity among the Member States, we call for the creation *ex nihilo* of a body to supervise the ECB. This could emanate from the European Parliament, which is responsible for discussing and analyzing the relevance of the monetary policy established with respect to the ECB's expanded objectives: price stability, growth, financial stability and the sustainability of the public finances. The ECB would then not only be invited to report on its policy – as it is already doing to Parliament and through public debate – but it could also see its objectives occasionally redefined. This "supervisory body" could for example propose quantified inflation targets or unemployment targets.

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[1] *Reforming Europe*, edited by Christophe Blot, Olivier Rozenberg, Francesco Saraceno and Imola Streho, *Revue de l'OFCE*, no. 134, May 2014. This issue is available in French and English and has been the subject of a post on the OFCE blog.

[2] This link is examined in "Assessing the Link between Price and Financial Stability" (2014), Christophe Blot, Jérôme Creel, Paul Hubert, Fabien Labondance and Francesco Saraceno, *Document de travail de l'OFCE,* 2014-2.

[3] The implementation of the banking union gives the ECB a role in financial regulation (Decision of the Council of the European Union of 15 October 2013). It is henceforth in charge of banking supervision (particularly credit institutions considered "significant") in the Single supervisory mechanism (SSM). As of autumn 2014, the ECB will be responsible for micro-prudential policy, in close cooperation with national organizations and institutions. See the article by Jean-Paul Pollin, "Beyond the banking union", in *Revue de l'OFCE, Reforming Europe* .

[4] Castro (2011), "Can central banks' monetary policy be described by a linear (augmented) Taylor rule or by a nonlinear rule?", *Journal of Financial Stability* vol.7(4), p. 228-246. This paper uses an estimation of Taylor rules between 1991:1 and 2007:12 to show that the ECB reacted significantly to inflation and to the output gap.

[5] In the United States, the mandate of the Federal Reserve is set by Congress, which then has a right of supervision and can therefore amend the Fed's articles and mandate.

[6] Beyond clarifying objectives in terms of inflation and growth, the central bank's fundamental objective is to ensure confidence in the currency.

[7] This issue is considered in part in a recent OFCE post.

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	1Jan 2014	9	1,0	0,5
	CICE yr 2	1Jan 2015	7	0,8	0,3
	CICE yr 3	1Jan 2016	1	0,8	0,0
	CICE yr 4	1Jan 2017	2	0,8	0,1
	CICE yr 5	1Jan 2018	1	0,8	0,0
Responsibility Pact	Reductions on low wages	1Jan 2015	4,5	0,9	0,2
	Reductions wages › 1.6 SMIC	1Jan 2016	4,5	0,8	0,2
	Reductions freelancers and artisans	1Jan 2015	1	0,8	0,04
	TOTAL		30		1,4
Solidarity Pact	Reductions social contributions ‹ 1.3 SMIC	1Jan 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 2016-2017	1 4	0,8	0,04 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.

Revising the budget in Croatia: yes, but … for whom and why?

By Sandrine Levasseur

Under the excessive deficit procedure that Croatia has been subject to since 28 January 2014, the country's government has been obliged to revise its projected budget for the forthcoming three years, which is the timeframe that has been set for putting its finances into "good order", with "good order" being understood to mean a public deficit that does not exceed 3% of GDP. This new budget is being fixed in adverse economic conditions, as the government's forecast of GDP growth for 2014 has been revised downward from 1.3% to a tiny 0.2%.

Paradoxically, the new budget could help prolong the recession in the country rather than help it recover, at least in 2014. This paradox is especially worth noting since this is also the opinion of those for whom the Croatian government is making this adjustment: first of all, the rating agencies, and second, the international institutions (or at least the IMF, as the European Commission has to keep quiet on the matter). In fact, a simple glance at the revised budget is enough to see that the fiscal adjustment being proposed by the Croatian government will not have an expansionary impact on GDP. For example, the budget provides for a hike in tax revenues, in particular through an increase in the rate of health insurance contributions from 13% to 15%.But this will also result in undermining the international competitiveness of the country's businesses, which have already been hit hard.

The wages and bonuses of civil servants will fall (by about 6%) so as to give the public finances some breathing room. But these cuts in civil servant salaries will not help perk up domestic demand, which has been anaemic due to the adjustments consumers and businesses have made in their balance sheets. To take the latest example, to help bail out the state finances the profits of state enterprises will not be reinvested in the economy. However, the country is thereby depriving itself of a source of growth since, because of their weight in the economy, these enterprises account for a large share of productive investment.

There is no doubt that Croatia's public finances need to be cleaned up. However, the horizon for the fiscal consolidation decided on by the Croatian government seems to us extremely "short-termist", as it doesn't call into question the existing model of growth or seek sources of sustainable growth. A few weeks ago, in an OFCE note we discussed the impact alternative fiscal adjustments would have on growth and the public finances. In the specific case of Croatia, the government cannot avoid the need to consider doing the following: restructuring the productive apparatus (including through privatization and concessions); improving the system of tax collection; and, more broadly, implementing an anti-corruption policy to improve the country's "business climate". In the meantime, in large part due to the fiscal decisions being taken, 2014 is likely to wind up as the sixth year in a row Croatia has been in recession. The IMF forecasts, which anticipate that the recessionary impact of the fiscal consolidation will be greater than that projected by the Croatian government, is expecting GDP to fall by about 0.5% to 1% in 2014. In total, the decline in GDP since 2009 will therefore come to between 11.6% and 12.5%. It's not exactly the stuff of dreams….

Growth in the 4th quarter of 2013, but …

By Hervé Péléraux

According to the OFCE's leading indicator, the French economy has grown by 0.5% in the fourth quarter of 2013. This result, which was anticipated, reflects the improvement in business surveys seen for about a year now. However, does this mark the return of GDP to a path of higher long-term growth? It is still too early to say.

The improvement in the business surveys anticipated the interruption in the second recession that took place in the first half of 2011. The national accounts then validated the signal emitted by the surveys, with renewed growth of 0.6% in the second quarter of 2013 (Table). GDP did of course fall again in the third quarter (-0.1%), but on average over the last two quarters there was growth of approximately 0.2% per quarter, a rate that, though very moderate, was still positive.

At the same time, the leading indicator, which aims to arrive at an estimate of GDP growth in the very short term by translating the cyclical information contained in the surveys, also pointed to a slow recovery in activity: on average over the last two quarters, growth was estimated at 0.1%, a figure that is slightly under the assessment of the national accounts.

Table. Rate of growth of French GDP according to the national accounts and the indicator

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

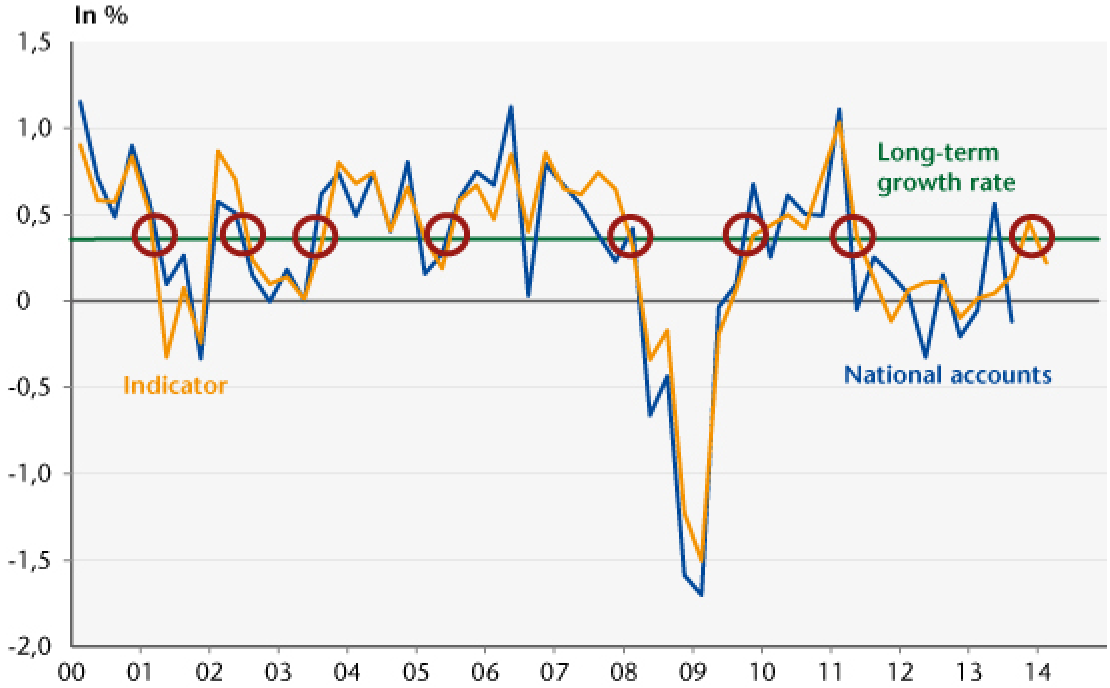
	2012	2013				2014
	Q4	Q1	Q2	Q3	Q4	Q1
National accounts	-0,2	-0,1	+0,6	-0,1	-	-
Indicator	-0,1	0,0	0,0	+0,1	+0,5	+0,2

Sources: INSEE, European Commission, OFCE calculations.

In the last few months, the uncontested growth in the confidence of private agents has enhanced the outlook for the end of 2013: the debate is now focusing on the possibility for the French economy to break through a turning point upwards and for growth to settle in at a level higher than the pace of long-term growth (0.35% per quarter).

Based on past experience, when the indicator has sent out warning signs of a turning point in the economic cycle, the signal issued for the fourth quarter of 2013 is indicating that the long-term growth rate of the French economy is being crossed (Figure). This signal is fragile: the still very partial information on the first quarter of 2014, i.e. the business surveys for January, point towards the growth rate falling below its potential. The possibility of a real lasting recovery that is able to create jobs and reverse the trend in unemployment is thus still very uncertain.

Figure. GDP growth – estimated and forecast



Sources: INSEE, European Commission, OFCE calculations.

Note on the leading indicator:

The leading indicator aims to forecast the quarterly growth rate for French GDP two quarters beyond the latest available data. The components of the indicator are selected from survey data sets that are rapidly available and unrevised. The selection of the data series is made on an econometric basis, starting from the business surveys carried out in different productive sectors (industry, construction, services, retail) and among consumers. Two series related to the international environment are also significant: the rate of growth of the real exchange rate of the euro against the dollar, and the real growth rate of oil prices.

Some components are at least two quarters in advance and as such can be used to predict GDP growth. Others are coincidental, or are not sufficiently advanced to make a forecast two quarters ahead. These series need to be forecast, but over a short-term horizon that never exceeds four months.

The leading indicator is calculated at the beginning of each month, shortly after the publication of the business and consumer surveys.

Does financial instability really undermine economic performance?

By [Jérôme Creel](), [Paul Hubert]() and Fabien Labondance

What relationship can be established between the degree to which an economy is financialized (understood as the ratio of credit to the private sector over GDP), financial instability and economic performance (usually GDP per capita) in the European Union (EU)? [A recent working paper [1]]() attempts to provide a few answers to this question.

Two major competing approaches can be found in the economic literature. On the one hand, an approach inherited from Schumpeter emphasizes the need for entrepreneurs to access sources of credit to finance their innovations. The financial sector is thus seen as a prerequisite to innovative activity and a facilitator of economic performance. On the other hand, financial development can be viewed instead as the result or consequence of economic development. Development implies increased demand for financial services on the part of households and businesses. There is therefore a source of endogeneity in the relationship between financial development and economic growth, as one is likely to lead to the other, and vice versa.

Until recently, analytical studies that attempted to disentangle and quantify these causalities showed a positive significant link between an economy's financial depth and its economic performance (Ang, 2008). However, the onset of the international financial crisis led to nuancing these conclusions. In particular, Arcand *et al.* (2012) showed that beyond a certain level the impact of increased financialization becomes negative [2]. The relationship between financialization and economic performance can be represented by a bell curve: positive at the beginning and then, from a level of 80%-100% for the private credit to GDP ratio, fading to zero or turning negative.

Unlike other works that include both developed and emerging or developing countries, our study focuses on the EU Member States from 1998 to 2011. The advantage of this sample is that we include only economies whose financial systems are developed or at least in advanced stages of development [3]. Moreover, it is a relatively homogeneous political space that permits the establishment of common financial regulations. We adopt the methodology of Beck & Levine (2004) who, using a panel and instrumental variables, are able to resolve the endogeneity issues discussed above. Economic performance is explained by the usual variables in endogenous growth theory, namely initial GDP per capita, the accumulation of human capital over the average years of education, government expenditure, trade openness and inflation. In addition, we include the aforementioned financialization variables. We show that, contrary to the usual results in the literature, an economy's financial depth does not have a positive impact on economic performance as measured by GDP per capita, household consumption, business investment or disposable income. In most cases, the effect of financialization is not different from zero, and when it is, the coefficient is negative. It is therefore difficult to argue that financial and economic development go hand in hand in these economies!

In addition, we included in these estimates different variables quantifying financial instability so as to check whether the results set out above might be due simply to the effects of the crisis. These financial instability variables (Z-score [4], CISS[5], bad debt rate, the volatility of stock market indices and an index reflecting the microeconomic characteristics of Europe's banks) usually seem to have a significant *negative* impact on economic performance. At the same time, the variables measuring the *degree* of an economy's financialization show no obvious effects on performance.

These various findings suggest that it is certainly unrealistic to expect a positive impact of any further increase in the degree of financialization of Europe's economies. It is likely that the European banking and financial systems have reached a critical size beyond which no improvement in economic performance can be expected. Instead, there are likely to be negative effects due to the financial instability arising out of a financial sector that has grown overly large and whose innovations are insufficiently or poorly regulated.

The findings of this study suggest several policy recommendations. The argument of the banking lobbies that regulating bank size would have a negative impact on growth finds absolutely no support in our results—quite the contrary. Furthermore, we show that financial instability is costly. It is important to prevent it. This undoubtedly requires developing a better definition of micro- and macro-prudential standards, together with effective supervision of Europe's banks. Will the forthcoming banking union help in this regard? There are many sceptics, including the economists of Bruegel, the Financial Times and the OFCE.

[1] Creel, Jérôme, Paul Hubert and Fabien Labondance, "Financial stability and economic performance", *Document de travail de l'OFCE*, 2013-24. This study was supported by funding from the European Union Seventh Framework Program (FP7/2007-2013) under grant agreement no. 266800 (FESSUD).

[2] We consider this work in an earlier post.

[3] In addition to the ratio of private sector credit to GDP, the depth of financialization is also indicated by the turnover ratio, which measures the degree of liquidity of financial markets, measured as the ratio of the total value of shares traded to total capitalization.

[4] Index measuring the stability of banks based on their profitability, their capital ratio and the volatility of their net income.

[5] Index of systemic risk calculated by the ECB and including five components of the financial system: the banking sector, non-bank financial institutions, money markets, securities markets (stocks and bonds) and foreign exchange markets.

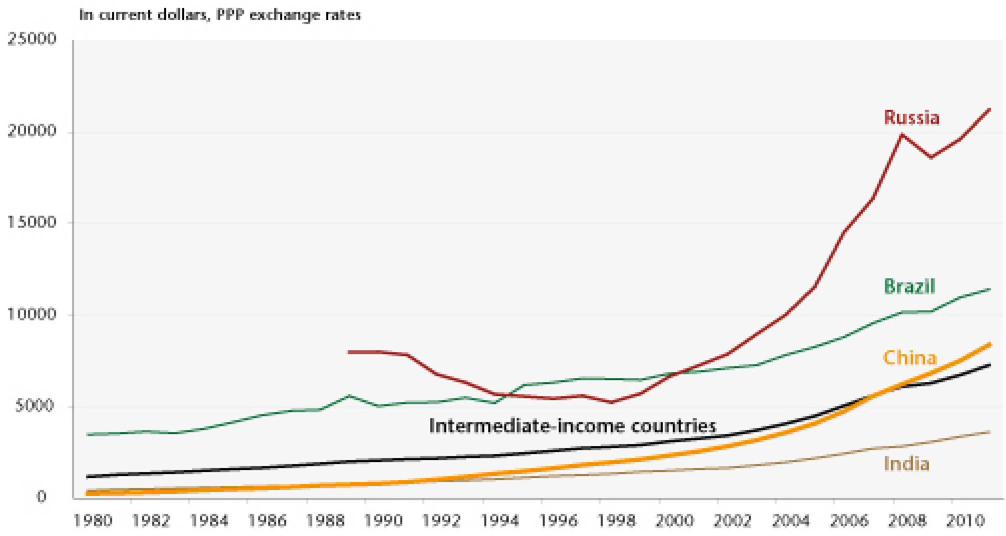
When Brazil's youth dream of something besides football…

By Christine Rifflart

The rise in public transport prices had barely been in force for two weeks when this lit the fire of revolt and led to a new twist in the so-called “Brazilian development model”. With its aspirations for high-quality public services (education, health, transport, etc.), the new middle class that formed during the last decade is claiming its rights and reminding the government that the money put up to host major sports events (2014 World Cup, 2016 Olympics) should not be spent to the detriment of other priorities, especially when growth has ceased and budget constraints demand savings.

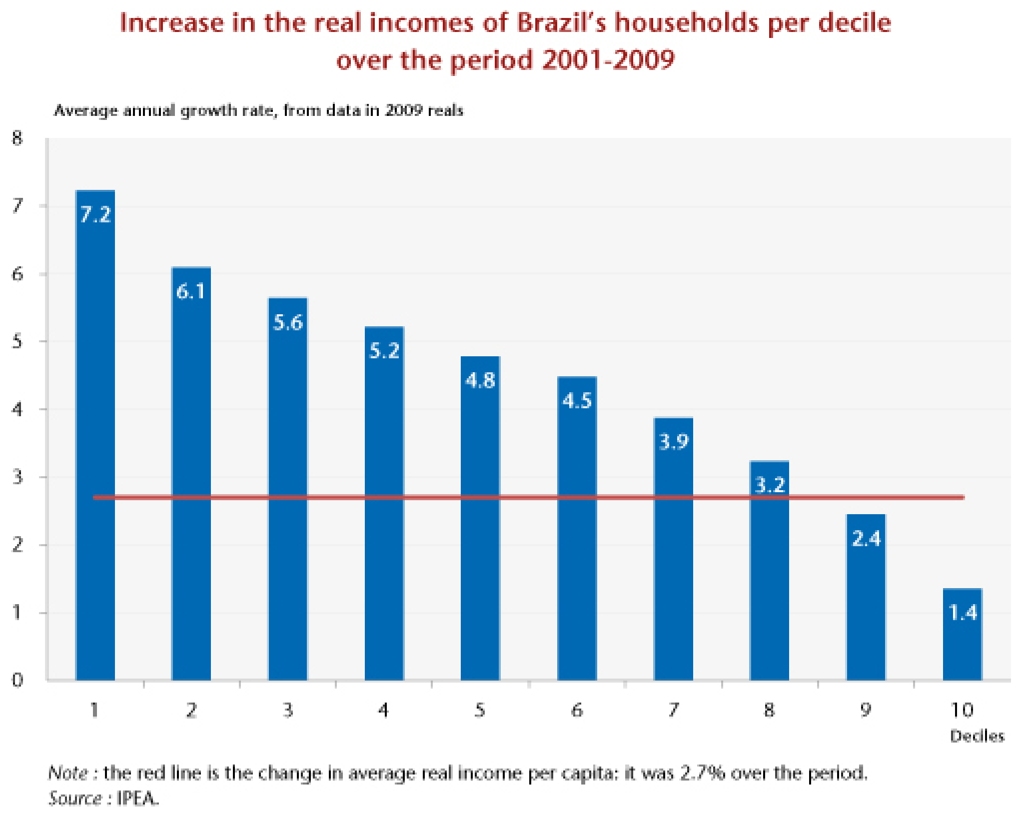
Over the years, Brazil’s growth accelerated from 2.5% per year in the 1980s and 1990s to almost 4% between 2001 and 2011. More importantly, for the first time the growth benefited a population that had traditionally been left out. Up to then, the slow growth of per capita income had gone hand in hand with rising inequality (the Gini coefficient for the period, at over 0.6, is one of the highest in the world) and an increase in poverty rates, which exceeded 40% during the 1980s. As hyperinflation was finally defeated by the 1994 “Plan Real”, growth resumed but remained fragile due to the series of external shocks that have hit the country (impact of the Asian crisis of 1997 and the Argentine crisis of 2001).

Change in per capita income in the BRICs and in intermediary countries according to the World Bank



Source : World Bank.

Lula’s accession to the presidency on 1 January 2003 marked a real turning point in this growth dynamic (Figure 1). While continuing the liberal orthodoxy of his predecessor F. H. Cardoso with respect to macro-economic policy and financial stability (unlike Argentina, for example), the new government took advantage of the renewed growth to better distribute the country’s wealth and to try to eradicate poverty. According to household surveys, real household income grew in local currency by 2.7% per year between 2001 and 2009, and the poverty rate fell by almost 15 percentage points to 21.4% of the population by the end of the period. In addition, the real income of the first eight deciles, especially the poorest 20% of the population, has increased much faster than the average income (Figure 2). Ultimately, 29 million Brazilians have joined the ranks of the new middle class, which now numbers 94.9 million (50.5% of the population), while the upper income class has welcomed 6.6 million additional Brazilians (and now represents 10.6% of the population). In contrast, the ranks of the poor decreased by 23 million, to 73.2 million in 2009. In terms of income, the new middle class now accounts for 46.2% of distributed income, more than the richest category, which saw its share decline to 44.1% [1].



This new configuration of Brazilian society is changing consumption patterns and aspirations, particularly in terms of education, access to health care, infrastructure, etc. But while consumer spending has accelerated for 10 years (durables in particular) and stimulated private investment, the wind of democratization is posing a serious challenge to the government. For while the hike in public transport prices was quickly canceled, providing new infrastructure and improving the quality of public services in a country that is 15 times the size of France is not done in a day. In 2012, of 144 countries surveyed, the *World Economic Forum (pp 116-117)* ranked Brazil 107th for the quality of its infrastructure and 116th for the quality of its education system. The authorities must skillfully respond to the legitimate demands of the population, especially the youth [2].

The country has a solid basis for dealing with this and stimulating investment: a stable political and macroeconomic environment, sound public finances, external debt below 15% of GDP, abundant foreign exchange reserves, the confidence of the financial markets and direct foreign investors, and of course varied and abundant natural resources in agriculture (soybeans, coffee, etc.), mining (iron ore, coal, zinc, bauxite, etc.) and energy (hydroelectricity, oil).

But many difficulties lie ahead. Currently, growth is lacking, and it is even running up against problems with production capacity. In 2012, growth came to only 0.9% (insufficient to increase per capita income) and, even though investment is recovering, the forecasts for 2013 have been regularly revised downwards to around 3%. At the same time, inflation is picking up, driven by strong pressure on the labour market (at 5.5%, the unemployment rate is very low), and since 2008 productivity has stagnated. Inflation, which hit 6.5% in May, is at the top of the range allowed by the monetary authorities. To meet the target of 4.5%, which would mean a reduction of more or less 2 percentage points, in April the central bank raised its key rate from 7.25% to 8%. Monetary policy is nevertheless still very accommodative – the difference between the interest rate and the inflation rate has never been so small – and the moderate growth should lead to calming the inflationary pressures. In addition, the relative support monetary policy is giving to the economy is being offset by a policy of continuing fiscal consolidation. Following a primary surplus of 2.4% of GDP in 2012, the goal for this year is to maintain this at 2.3%. The net public sector debt is continuing to decline: from 60% ten years ago to 43% in 2008, reaching 35% last April.

The virtual stagnation in growth has been due in particular to a serious problem with competitiveness, which undercut the country’s growth potential. In a lackluster international economy, higher production costs and a seemingly overvalued currency have resulted in a drop in export performance, a reluctance to invest, and greater recourse to imports. The current account balance deteriorated by 1 GDP point in one year, reaching 3% in April.

To deal with this supply-side problem, Brazil’s central bank is intervening more and more to counter the adverse effects of capital inflows – attracted by high interest rates – on the exchange rate, while the government is seeking to boost investment. The investment rate, which has been under 20% of GDP over the last 20 years and close to 15% between 1996 and 2006, is structurally insufficient to lead the economy back onto a path of virtuous growth. For comparison, the investment rate over the past five years has been 44% in China, 38% in India and 24% in Russia. To lift Brazil’s investment rate towards a target of around 23%-25%, in 2007 the government introduced a “growth acceleration programme” (PAC), based on the implementation of major infrastructure projects.

In four years, public investment rose from 1.6% of GDP to 3.3%. The year 2011 saw the launch of the second phase of the PAC, which is slated to receive a budget of 1% of GDP per year for 4 years. There are also other investment programmes whose benefits, though disappointing in 2012, should still help resolve some of the problems. But the efforts being made are still insufficient. According to a 2010 study by Morgan Stanley [3], Brazil would need to invest 6 to 8% of its GDP in infrastructure every year for 20 years to catch up with the level of the infrastructure in South Korea, and 4% to catch that of Chile, the benchmark in the field in South America!

By improving the productive supply and by stimulating demand through increased public investment, the authorities’ objective is therefore to make up some of the delay built up from the past. But is it possible to carry out large-scale investment projects while simultaneously pursuing a policy of debt reduction when net public debt is close to 35% of GDP? The authorities should speed up the reform process to spur private investment, in particular by promoting the development of a national long-term savings programme (pension reform, etc.) while stimulating financial intermediation, which goes hand in hand with this.

The volume of loans granted by the financial sector to the non-financial sector represented only 54.7% of GDP in May. A little less than half of these are earmarked loans (rural credit, National Development Bank, etc.) at heavily subsidized interest rates (0.5% in real terms against 12% for non-subsidized loans to business, and 0.2% against 27.7% respectively for individuals). But the state must also reform a cumbersome and corrupt government.

Brazil has been an emerging country for over four decades. With an income of 11,500 dollars (PPP) per capita, it is time that this great country reaches adulthood by providing developed country quality standards for its public services and by refocusing its new development model on its new middle class, whose needs are still going unmet.

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[1]See The Agenda of the New Middle Class | Portal FGV on the site of the Fondation Gétulio Vargas.

[2]http://www.oecd.org/eco/outlook/48930900.pdf

[3]See the study by Morgan Stanley Paving the way, 2010.