

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.



The euro zone in crisis

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

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

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

– For some, it is the irresponsible policies of the South that are the cause of the imbalances: they have allowed the development of wage and property bubbles, while the Northern countries have been implementing virtuous policies of wage austerity and structural reform. The Southern countries thus need to adopt the North’s strategy and undergo a lengthy

austerity cure. For others, the single currency has led to the development of twin opposing imbalances: this has led to under-valuing the economies of the North, which enabled them to offset their excessive policies on wage and social austerity with excessive external surpluses, and it has allowed the persistence of the South's external deficits; this has resulted in the need for a controlled convergence, whereby recovery in the North facilitates the absorption of the South's external imbalances.

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

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

- For some, ending the debt crisis of the euro zone countries requires the establishment of a fiscal union, which means the

establishment of binding rules enshrined in the Fiscal Pact and a certain degree of fiscal federalism; the European Commission and Council should have a say on the fiscal policies of the Member States. Others think that the Member States should have a degree of autonomy to practice the fiscal policy they choose; this is a matter of both democracy and economic efficiency: the economic situations of the different countries are too diverse to invoke a uniform fiscal policy; what is needed is the open coordination of economic policy, without rigid pre-established standards on public finances, with the aim of ensuring satisfactory growth and the winding down of external imbalances.

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

[\[2\]](#) Ten of which are in English and two in French.

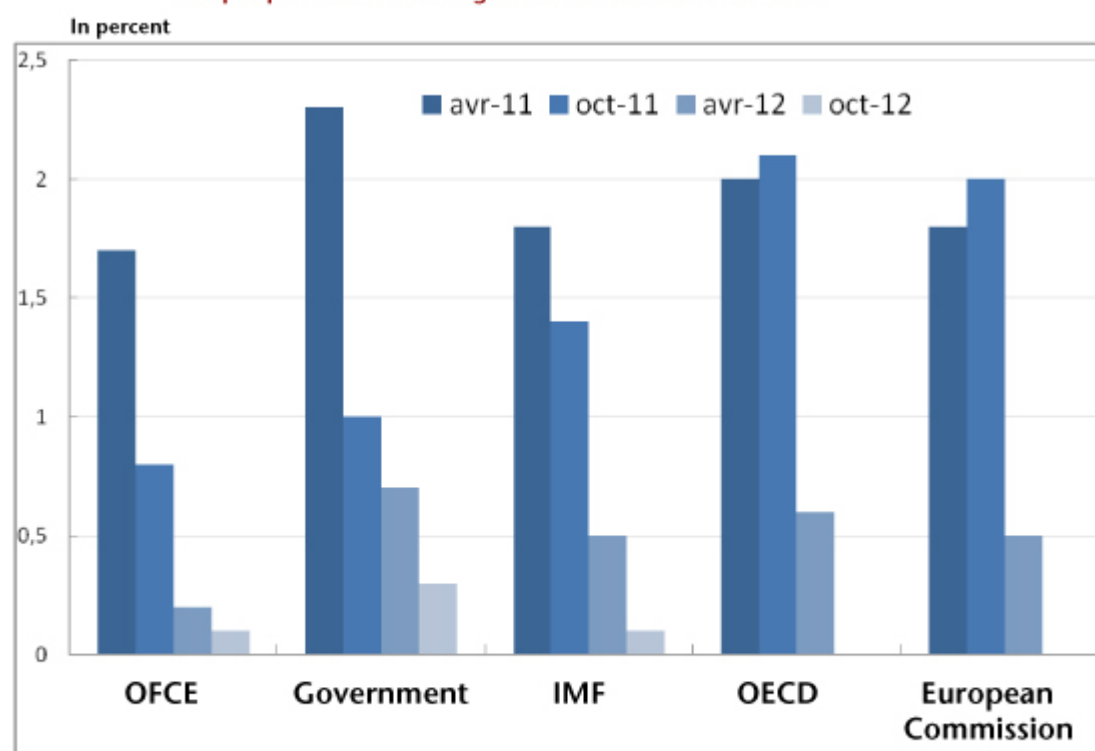
Why has French growth been revised downwards?

By Bruno Ducoudré and [Eric Heyer](#)

In its [October 2012 forecasts](#), the OFCE has revised its growth forecast for 2012 and 2013. The major international

institutions, the OECD, the IMF and the European Commission, also regularly review their growth forecasts to incorporate newly available information. An analysis of these revised forecasts is particularly interesting in that it shows that these institutions use low fiscal multipliers in developing their forecasts. In other words, the recessionary impact of fiscal policy has been underestimated by the OECD, the IMF and the European Commission, leading to substantial revisions of their growth forecasts, as is evidenced by the dramatic shifts by the [IMF](#) and the [European Commission](#) in the size of the multipliers.

Graphique 1. Révisions of growth in French GDP for 2012



Note : Growth in 2012 is reviewed four times each year by each institution. The first revision took place in April 2011, the second in October 2011, the third in April 2012 and the final one in October 2012. The OECD has not yet published its latest revisions.

Sources : IMF, European Commission, OECD, OFCE October 2012 calculations and forecasts.

Figure 1 shows that between the forecast made in April 2011 and the latest available forecast, the government, like all the other institutions, revised its growth forecast for France sharply downwards.

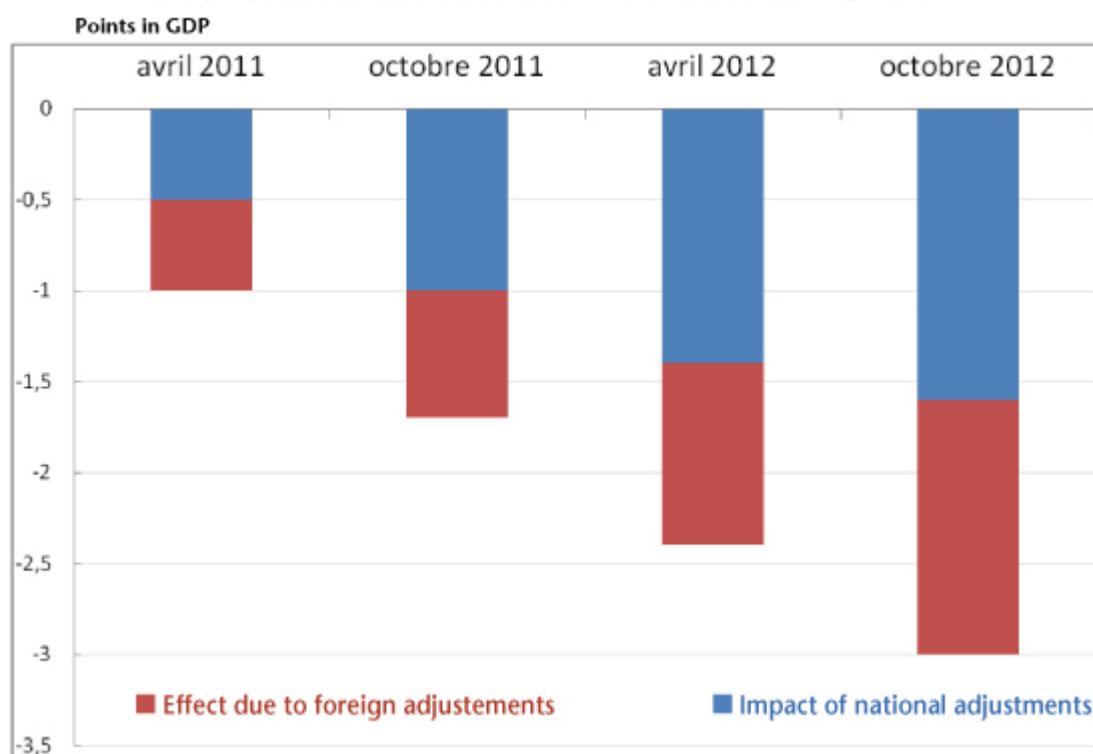
The austerity policies have also been strengthened at the same time, particularly in the euro zone. The European countries

undertook their stability program in order to return to balanced public finances within three years. In contrast to the years before the crisis, the implementation of these commitments is now considered a necessary or even sufficient condition for pulling out of the crisis. Moreover, in a context of financial uncertainty, being the only State not to meet its commitment to fiscal consolidation would be punished immediately by the markets (higher sovereign rates, a downgraded rating, a fine from the European Commission, implicit contagion of sovereign defaults). But in trying to reduce their deficits abruptly and synchronously, Europe's governments are inducing new slowdowns in activity.

A vicious circle has been created: with each downward revision in their forecasts for 2012 growth, Europe's governments implement new austerity measures to meet their deficit commitments. This has happened in France, but especially in Italy, which has virtually tripled its fiscal effort, and in Spain, which is now engaged in the greatest austerity effort of any major European country.

According to our estimates for the French economy (that is to say, using a multiplier of 1), the series of fiscal savings plans adopted at the national level have led to revising growth downwards by -1.1 points between April 2011 and October 2012 (from an impact of -0.5 GDP point to -1.6 points). Since these same policies are in force in our trading partners, this has led to revising growth for this same period by 0.9 point due to foreign trade (from -0.5 GDP point to -1.4 point) (Figure 2).

Graphique 2. Impact of the latest fiscal adjustments on 2012 growth



Source : OFCE October 2012 calculations and forecasts.

For the year 2012, the OFCE's revisions for the French economy can be explained in full simply by the escalation in the fiscal savings measures announced over the last 12 months, *i.e.* the national plans and those applied by our partner countries (Table 1).

Tableau 1. Determinants of the revisions to the OFCE forecast for France for 2012

	April 2011	October 2012	Revision
GDP growth	1,7	0,1	-1,6
(a) - Austerity measures (in GDP pt)	-0,6	-1,60	-1,0
(b) - Value of the fiscal multiplier	0,95	0,95	0,0
Impact of austerity plans in France (a + b)	-0,5	-1,6	-1,1
Impact of the austerity measures of France's partners	-0,5	-1,4	-0,9
Other adjustment factors			0,4

Source : OFCE calculations.

Leaving aside this escalation of austerity, our diagnosis of the French economy has changed very little over the last 18 months: without it, we would have even revised our growth forecast slightly upwards (0.4%).

Has monetary policy become ineffective?

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

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

Since the summer of 2007, the central banks of the industrialized countries have intervened regularly to counter the negative impact of the financial crisis on the functioning of the banking and financial system and to help kick-start growth. Initially, key interest rates were lowered considerably, and then maintained at a level close to 0 [\[1\]](#). In a second phase, from the beginning of 2009, the central banks implemented what are called unconventional measures. While these policies may differ from one central bank to another, they all result in an increase in the size of their balance sheets as well as a change in the composition of their balance sheet assets. However, three years after the economies in the United States, the euro zone and the United Kingdom hit bottom, it is clear that recovery is still a ways off, with unemployment at a high level everywhere. In Europe, a new recession is threatening [\[2\]](#). Does this call into question the effectiveness of monetary policy and of unconventional measures more specifically?

For almost four years, a wealth of research has been conducted on the impact of unconventional monetary policies [\[3\]](#). Cecioni, Ferrero and Sacchi (2011) [\[4\]](#) have presented a review of recent literature on the subject. The majority of these studies focus on the impact of the various measures taken by the central banks on financial variables, in particular on

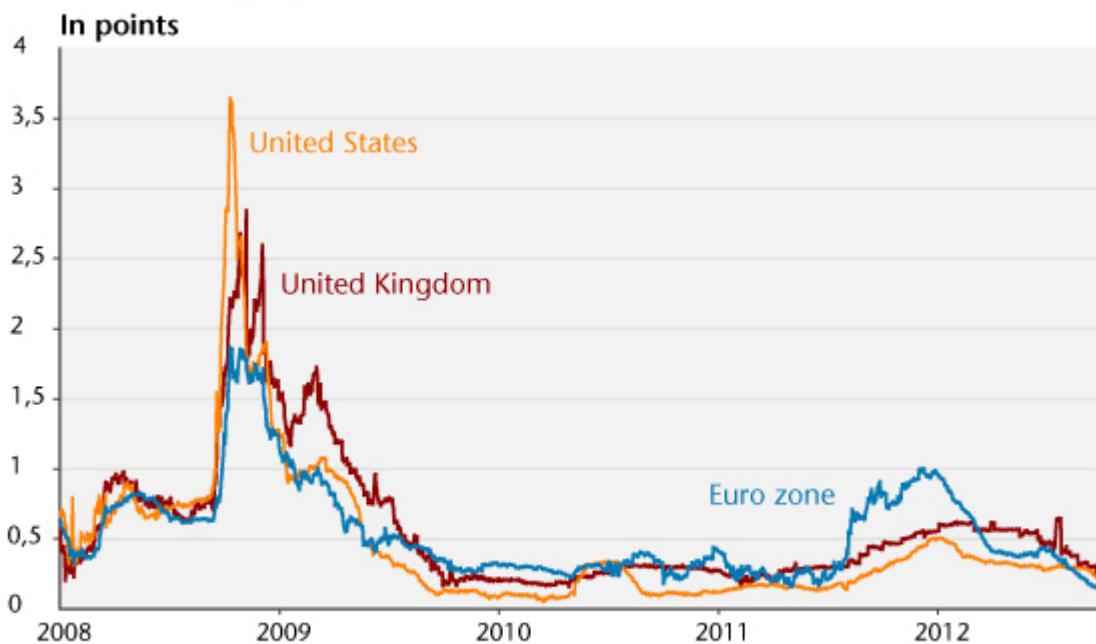
money market rates and bond yields. Given the role of the money market in the transmission of monetary policy, the ability of central banks to ease the pressures that have emerged since the beginning of the financial crisis constitutes a key vector for effective intervention. More recently, this was also one of the reasons motivating the ECB to conduct an exceptional refinancing operation in two stages, with a maturity of 3 years. This intervention has indeed helped to reduce the tensions on the interbank market that had reappeared in late 2011 in the euro zone, and to a lesser extent in the United States and the United Kingdom (see graph). This episode seems to confirm that central bank action can be effective when it is dealing with a liquidity crisis.

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

Under these conditions, how is it possible to explain the weakness or outright absence of a recovery? One answer evokes the hypothesis of a liquidity trap [\[8\]](#). Uncertainty is still prevalent, and the financial system is still so fragile that agents are continuing to express a preference for liquidity

and safety, which explains their reluctance to undertake risky projects. Thus, even if financing conditions are favourable, monetary policy will not be sufficient to stimulate a business recovery. This hypothesis probably explains the timidity of the recovery in the United States. But in the euro zone and the United Kingdom this hypothesis needs to be supplemented with a second explanation that recognizes the impact of restrictive fiscal policies in holding back recovery. The euro zone countries, like the UK, are pursuing a strategy of fiscal consolidation that is undermining demand. While monetary policy is indeed expansionary, it is not able to offset the downward pressure of fiscal policy on growth.

Graphique. Tensions on the interbank markets*



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

Source : Datastream.

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

[\[2\]](#) The first estimate of UK GDP for the third quarter of 2012 indicates an upturn in growth following three quarters of

decline. However, this rebound is due to unusual circumstances (see [Royaume-Uni: l'enlissement](#)), and activity will decline again in the fourth quarter.

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

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

[5] "[The impact of Federal Reserve asset purchase programmes: another twist](#)", *BIS Quarterly Review*, March, pp. 23-30.

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

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

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

The euro zone: confidence won't be enough

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

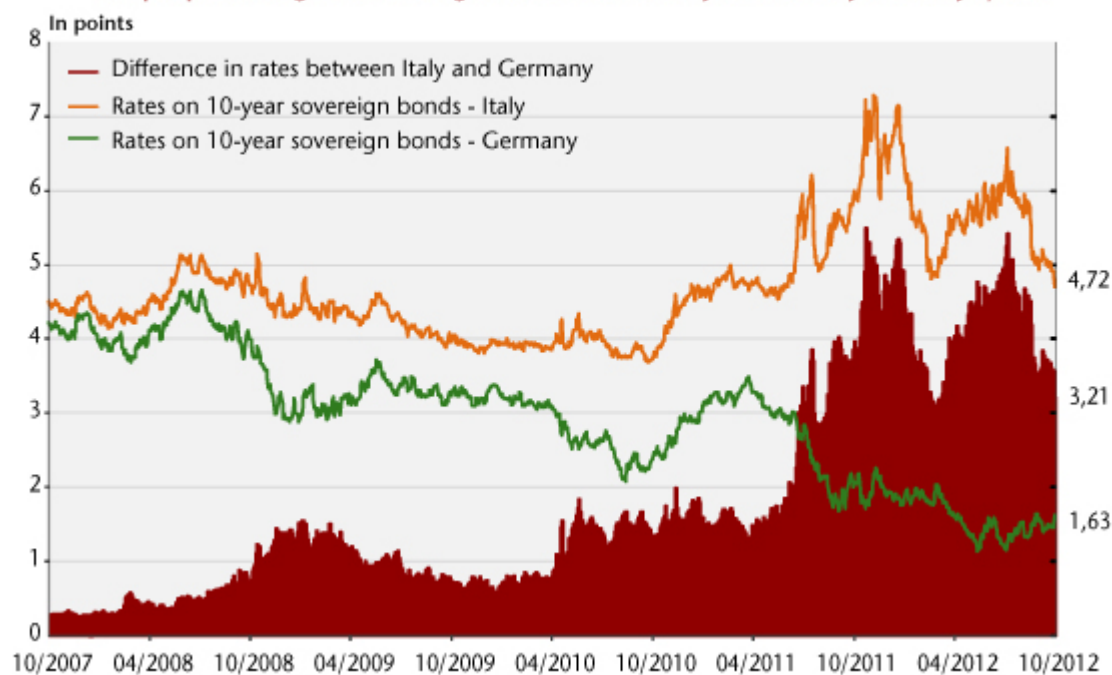
This text summarizes the OFCE's October 2012 forecasts for [the economy of the euro zone](#).

After more than two years of crisis in the euro zone, this time the meeting of the European Council, held on 18 and 19 October, had nothing of the atmosphere of yet another last-chance summit. Even though discussions on the future banking union [\[1\]](#) were a source of tension between France and Germany, there was no sword of Damocles hanging over the heads of the European heads of state. However, it would be premature to assume that the crisis is coming to an end. It is sufficient to recall that the GDP of the euro zone has still not regained its pre-crisis level, and in fact declined again by 0.2% in the second quarter of 2012. This decline is forecast to continue, as we expect GDP to fall by 0.5% in 2012 and by 0.1% in 2013. Consequently, the unemployment rate in the euro zone, which has already surpassed its previous historical record from April 1997, will rise further, reaching 12.1% by end 2013. What then are the reasons for the lull? Can the euro zone quickly resume its growth and hope to finally put an end to the social crisis?

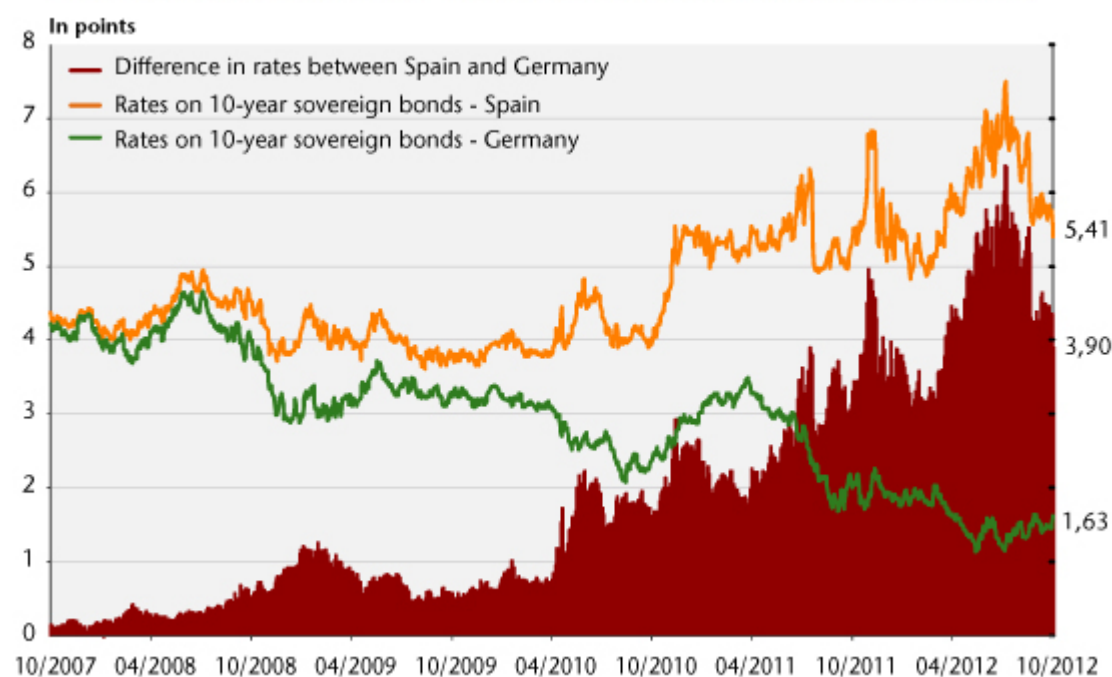
Since the end of 2011, Europe has adopted a new treaty (the Treaty on stability, coordination and governance, the TSCG) which is being ratified in the 25 signatory countries. The new law is specifically intended to strengthen both budgetary discipline – through the adoption of national golden rules – and solidarity through the creation of the European Stability Mechanism (ESM), in so far as the use of the ESM is conditional on ratification of the TSCG. On 6 September, the ECB unveiled the basic points of its new conditional purchase of sovereign debt ([see here](#)), which is aimed at reducing the interest rates of countries subject to the ESM. Thus, the risk premium, as measured by the difference between the Italian and Spanish sovereign interest rates and the German rate, after peaking on 24 July 2012, decreased respectively by 2.2 and 2.5 points (Figures 1 and 2). This is of course still far from normal, but this lull is nevertheless welcome and it shows that the spectre of a breakup of the euro zone has receded.

Could this new wave of optimism be a precursor to an upturn in the economy of the euro zone? The answer to this question is, unfortunately, negative. The fiscal policies of countries in the zone are still highly restrictive, a situation that has even intensified in 2012, pushing Italy and Spain back into recession and deepening the recession that was already hitting Portugal and Greece. For the euro zone as a whole, the fiscal stimulus will come to 1.7 percent of GDP in 2012 (table). The series of votes on national budgets confirms this strategy of a forced reduction of budget deficits for 2013, with the overall fiscal consolidation for the euro zone as a whole coming to 1.3%. There will be significant differences between the countries, since in Germany the fiscal stimulus will barely be negative (-0.2 point) while in Spain, Italy and Greece it will be more than -2 GDP points. However, the recessionary impact of this synchronized fiscal consolidation will be even greater given that the euro zone countries are still at the bottom of the economic cycle. In these conditions, the targets for budget deficit reduction will not be met, which will inevitably raise the question of the appropriateness of further budget cuts. More and more Member States thus risk being caught in a vicious circle where low growth calls for further fiscal adjustments that in turn deepen the economic and social crisis. It is essential that any decision about improving the governance of the European Union or the transmission of monetary policy restores confidence and creates the conditions for a return to growth. But this will be insufficient to escape the recession and should not obscure the impact of the fiscal strategy.

Graphique 1. Long-term sovereign interest rates in Italy and the Italy-Germany Spread



Graphique 2. Long-term sovereign interest rates in Spain and the Spain-Germany Spread



Source : Datastream.

Tableau. Fiscal stimulus in the euro zone countries

In GDP points

	2009	2010	2011	2012	2013
Germany	0,7	1,5	-0,9	-0,5	-0,2
Austria	0,4	0,6	-1,6	-0,1	-0,9
Belgium	1,9	-0,3	-0,1	-1,1	-0,8
Spain	3,8	-2,5	-1,1	-3,4	-2,4
Finland	0,4	1,5	-1,6	-0,4	-1,3
France	2,3	-0,5	-2,9	-1,6	-1,8
Greece	3,2	-8,0	-5,3	-5,0	-3,9
Ireland	2,2	-4,4	-1,5	-2,4	-1,8
Italy	0,8	-0,4	-1,2	-3,2	-2,1
Netherlands	4,0	-1,1	-0,2	-1,0	-1,2
Portugal	5,0	-0,7	-3,7	-3,7	-1,8
Euro zone 11*	1,8	-0,3	-1,3	-1,7	-1,3

* Excluding Cyprus, Luxembourg, Malta, Slovakia, Slovenia and Estonia.

Note : The fiscal stimulus is measured by the opposite of the variation in the cyclically adjusted primary balance, that is, excluding interest charges and exceptional revenue: it approximates the discretionary budget policy.

Sources : OFCE calculations and forecasts, October 2012.

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[1] See [here](#) for an analysis of the importance of the proposed banking union and the questions it raises.

France: will the war of the 3% take place?

By [Eric Heyer](#)

This text summarizes the [OFCE's October 2012 forecasts for the French economy](#).

The French economy is expected to see average annual growth of 0.1% in 2012 and 0.0% in 2013. This performance is particularly poor and far from the path that an economy

recovering from a crisis would normally experience.

Four years after the onset of the crisis, the French economy has real potential for a rebound: this should lead to spontaneous average growth of about 3.0% per year in 2012 and 2013, making up some of the output gap built up since the start of the crisis. But this spontaneous recovery is being hampered, mainly by the establishment of budgetary savings plans in France and throughout Europe. The fiscal consolidation strategy imposed by the European Commission is likely to slice nearly 6 percentage points off GDP in France during 2012 and 2013.

Table 1. The brakes on growth in France

En points of GDP

Rythm	... quaterly		... annually	
	2012	2013	2012	2013
Spontaneous recovery	0,8	0,8	2,1	3,1
Budget impact	-0,4	-0,4	-1,6	-1,7
Oil shock	-0,05	0,0	-0,2	0,0
External environment	-0,4	-0,3	-1,4	-1,2
Achievement			-1,0	-0,2
Growth forecasts	-0,04	0,04	0,1	0,0

Sources : INSEE, OFCE calculations.

By setting a pace that is far from its potential, the expected growth will increase the output gap accumulated since 2008 and will lead to a further deterioration on the labour market. The unemployment rate will rise steadily and hit 11% by late 2013.

Moreover, the reduction of the budget deficit expected by the Government due to the implementation of its consolidation strategy – the target for the general government deficit is 3% of GDP in 2013 – will be partially undermined by the shortfall in tax revenue due to weak growth. The general government deficit will come to 3.5% in 2013.

Under these conditions, should the government do whatever it can to fulfil its commitment to a 3% deficit in 2013?

In a context of financial uncertainty, being the only State not to keep its promise of fiscal consolidation is a risk, *i.e.* of being punished immediately by an increase in the financial terms on the repayment of its debt. This risk is real, but limited. The current situation is that of a “liquidity trap” and abundant savings. The result is a “flight to quality” phenomenon on the part of investors seeking safe investments. But among these are both German and French government bonds. Under these conditions, reducing the government deficit by 1 GDP point instead of 1.5 point would have very little impact on French bond rates.

However, maintaining a target of a 3% deficit in 2013 could have a dramatic impact on economic activity and employment in France. We simulated a scenario in which the French government maintains its budgetary commitment regardless of the costs and the economic situation. If this were to occur, it would require the adoption of a new programme of budget cuts in the coming months in the amount of 22 billion euros.

This strategy would cut economic activity in the country by 1.2% in 2013. It would lead to a further increase in the unemployment rate, which would reach 11.7% at year end, nearly 12%. As for employment, this obstinacy would intensify job losses, costing nearly 200,000 jobs in total.

A darker scenario is also possible: according to our forecasts, and taking into account the draft budget bills known and approved, no major European country would meet its deficit reduction commitments in 2013. By underestimating the difficulty of reaching inaccessible targets, there is a high risk of seeing the euro zone countries locked into a spiral where the nervousness of the financial markets would become the engine driving ever greater austerity. To illustrate this risk, we simulated a scenario in which the major euro zone countries (Germany, France, Italy and Spain) implement new austerity measures to meet their deficit targets in 2013. Adopting such a strategy would result in a strong negative

shock to economic activity in these countries. For the French economy, it would lead to additional austerity that either at the national level or coming from its euro zone partner countries would cause a severe recession in 2013. French GDP would fall by more than 4.0%, resulting in a further increase in the unemployment rate, which would approach 14%.

Table 2. Illustrative scenarios of risks to French growth

In %

	2011	2012*	2013*
Central scenario			
GDP	1,4	0,1	0,0
Gov't deficit (in GDP points)	-7,1	-4,4	-3,5
Unemployment rate	9,4	10,2	11,0
Market employment	104	-95	-166
Scenario where France alone meets its budget commitments			
GDP			-1,2
Gov't deficit (in GDP points)			-3,0
Unemployment rate			11,7
Market employment (in 1000s)			
Change			-361
Deviation from central scenario			-195
Scénario where euro zone countries meet their budget commitments			
GDP			-4,6
Gov't deficit (in GDP points)			-3,0
Unemployment rate			18,8
Market employment (in 1000s)			
Change			-910
Déviation from central scenario			-744

* OFCE forecast October 2012

Sources : INSEE ; OFCE calculations *e-mod.fr*.