How can Europe be saved? How can the paradigm be changed?

By Xavier Ragot

There are new inflections in the debate over the construction of Europe. New options from a variety of economic and political perspectives have seen the light of day in several key conferences and workshops, though without the visibility of public statements. The debate is livelier in Germany than in France. This is due probably to the caricature of a debate that took place during France's presidential elections, which took the form of "for or against the single currency", while the debate needed was over how to orient the euro area's institutions to serve growth and deal with inequalities.
Two conferences were held in Berlin one week apart that considered opposing options. The first tackled the consequences of a country leaving the euro area; the second examined an alternative paradigm for reducing inequalities in Europe. In other words, the two conferences covered almost the entire spectrum of conceivable economic policies.

Sowing fear: the end of the euro area?

The first question: What would happen if one or more countries left the euro area? Should we hope for this, or how could we prevent it? A conference held on March 14 under the title "Is the euro sustainable – and what if it isn't?" brought together the heads of influential institutes like Clemens Fuest, one of the five German "wise men", Christoph Schmidt, and economists frequently seen in the German media like Hans-Werner Sinn, as well as economists like Jeromin Zettelmeyer. The presence of the OFCE, which I represented, hopefully helped to serve as a reminder of some simple but useful points.

This first conference sometimes played with the ambiguity of the issue, with some contributions seeming to wish for an end to the euro area while others were more analytical in order to show the risks. The voice of Hans-Werner Sinn stood out during this discussion for its radical stance. Without going so far as to wish that Germany left the euro area, Sinn insisted in a systematic (and skewed) way that Germany was suffering under Europe's monetary policy. He insisted in particular on the role of Germany's hidden exposure to the debt of other countries through the European Central Bank and TARGET2, which books the surpluses and deficits of the national central banks vis-à-vis the ECB. The TARGET2 balance shows that the southern European countries are running a deficit, while Germany has a substantial surplus of almost 900 billion euros, which represents 30% of German GDP. These amounts are very significant, but do not in any way represent a cost for Germany.

In the most extreme case of a national central bank's failure to pay (i.e. an exit from the euro area), the loss would be shared by all the other states independently of the surpluses. The TARGET2 balances are part of Europe's monetary policy, which is aimed at achieving a goal that was agreed on: an average inflation level of 2%. This target has not been hit for many years. Moreover, this policy has led to low interest rates that benefit Germans who pay low interest charges on their public debt, as Jeromin Zettlemeyer pointed out. Finally, Germany's large trade surplus shows that the lack of an exchange rate mechanism in the euro area has benefited Germany significantly. Recall that the volume of Germany's exports exceeded China's in 2016, according to the German institute Ifo!

My presentation was based on the OFCE's numerous studies of the European crisis. The OFCE has published an analytical note on the effects of an exit from the euro area, showing all the related costs. The studies by Durand and Villemot provide the analytical basis for providing orders of magnitude. How much would Germans' wealth decline if the euro area were to collapse? The result is, in the end, not very surprising. The Germans would be the greatest losers, with a loss of wealth on the order of 15% of GDP. These figures are of course very tentative and need to be interpreted with the utmost care. The collapse of the euro area would plunge us into unexplored territory, which could surprise us with unexpected sources of instability.

After these preliminary elements, the heart of my presentation was then focused on a simple point. The real challenge facing us is to build coherent labor markets within the euro area, while reducing inequalities. Following on the common monetary policy, the coordination of fiscal policy that was carried out so painfully after 2014 and the aberrations associated with the recessionary fiscal policy (austerity), the main question facing Europe over the next ten years is to develop coherent labor markets. Indeed, Germany's wage moderation, the result of the difficulties with reunification in the early 1990s, has been a powerful destabilizing force in Europe, as was shown in an article by Mathilde Le Moigne. What is called the supply problem in France is in fact the result of divergences within Europe on the labor market in the wake of Germany's wage moderation. I proposed that the European Parliament initiate a Europe-wide discussion of national wage dynamics in order to bring about the convergence of wages in a non-deflationary way while avoiding high unemployment in southern Europe. This co-ordination of economic policy on the labor market is designated by the English term "wage stance". Co-ordination of changes in minimum wages and in regulated wages, which orients the direction of wage changes in labour negotiations, are tools for the co-ordination of labor markets.

A second tool is of course the establishment of a European system of unemployment insurance, which would be much less complex than one might think. A European unemployment insurance would aim to be complementary to national unemployment insurance, and not a replacement. National unemployment insurance systems are actually heterogeneous because, on the one hand, the labour markets are distinct, and on the other hand national preferences differ. Unemployment insurance systems are for the most part the result of historical social compromises.

How should this relatively radical German stance against Europe be interpreted today? Perhaps it represents the discontent of economists who are losing influence in Germany. It might seem paradoxical, but many German economists and observers are adjusting to recognize the necessity of building a different Europe, one not based on rules, but leaving room for political choices within strong institutions – i.e. for agile, well respected institutions rather than rules. This position is associated with France in the European debate: choices rather than rules. The German coalition agreement that paved the way for an SPD/CDU government has placed the issue of Europe at the center of the agreement, but with a great deal of vagueness about the content. Certain developments will test the relevance of this hypothesis, in particular the issue of a euro area minister and the nature of the decision-making rules within the key crisis-resolution mechanism, the European stability mechanism.

Europe: Changing the software / model / paradigm / narrative

A second, more confidential conference proved to be even more exciting, with the presence of the European Climate Foundation on the climate issue, the INET institute on developments in economic thought, and the OFCE on European imbalances. The aim of the conference was to reflect on a shift in the paradigm, or narrative, and come up with a new articulation between politics and economics, the state and the market, in order to think sustainable growth in terms of both the climate and society. A narrative is a vision of the world conveyed by simple language. Thus the “neoliberal” narrative is built on positive words like “competition”, “markets” and “freedom” as

well as negative words like “profit”, “interventionism” and “egalitarianism”, which allowed the creation of a language. Donald Trump produces an equally effective narrative: “giving power back to the people”, “America first”; this narrative marks the return of politics to a mode that assumes an underlying nationalism.
How could another narrative be built that has a central focus on the evidence for the fight against global warming and the aggravation of inequality and financial instability?

For one day economists who are renowned in Europe spoke about artificial intelligence, global warming, current forms of economic and industrial policies, the dynamics of credit and financial bubbles, and more. Empirical work at the forefront of current research as well as reflections about the possibility of a coherent storyline were combined in the promise of an alternative narrative. It was just the start. The possibility of a renewal of thought that transcended political divisions and spoke about what was essential came to light: how could the economy be placed at the service of a political project that aims not to rebuild borders to exclude but to imagine our common humanity?

These two conferences show the vitality of the European debate, which is presented from an overly technical perspective in France. The *raison d’être* of the euro is a common project. It is at this level that we need to conduct the discussion leading into the 2019 European elections.

European unemployment insurance

By Léo Aparisi de Lannoy and [Xavier Ragot]

The return of growth cannot eradicate the memory of how the crisis was mismanaged at the European level economically, but also socially and politically. The divergences between euro area countries in unemployment rates, current account balances and public debts are at levels unprecedented for decades. New steps in European governance must aim for greater economic efficiency in reducing unemployment and inequalities while explaining and justifying the financial and political importance of these measures in order to render them compatible with national policy choices. The establishment of a European unemployment insurance meets these criteria.

The idea of a European mechanism for unemployment compensation is an old idea dating back to at least 1975. The idea is now being extensively debated in Europe, with proposals from Italian and French economists and policymakers and studies conducted by German institutes, with the latest [OFCE Policy Brief] offering a summary. The possibility is even being mentioned in communications from the European Commission. The Policy Brief describes the European debates, as well as the system in place in the United States.

The European unemployment insurance mechanism presented in this note aims to finance the unemployment benefits of countries experiencing a severe recession and draws on the US experience to do this. A programme like this would constitute a second European level, supplementing the different national levels of unemployment insurance. It would help provide the unemployed support in countries hit by a deep recession, which would also contribute to sustaining aggregate demand and activity while reducing inequality in the recipient countries.

It is also consistent with a reduction in the public debt. This mechanism would not lead to permanent transfers to countries that are not carrying out reform, nor to unfair competition or the transfer of political powers that are now covered by subsidiarity. As in the case of the United States, it is consistent with the heterogeneous character of national systems.

To give an order of magnitude, an insurance system that is balanced over the European economic cycle and involves no permanent transfers between countries would have boosted growth in Spain by 1.6% of GDP at the peak of the crisis, while Germany would have received European aid from 1996 to 1998 and from 2003 to 2005. France would have experienced a GDP increase of 0.8% in 2013 thanks to such a system, as shown by the simulations conducted by the European teams.

For the complete study, see: *Policy Brief de l'OFCE*, no. 28, 30 November 2017.

"The economic negationism" of Cahuc and Zylberberg: the first-order economy

By Xavier Ragot

The book by Pierre Cahuc and André Zylberberg[1] is an injunction to take scientific truths about economics into account in the public debate, in the face of interventions that conceal private and ideological interests. The book contains interesting descriptions of the results of recent empirical work using natural experiments for the purpose of evaluating economic policies in the field of education, tax policy, the reduction of working hours, etc.

However, assertions in the book that are at the borderline of reason ultimately make it a caricature that is probably counter-productive. More than just the debate over the 35-hour working week or France's CICE tax credit, what is at stake is the status of economic knowledge in the public debate.

1) Has economics become an experimental science like medicine and biology?

The heart of the book is the claim that economic science produces knowledge to treat social ills that is on the same scientific level as medicine. I do not believe this is true. Consider this quote from the winner of the 2015 Nobel Prize in Economics, Angus Deaton:

"I argue that experiments have no special ability to produce more credible knowledge than other methods, and that actual experiments are frequently subject to practical problems that undermine any claims to statistical or epistemic superiority." (Deaton 2010)

The charge is serious; the point is not to deny the contributions of economic experiments but to understand their limitations and to recognize that there are many other approaches in economics (natural or controlled experiments constitute only a small percentage of the empirical work in economics).

What are the limits of experiments? Natural experiments serve only to measure average first-order effects without measuring secondary effects (so-called general equilibrium effects) that can significantly change the results. A well-known example: the work of the Nobel laureate Heckman (1998) in the economics of education, which showed that, at least in some cases, these general equilibrium effects significantly affect the results of experiments.

Moreover, experiments are not able to take into account the heterogeneity of the effects on populations, to accurately measure the confidence intervals, etc. I'll leave these technical discussions to the article by Deaton. It should also be noted that the power to generalize from natural experiments is often weak, as these experiments are by their nature not reproducible.

Let's take an example: Cahuc and Zylberberg use the study by Mathieu Chemin and Etienne Wasmer (2009) comparing the effects of the reduction of working time between Alsace and the whole of France to identify the impact on employment of an additional reduction of 20 minutes of working time. This work finds no impact from an additional 20-minute reduction in working time on employment. Can we conclude that the transition to 35 hours, a reduction in working time more than ten times as great, has no impact on employment? Could there be interaction effects between lowering social contributions and reducing working time? I don't think it can be said that simply reducing working time creates jobs, but it seems difficult to claim scientifically that the transition to 35 hours did not create jobs based on the studies cited (the authors also draw on the example of Quebec, where the reduction was much greater).

The economist uses data in much more diverse ways than presented by Cahuc and Zylberberg. The book does not discuss laboratory experiments conducted in economics (see Levitt and List, 2007). Further, the relationship of economics to data is undergoing change as digital distribution creates vast access to data ("big data" in short). Econometric techniques will in all likelihood make more intense use of structural econometrics. In a recent work (Challe et al., 2016), we develop, for example, a framework for using both microeconomic and macroeconomic data to measure the impact of the great recession in the US. Finally, there has been a renewal of economic history and long-series studies. The work of Thomas Piketty is an example that has not gone unnoticed. Other work, including on financial instability (especially that by Moritz Schularik and Alan M. Taylor), also uses long time periods to enhance intelligibility. In short, the relationship of data to economics involves multiple methods that can yield conflicting results.

This is no mere detail: the scientistic approach of the book is reductive. The book by Zylberberg Cahuc advances a faith in the knowledge drawn from natural experiments that I don't believe has a consensus in economics.

2) How to sidestep major questions

Here is a concrete illustration of the problem with this approach. The authors render a severe verdict on France's CICE tax credit (the government's reduction of employer social charges on up to 2.5 times the minimum wage, the SMIC). The main argument is that it is well known that reducing charges in the neighbourhood of the SMIC has a much bigger impact on employment than for higher wage levels. This last point is true – but the authors are sidestepping the real issue. What is it?

The early years of the euro have seen an unprecedented divergence in labour costs and inflation between European countries. Up to the 1990s, these differences were handled over the years by devaluations / revaluations. But the single currency has made this no longer possible. The question facing economists looking at this situation is whether the euro zone can survive such misalignments (see the recent position of Stiglitz on this subject). The discussion has been focused on establishing internal devaluations in overvalued European countries and boosting wages in undervalued countries. To this end, Germany established a minimum wage, some countries cut the salaries of civil servants, while others lowered their social contributions (the CICE tax credit in France), in the knowledge that other fiscal tools are also possible (see Emmanuel Farhi, Gita Gopinath and Oleg Itskhoki, 2013). The crucial question is therefore: 1) Is an internal devaluation necessary in France, and if so how much? 2) And how could a non-recessionary internal devaluation be implemented without increasing inequality?

So there is clearly a problem if one answers these questions based on the impact of reductions of social charges near the SMIC wage level. This shows the danger of basing oneself solely on results measurable by experiments: it neglects key issues that cannot be decided by this method.

3) The problem of “Keynesianism”

The authors claim that Keynesianism provides fertile soil for negationism even while stating in the book that Keynes’ recipes sometimes work, but not all the time, which any economist would acknowledge. In the absence of clarification, these remarks become problematic. Indeed, recent years (following the 2008 subprime crisis) have witnessed a return of Keynesian approaches, as can be seen in recent publications. I would go so far as to say that we are living in a Keynesian moment, with great financial instability and massive macroeconomic imbalances (Ragot, 2016).

What then is Keynesianism? (It is not, of course, fiscal irresponsibility with ever greater public debt). It is the claim that price movements do not always allow markets to operate normally. Prices move slowly, wages are downwardly rigid, nominal interest rates cannot be very negative, etc. Because of all this, there are demand externalities that justify public intervention to stabilize the economy. The French debate generates concepts like “Keynesianism” and “liberalism” that have no real meaning in economic science. It is the role of the scientist to avoid false debates, not to perpetuate them.

4) Should we listen only to researchers publishing in the top journals?

The public debate differs greatly from the scientific debate in both purpose and form. Cahuc and Zylberberg want to import the hierarchy of academic debate into the public debate. This won’t work.

There will always be a need for non-academic economists to discuss economic issues. The economic situation raises problems where there is no academic consensus. The business press is full of advice from bank economists, markets, institutions and trade unions, all of whom have legitimate, though non-academic, points of view. Newspapers like *Alternatives Economiques*, quoted by Cahuc and Zylberberg, present their views, as does the *Financial Times*, which has a mix of genres. Economists without formal academic credentials play a legitimate role in this debate, even if their opinions differ from those of other researchers with longer CVs.

These contradictions are concretely lived at the OFCE, whose mission is to contribute to the public debate with academic rigor. This is a very difficult exercise; it requires knowledge of the data, the legal framework, and the academic literature produced by institutions such as the Treasury, the OECD, the IMF, and the European Commission. Knowledge of the economic literature is essential, but it is far from sufficient to make a useful contribution to the public debate.

The willingness of economists to contribute to the public debate was exemplified in the various petitions around the El Khomry law. These petitions widely debated the effect of redundancy costs on hiring and the form of the employment contract, but not the overturning of norms (a subject that to my knowledge is impossible to evaluate rigorously) – even though this is at the heart of the debate between the government and the trade unions! It is not certain that the idea of a consensus among economists will emerge strengthened by this episode.

5) When a consensus exists in economics, do we have to listen to it?

The consensus before the subprime crisis was that financialization and securitization were factors promoting economic stabilization, because of risk allocation, etc. Microeconomic studies confirmed these intuitions, because they failed to capture the real source of financial instability, which was the correlation of risks in investor portfolios. We now know that the consensus was wrong. Some economists outside the consensus, such as Roubini or Aglietta, and some economics journalists such as *The Economist*, warned of the destabilizing effects of finance, but they were outside the consensus.

Policy (and the public debate) is forced to ask: what will happen if the consensus is wrong? It has to manage all the risks – that’s its responsibility. The consensus view among economists is frequently not very informative about the diversity of viewpoints and the risks involved. The public voice of economists outside the consensus is necessary and useful. For example, the Nobel Prize in Economics was awarded to Eugene Fama and Robert Schiller, who both studied financial economics. The first asserts that financial markets are efficient, and the second that financial markets generate excessive volatility. Newspapers carry visions outside the consensus, such as *Alternatives Economiques* in France (at least it’s in the title). These publications are useful to public discussion, precisely because of their openness to debate.

In science, the diversity of methods and knowledge about methodology outside the consensus enrich the debate. For the same reason, I tended to be against the creation of a new section of heterodox economists, supported by the French association of political economists (AFEP), because I see an intellectual cost to the segmentation of the world of economists. For the same reason, giving a consensus among economists the status of truth (Cahuc, Zylberberg, p. 185) is troublesome, because it ignores the contributions of the "minority" effort.

6) "Economic negationism: radicalization of the discourse

The authors castigate ideological criticisms of economics that are unfamiliar with the results or even the practice of economists. The science of economics has strong political implications, and is therefore always attacked when generates disturbing results. Some criticisms lower the intellectual debate to the level of personal insults. A defence of the integrity of economists is welcome, but it requires real learning and modesty to explain what is known and what is not known.

On reading the book by Cahuc and Zylberberg, it seems that the authors take up the arms of their opponents: two camps are defined (real science and deniers), doubts are planted about the intellectual honesty of pseudo-scientists outside the consensus, we proceed by amalgamation, by mixing intellectuals (Sartre) and academic economists. The very title of the book proceeds from great violence. This book is on a slippery slope in the intellectual debate that is heading towards a caricature of debate and verbal abuse. Every economist involved in the public debate has already been insulted by people who disagree with the results presented for purely ideological reasons. Insults need to be fought, but not by suggesting that debate can be avoided due to one's academic status.

The debate in England on Brexit showed how economists and experts were rejected because of their perceived arrogance. I'm not sure that the scientistic position of the book offers a solution to these developments in the public debate. To quote Angus Deaton once again, in a recent interview he did with the newspaper *Le Monde*:

"To believe that we have all the data is singularly lacking in humility. … There is certainly a consensus in economics, but its scope is much narrower than economists think."

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What Donald Trump's economic programme reveals

By Xavier Ragot

The US elections are proving to be very revealing. Three different perspectives on the current elections are yielding insights into three areas: first, on the state of the US economy, second, on the state of the thinking of economists, and finally, on the nature of the relationship between economists and politicians.

The US primaries were marked by both the "resistible rise" of Donald Trump and the emergence of Bernie Sanders, who has hit Hilary Clinton from the left but failed to win.

The success of Donald Trump, who circumvented the Republican Party, was based on policy mainsprings that draw on some paranoia about the loss of identity of the United States in the face of concessions made economically to China, politically to Iran, and militarily in Iraq. The country's loss of status is a very real topic in the United States. The success this theme has enjoyed also stems from the reality of the economic situation of the middle and working classes in the US. The social scars caused by inequality in the country, so elegantly studied by Thomas Piketty, are visible on the streets, reflecting the reality of unequal access to health care (so incomprehensible to a European). While this theme of inequality is the central focus of the Bernie Sanders campaign, popular anger is also being expressed in the Republican camp.

Donald Trump's economic programme has the poetic but disturbing charm of a ramshackle inventory. By European standards it is difficult to identify it as right, extreme right or left. Trump does have [a formal fiscal programme](), but it has been significantly "enriched" by media interventions. He is in favour of investment in infrastructure and military spending, the reduction of taxes, an increase in the minimum wage, an end to Obamacare and the total privatization of health care, the taxation of the rich, a reduction of immigration, especially from Mexico (building a wall between the US and Mexico), an aggressive trade policy toward China, which he accuses of dumping and, more recently, a partial default on US public debt. This last point has caused serious waves among Republicans. The United States is one of the world's few countries to have never defaulted on its public debt, so the Republican candidate publicly raising this possibility comes as a shock.

On this last point, I personally think that defaulting on public debt is a bad idea. This amounts to an uncontrolled tax, without assumption of responsibility, and it can also add to banking instability. Much better would be to impose a tax after a democratic debate. Furthermore, to ease the public debt burden, it is always possible to lower real interest rates on the public debt for a number of years using an accommodative monetary policy, without financial repression (see the article by Blanchard, Dell'Ariccia and Mauro).

Few economists defend Donald Trump's programme, even the part that sticks strictly to economics. A fairly positive interpretation of Trump's programme recently gained attention, as it came from a recognized and respected economist, Narayana Kocherlakota (here). Before getting into the reasons for Kocherlakota's (very relative) support for Trump, it is worth reviewing this economist's career to see how a crisis can change the way economists think. Narayana Kocherlakota trained as an economist at the University of Chicago, and he has made fundamental, highly technical contributions to financial theory, monetary theory and the dynamic theory of public finances, which are based on the application of tools from intertemporal contract theory. This is a very serious academic! Kocherlakota wrote a [text on the state of macroeconomic thought post-crisis]() that is very interesting because it is based on the broad vision of a researcher who doesn't recognize his discipline when he looks at economics textbooks (not to mention popular texts). Kocherlakota became chair of the Federal Reserve of Minneapolis in 2009 (stepping down on 1 January 2016). The Minneapolis Fed is known as a hard-core, intellectually active outpost of "anti-Keynesian" thought, to put it in a nutshell. Kocherlakota went through a profound intellectual transformation while at the Fed and took a fairly radical Keynesian turn ([here is one original theoretical contribution]()), which led to conflicts with his colleagues. What was missing in Kocherlakota's academic output? What economic facts destabilized him to such an extent?

It is obviously difficult to answer these questions. However, it could be argued that Kocherlakota's own work did not make it possible to foresee the effectiveness of unconventional monetary policy or the impact of Obama's fiscal stimulus plans. Indeed, the US government conducted a very Keynesian monetary and fiscal policy (tax cuts and massive monetary creation), which had positive effects that could not be encompassed by the models of the Minneapolis Fed. The major missing ingredients were the nominal rigidities that give aggregate demand a potentially important role. This issue of nominal rigidities is not a detail in macroeconomics. I have written a [text about the return of Keynesian thinking]() on this issue.

Kocherlakota's indulgence of the Trump programnme is not therefore that of a hard-core free marketer, but rather that of a converted Keynesian, whose faith seems a bit extreme. Kocherlakota is selling Trump's Keynesian stimulus based on public spending and lowering taxes. His only concern is that he would like to be sure that Trump would accept higher inflation of around 4% rather than 2%.

Thus, the Trump programme is further blurring the lines between the economic policy of the left and the right. The theme of inequality and impoverishment is dominating debate in the middle and working classes. The global problem of lack of demand and underemployment is worrying economists under the rubric of secular stagnation. The emergence of Bernie Sanders, the hodge-podge of Trump's economic programme (the violence of his remarks on immigration is not the subject of this text), and on another scale, Kocherlakota's transformation, all reveal the difficulty facing the emergence of a coherent economic paradigm that has a broad social base. Policy (Republican and Democratic) is groping for a different articulation between the State and the market, a coherent and effective return of economic policy (fiscal and monetary) that is able to stabilize market economies and reduce inequality. This debate will be identical, but, due to the European issue, will take a different form in France's presidential elections.

Slowing growth: due to the supply side?

By Jérôme Creel and Xavier Ragot

The weakness of the recovery in 2014 and 2015 raises the need for a structural re-examination of the state of France's productive fabric. Indeed, an analysis of investment dynamics, the trade balance, productivity gains and business margins, and to a lesser extent companies' access to credit, indicates the existence of some disturbing trends since the early noughties. In addition, the persistence of the crisis inevitably poses the question of the unravelling of France's productive fabric since 2007 due to a combination of low growth, weak investment and numerous bankruptcies.

The contributions gathered in *Revue de l'OFCE* no.142 have a double ambition: first, to put France's businesses and economic sectors at the heart of reflection about the ins and outs of the current slowdown in growth, and second, to question the basis for theoretical analyses of future growth in light of the situation of France and Europe. Based on the various contributions, nine conclusions emerge:

1) Growth potential, a concept that aims to measure an economy's medium-term productive capacity, has fallen in France since the crisis. While the level of potential growth is high over the long term, on the order of 1.8%, it has fallen since the crisis by about 0.4 point, according to the new measurement provided by Eric Heyer and Xavier Timbeau.

2) The main point is to figure out whether this slowdown is temporary or permanent. This is important for growth forecasts but also with respect to France's European commitments, which depend on its growth potential. One important conclusion is that a very large portion of the current slowdown is transitory and linked to France's economic policy. As Bruno Ducoudré and Mathieu Plane demonstrate, the low level of investment and employment can be explained by the macroeconomic environment and in particular by the current sluggish economy. Business behaviour does not seem to have changed during the crisis. The analysis by Ducoudré and Plane also shows that the determinants of investment differ in the short term and the long term. A 1% increase in economic

activity increases investment by 1.4% after one quarter, whereas a 1% increase in the margin rate has very little impact in that same period. However, over the long term (10 years), a 1% increase in activity boosts investment by about 1%, while a 1% increase in the margin rate boosts investment by 2%. So promoting investment means supporting economic activity in the short term, while boosting margins will have an impact over the longer term.

3) France’s productive fabric will take time to recover from the effects of the crisis because of three major obstacles: the weakness of investment, of course, but also the decline in the quality of investment and finally the disruption of production following on from the poor allocation of capital during the crisis, including its territorial dimension. Sarah Guillou and Lionel Nesta show that the low level of investment makes it impossible to go upmarket, which has meant less technical progress since the crisis. Jean-Luc Gaffard and Lionel Nesta then show that regional convergence has slowed since the crisis, and that economic activity has tended to decline in the most productive areas.

4) The concept of growth potential as a tool for macroeconomic management has emerged from the crisis in a profoundly weakened state. Whatever the methods used, ongoing revisions of growth potential make the idea of a system of rules-based European guidance dangerous, according to Henri Sterdyniak. There is a need to rediscover European economic policy that is discretionary in character. In addition, fiscal policy that is more contingent on macroeconomic and financial conditions needs to be better coordinated with the climate issue, as Jérôme Creel and Eloi Laurent argue.

5) The notion of secular stagnation, that is to say, a lasting weakening of growth, has led to intense debate. Two visions of secular stagnation are discussed. The first vision, associated with Robert Gordon, insists that technological progress has been exhausted. The second flows from the analysis of Larry

Summers and stresses the possibility of a permanent demand deficit. Jérôme Creel and Eloi Laurent show the limitations of the analysis of Robert Gordon for France; in particular, French demographics are more an advantage for French growth than a hindrance. Gilles Le Garrec and Vincent Touzé show the possibility of a long-term demand deficit that would hinder capital accumulation, due to the central bank's inability to make further interest rate reductions. In this kind of environment, support for demand is necessary to get out of an unfavourable equilibrium between low inflation and high unemployment, which leads to a negative perception of growth potential. Changing expectations may require large-scale policies to stimulate economic activity, along with an acceptance of high inflation over the long term.

6) The analyses presented here therefore recognize the profound difficulties with France's productive fabric and recommend better coordination of public policy. Support for demand is needed rapidly in order to restore investment, followed by an ongoing progressive policy to boost the margins of companies exposed to international competition – so, according to Jean-Luc Gaffard and Francesco Saraceno, not a competitive shock, but rather support for business that takes into account the time profile of productive investment.

7) In the longer term, part of what can be characterized as the French supply-side problem is the result of poor European adjustments, including the discrepancy in wages between Europe's major economies. The divergence between France and Germany since the mid-1990s has been impressive. Mathilde Le Moigne and Xavier Ragot show that German wage restraint is a singularity among European countries. They offer a quantification of the impact of this wage moderation on France's foreign trade and economic activity, and conclude that German wage restraint has contributed to an increase of more than 2 points in France's unemployment rate. A supply policy could also go by the name of a policy for European re-

convergence.

8) The deep-going modernization of the productive fabric will depend on spaces for cooperation, collective learning and collaboration so as to nourish the creativity made possible by new technologies. These spaces need to recognize the importance of difficult-to-value intangible assets. In economies with an ageing workforce, advances in robotics and artificial intelligence should lead to enhancing potential productivity, according to Sandrine Levasseur. Cooperation also needs to be strengthened in two areas: the company and the territory. Within companies, partnership governance should help limit short-termist financial tendencies. With respect to territory, the definition of regional innovation systems should be the focus of a modern industrial policy, according to Michel Aglietta and Xavier Ragot.

9) Guillaume Allègre concludes that it is not so much the level of production that is disturbing as the inequitable distribution of the fruits of growth, however small these may be. The emerging consensus on the negative impact of inequality on economic growth should not obscure the real debate, which does not concern just the income gap, but also what that income makes it possible to consume, i.e. equal access to goods and services of equal quality. The key question is thus the content of production, more than simply growth.

Wage moderation in Germany –

at the origin of France’s economic difficulties

By *Xavier Ragot, President of the OFCE, CNRS-PSE, together with Mathilde Le Moigne, ENS*

If the future of the euro zone does indeed depend on political cooperation between France and Germany, then economic divergences between the two countries should be a cause for concern. These divergences need to be analysed, with particular attention to three specific areas: the unemployment rate, the trade balance and the public debt. Germany’s unemployment rate is falling steadily; in June it was under the 5% mark, which represents almost full employment, whereas the French rate is over 10%. Germany’s low unemployment rate does not however reflect strong consumption by German households, but rather the country’s export capacity. While France continues to run a negative trade balance (importing more than it exports), Germany is now the world’s leading exporter, ahead of China, with a trade surplus that will run close to 8% in 2015. As for the public deficit, it will be around 3.8% in France in 2015, while Germany is now generating a surplus. This has impressive consequences for the way the public debt is changing in the two countries. In 2010 they were similar, at around 80% of GDP, but in 2014 Germany’s public debt fell below 75%, and is continuing to decline, while France’s debt has continued to grow, and has now hit 97%. This kind of gap is unprecedented in recent times, and is fraught with mounting tension over the conduct of monetary policy.

This triple divergence is inevitably leading to differences in the political response, with respect to the population’s ability to take in migrants and to the understanding of countries facing economic difficulties, such as Greece, but also with respect to the ability to cope with future economic crises. Economic divergence will become political divergence. The point is not to idealize the German situation, which is characterized by a large number of workers who have failed to benefit from the fruits of growth, as is shown in a recent study by France Stratégie, as well as by a rapid decline in population. This should not stop us from taking a hard look at the economic gap arising between the two countries.

What are the reasons for Germany's commercial success?

Many factors have been advanced to explain the divergence between the two neighbours: for some, it's a matter of the German strategy – outsourcing value chains, aggressive wage moderation, fostering competition between companies – and for others, French weaknesses: poor geographical and / or sectoral specialization, insufficient public support for exporters, and a lack of competition in certain sectors. Our recent study emphasizes the delayed impact of German wage moderation and suggests that this could explain almost half of the Franco-German divergence. To understand the mechanisms involved, it is necessary to distinguish between the sectors exposed to international competition and the sectors that are sheltered. The exposed sectors include industry, but also agriculture, including animal husbandry, which is currently in the news, and some services that can be traded. The sheltered sector includes transportation, real estate, retailing and a large part of personal services.

While unit labour costs in France have risen regularly and at similar levels in the two above-mentioned sectors, they have remained extraordinarily stable in Germany for nearly ten years. This wage moderation is the result of both poor management of German reunification, which tipped the balance of power during wage negotiations in favour of employers, and, to a much less extent, the introduction of the Hartz reforms in 2003-2005, which aimed to create low-paid work in the less competitive sectors (particularly the sheltered sector). The cost of German reunification is estimated at 900 billion euros, in terms of transfers from former West Germany, or slightly less than three times the Greek debt. Faced with this kind of challenge, the wage moderation initiated in 1993 represented a strategy for re-convergence between the two parts of Germany. In 2012, German nominal wages were 20% lower than French wages in the exposed (tradable) sector and 30% lower in the sheltered sector, compared to the 1993 levels. A look at French and German margin levels shows that in the exposed sector, French exporters have made significant efforts by reducing their margins in order to maintain their price competitiveness. In the sheltered sector, French margins are on average 6% higher than German margins. The bulk of France's loss of price competitiveness is therefore a loss of cost competitiveness.

How much have these differences contributed to unemployment and the trade balance in the two countries? Our quantitative analysis shows that if German wage restraint had not taken place between 1993 and 2012, today's 8% gap in the trade balances would instead be 4.7% (2.2% of this being due solely to German wage moderation in the sheltered sector). Thus, Germany's wage moderation policy explains almost 40% of the difference in trade performance between the two countries. We also found that this wage moderation accounts for more than 2 points of France's unemployment.

The non-price competitiveness gap

This leaves nearly 60% of the difference in the trade balances still needing to be explained. Our study suggests that this difference is due to the quality of the goods produced, so-called non-price competitiveness. Between 1993 and 2012, the German quality-price ratio increased by around 19% compared with that of France, which has therefore more than offset the rise in German export prices relative to French prices. There is clearly a "quality" effect in this non-price competitiveness: Germany produces "high end", more innovative goods than France does in the same sectors. It is also possible to see an impact due to the outsourcing of some German production (nearly 52% of production volume in 2012) to countries where costs are lower: Germany today is a centre for design and assembly, which saves money on its intermediary costs, enabling it to invest more in brand strategies and efforts to move upscale.

This effect is nevertheless probably endogenous, that is to say, it flows in part from Germany's advantage in cost competitiveness. Low labour costs have enabled German exporters to maintain their margins in the face of external competition. The funds generated have led to investments which French companies have probably had to forego in order to maintain their price-competitiveness, thus losing the opportunity to catch up with German products in terms of non-price competitiveness over the longer term.

A positive way out and up

The root cause of the gap in economic performance between Germany and France lies in the nominal divergence observed between the two countries since the early 1990s. One way to reduce these differences would be to promote convergence in wages in Europe and in its labour markets more generally. Germany would need to allow wage inflation that was higher than in the periphery countries, thereby dealing with the increase in social inequalities in Germany, while France must not fall into the trap of competitive deflation, which would destroy its domestic demand, while keeping wage movements under control. In this respect, the report of the five Presidents presented by the European Commission on 22 June 2015 proposes the establishment of national competitiveness authorities, which hopefully would allow greater cooperation on social welfare and employment.

The difference in wages between France and Germany has profound implications in terms of economic thought. The increased trade integration that followed the introduction of the euro led not to a convergence but to a divergence in labour markets. It is then up to each State to once again bring about convergence of the economies while supporting economic activity. This State intervention in the economy is more complex than the simple Keynesian framework for the management of aggregate demand, and now involves the convergence of labour markets. Heretofore, Europe's response has been systematic cuts in labour costs, while what is really needed is to increase wages in surplus countries, such as Germany, for example by using the minimum wage as a tool. All this, it is true, is economics. The politics begins when we realize that only long-term cooperation can bring about a convergence in national interests.

The erosion of France's productive base: causes and remedies

Xavier Ragot, President of the OFCE and the CNRS

The deindustrialization of France, and more generally the difficulties facing sectors exposed to international competition, reflects trends that have been at work in France and in Europe for more than a decade. Indeed, while the strictly financial moment when the crisis struck in 2007 was the result of the bursting of the American real estate bubble, the scale of its impact on Europe's economy cannot be understood without looking at vulnerabilities that have previously been neglected.

In “Érosion du tissu productif en France: Causes et remèdes”, *OFCE working document no. 2015-04*, Michel Aglietta and I offer a summary of both the microeconomic and macroeconomic factors behind this productive drift. Such a synthesis is essential. Before proposing any policy changes for France, it is necessary to make a coherent diagnosis of major trends in international trade as well as of the real situation of France’s productive fabric.

European divergences

The starting point is the surprising divergence seen in Europe. The euro zone’s two largest countries, Germany and France, have diverged in an unprecedented way since the mid-1990s. While property prices remained stable in Germany, in France they increased by a factor of 2.5, hitting the country with two negative consequences: a high cost of living for its employees, and a collapse in property investment by its businesses. Wages in Germany are now 20% lower than in France due to the wage moderation implemented to manage the former’s reunification process. Furthermore, until the crisis, real short-term interest rates (which take into account inflation differentials) were about 1 percentage point lower in France and Spain than in Germany. This change in the price of the production factors (higher real interest rates and lower wages in Germany than in France) did not give rise to a greater substitution of capital for labour in France. There was little difference between the two countries in the investment rate, which was relatively stable in both. Other indicators, such as the number of robots, indicate on the contrary that there was less modernization of France’s productive fabric. These changes in factor prices have not therefore translated into an adjustment in the productive fabric, but have instead led to an unsustainable divergence in the current accounts.

Current account balances are crucial concepts for measuring disequilibria within Europe. A positive current account means that a country is lending to the rest of the world, while a negative current account means that it is borrowing from the rest of the world. While European rules have focused attention on the public deficit alone, the proper measure of a country’s indebtedness is the current account, the sum of public and private debt. On this measure, Germany’s current account is one of the most positive in the world, meaning that it is lending heavily to other countries. While over the last three years the differences between European current accounts have been narrowing, this is the result more of a contraction in activity due to austerity measures than of a modernization of the productive base in countries with negative current accounts. The European framework for analysing macroeconomic imbalances does of course have numerous indicators, including the current account. However, in practice the multiplicity of indicators gives a crucial role to the numerical public deficit targets. So while the framework for European surveillance seems very general in its assessment of economic imbalances, it is the short-term budgetary aspect alone that dominates analysis. Don’t forget that Spain’s public debt was less than 40% of GDP in 2007, but over 90% of GDP in 2013. Low public debts are not therefore a sufficient condition for macroeconomic stability, just as public debts that are temporarily high are not necessarily a sign of structural problems.

The fragility of France’s productive base

In this sense, corporate data can be used to gain insight into trends in the French economy. French companies did of course experience a fall in margins, but this has mainly affected sectors exposed to international competition. Corporate profitability (which finances the payment of dividends and interest and contributes to investment) fell from 6.2% in 2000 to less than 5% in 2012. Despite this decline, the investment rate held steady in all business categories during the period, in part funded by corporate savings, which declined from a rate of 16% in 2000 to 13% in 2012. The result has been a substantial rise in corporate debt, although up to now this has not led by higher debt costs due to the fall in interest rates. All these factors are inevitably fuelling concern about the health of our productive fabric: France’s businesses have responded to economic difficulties, not by innovation, but by financializing their balance sheets and taking on debt.

Towards partnership in governance

To innovate, invest and upscale, France’s companies must make efforts over the long term – this is the only way there will be a process of reconvergence in Europe. The point is not to maximize short-term financial returns, through for example excessive dividend payments, but rather to invest over horizons that are typically considered (too) long by companies. As a result, making improvements to France’s productive fabric will require shifting corporate governance towards a model based on stronger partnerships and a more long-term vision in order to invest in employees’ skills and qualifications, in intangible assets, and in new technologies. Social dialogue is not just about income distribution and tax reform but is also essential within companies in order to ensure the mobilization of our only productive wealth, men and women who are putting their all into their work.