

The irresistible attraction to recession

By [Hervé Péléraux](#)

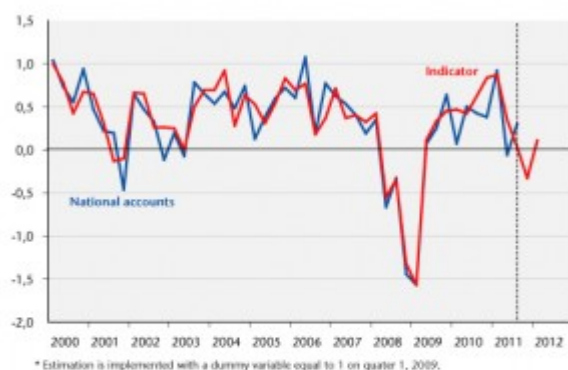
Here is the leading indicator for the French economy, updated to 30 January 2011.

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

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

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

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



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

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

Sources : INSEE, OFCE forecasts and calculations.

Next update on 29 February 2012

Working hours and economic performance: What lessons can be drawn from the Coe-Rexecode report?

By [Eric Heyer](#) and [Mathieu Plane](#)

Do people work less in France than in the rest of Europe? Is France the only country to have reduced working hours in the last decade? Is the 35-hour work week really dragging down the French economy? The report published on 11 January by the [Coe-Rexecode](#) Institute provides fresh material for answering these questions.

We have produced [a note on the main conclusions of the report](#),

which can be summarized as follows:

1. People work fewer hours in France than in the rest of Europe.

- TRUE for full-time employees,
- FALSE for part-time employees,
- FALSE for non-salaried employees,
- UNDETERMINED for the total.

2. Working hours have fallen more in France than in Germany over the last 10 years.

- FALSE

3. “The shorter work week has failed to meet the goal of job creation and work-sharing” in France.

- FALSE

4. “The shorter work week has undermined per capita purchasing power” in France.

- FALSE

“Buy French”: From the slogan to the reality

By [Jean-Luc Gaffard](#), [Sarah Guillou](#), [Lionel Nesta](#)

The current election campaign is lending weight to simplistic proposals like the slogan “buy French”, which evokes the need for France to re-industrialize. And to accomplish this, what could be simpler than to convince the population to buy native products designated with a special label? This is also more

politically correct than advocating a straightforward return to protectionism. Employment is expected to benefit, along with the balance of trade. But if we look more closely, not only is it difficult to identify the geographical origin of products, but even if that were possible, any preference that these products might enjoy could well wind up in job losses. This solution for dealing with the need for re-industrialization ultimately reflects a refusal to get to the bottom of the problem.

Can we really define what it means to “buy French”? Does it mean buying the products of French companies? What about buying products made ☐in France by foreign companies instead of buying products made abroad by French companies? These simple questions show that it is not so easy to pin down what is “Made in France”. One major difficulty is that the final goods produced in a country usually incorporate intermediate goods manufactured abroad. It may even happen that the components of a final product are manufactured by a competitor in another country. The iPhone is emblematic of this [fragmentation](#). Should we refrain from purchasing intermediate goods from low-wage countries even though this makes it possible to produce final goods at a lower cost and boost exports by being more competitive on price? Those who think so should no longer be touting German industry as an example, since everyone knows about the growing share of imported inputs in the production of the final goods Germany exports (OECD, *Measuring Globalisation: OECD Economic Globalisation Indicators 2010*, p. 212).

Imagine, nevertheless, domestic consumers who are able to identify products with a high labour content and are ready to make sacrifices out of a spirit of economic patriotism. Don't the polls tell us that over two-thirds of consumers would be willing to pay more for French goods? While there are doubts about whether they would actually do this, it would be risky to ignore the opportunity cost of such a choice. Buying more

expensive products simply because they are French reduces purchasing power. Other goods and services would not be purchased or would be bought for less abroad. The balance sheet for employment is far from certain.

Should this exercise in economic patriotism actually materialize, it would be a way that consumers form attachments to certain types of products, in this case based on their place of manufacture, which would in turn reduce the intensity of competition. This could lead the companies concerned to cut back on their efforts to become more competitive on price and other factors. Why, indeed, should they shell out for expensive and risky investments when have a guaranteed customer base? It's a safe bet that they will not do this much, if at all. The national economy would then be locked in a low technology trap, doomed to slower growth, obviously with damaging consequences for employment in the medium and long term. This would also deprive the economy of the means to innovate and improve the competitiveness of its products.

Finally, it is likely that the willingness to buy French products would benefit products that replace goods made elsewhere in Europe rather than goods made in developing countries, either because the latter are no longer manufactured at all in France or because the price differences with French products would still be prohibitive. Ultimately it would not be possible to avoid further shifts in production to low-wage countries, with the consequent job losses. Furthermore, from a European perspective the non-cooperative character of this kind of measure could lead our European partners to adopt reciprocal measures, which would be detrimental to exports and employment.

The slogan "buy French" masks a refusal to see that the downturn is a global phenomenon which calls for a comprehensive response at the European level, and a refusal to consider a proactive industrial policy that takes into account the realities of supply as well as demand.

This is not just a matter of looking the other way. France is undergoing a deindustrialization process that threatens its capacity for growth. But who can deny that this phenomenon has accelerated with the crisis and that this acceleration is set to increase [as the general austerity measures and restrictions on bank credit further undermine domestic and European demand](#) for consumer durables? Unless we are willing to accept that an entire segment of industry in France and elsewhere in Europe is destroyed, with no hope of ever returning, and with as a consequence still greater disparities between countries and sharper conflicts of interest, it is clearly urgent to support this kind of demand.

Is this kind of support “the solution”? Of course not: propping up demand will not be enough, as an industrial policy aimed at strengthening the supply side is also needed. The point is not to protect domestic production nor to promote the conquest of foreign markets through competition on taxation or social charges, but to stimulate investments designed to produce new goods and services, which is the only way to create stable jobs. Rather than try to rely on dubious slogans, the goal should be [to consolidate production that has the advantage of being high quality in terms of design, safety and reliability](#), and which corresponds to what French and European consumers genuinely want.

What employment policy during

a crisis?

By Marion Cochard

After a lull of only a year, unemployment figures started to rise again in April 2011. We are seeing a replay of the dynamics of the 2008 recession: a hiring freeze and the non-renewal of temporary and fixed-term ("CDD") contracts, with redundancies to follow later in the year. The reason, of course, is the current economic downturn, which is hitting while French business margins are still in bad shape after the shock of 2008-2009, particularly in industry. The weakened companies no longer have the strength to cushion the fall as they did four years ago. The French economy is thus expected to slide into recession in the fourth quarter of 2011, and we foresee a fall in activity of 0.2% in 2012. Given that annual growth of 1.1% is needed to kick-off job creation, the resumption of job losses seems inevitable. If we add the existence of a growing workforce to this bleak picture, the number of unemployed will surpass the 3 million threshold by year end.

On the eve of a tense social summit, what are the options for cushioning the impact of the crisis on the labor market? Given the urgency of the situation, the government has two main levers that are responsive and inexpensive: partial unemployment and subsidized jobs in the non-profit sector.

Partial unemployment can cushion the economic hardships faced by business and retain skills in the companies. There is substantial room to expand its use. By way of comparison, in 2009 maximum compensation for partial unemployment was extended to 24 months in Germany, versus 12 months in France. In addition, the greater level of state coverage in Germany partly explains how extensively it is taken up there: partial unemployment affected 1.5 million people at the peak of the crisis, but only 266,000 in France. Nor does this put much of

a burden on public finances, as the 610 million euros disbursed by the States on partial unemployment in 2009 were offset by savings on unemployment benefits and the preservation of human capital.

But partial unemployment benefits workers in stable industrial jobs above all, while the brunt of the crisis is being borne by those in precarious employment and young people. These are the sections of the population targeted by subsidized employment. Again, the government has some leeway, because 70,000 subsidized non-profit contracts were eliminated since end 2010 and 300,000 since the early 2000s, and it is also not a very expensive scheme. The creation of 200,000 jobs would for instance cost the state 1 billion euros – contrast this with the shortfall of 4.5 billion euros due to the tax exemption of overtime, which, furthermore, is inconsistent with the logic of partial unemployment. These programs are targeted at those among the unemployed who are most isolated from the labor market – the long-term unemployed and unskilled – and would lower their risk of dropping out of the labor market.

However, even though these tools should be used immediately, they are still just stop-gaps. Partial unemployment remains confined to 80% of industry and designed for short-term use. If today's dire economic situation continues, we know that this approach will only delay layoffs. Similarly, subsidized jobs are not intended to be long-term. These are low-paid part-time jobs intended to deal with reintegration into the labor market, and not a long-term approach.

The biggest challenge is really a correct diagnosis of the current economic situation. By focusing negotiations on the issue of partial unemployment and subsidized jobs, the government seems to be betting on a quick recovery. Yet it is precisely the combined effect of austerity plans throughout Europe that will weigh on growth in the years to come. Furthermore, the policy of reducing public deficits, which

will cost 1.4 percentage point of growth in France in 2012, is expected to continue at least into 2013. It is difficult in these circumstances to expect to pull out of the stagnant situation quickly enough to avoid the looming social catastrophe. Unless there are plans for a new permanent reduction in working hours and the creation of public sector jobs, the best employment policy remains growth. It is thus the issue of macro-economic governance that is posed above all today in France and throughout the euro zone.

In defense of France's "family quotient"

By [Henri Sterdyniak](#)

At the start of 2012, some Socialist Party leaders have renewed the claim that the "family quotient" tax-splitting system is unfair because it does not benefit poor families who do not pay taxes, and benefits rich families more than it does poor families. This reveals some misunderstanding about how the tax and social welfare system works.

Can we replace the family quotient by a flat benefit of 607 euros per child, as suggested by some Socialist leaders, drawing on the work of the Treasury? The only justification for this level of 607 euros is an accounting device, *i.e.* the total current cost of the family quotient uniformly distributed per child. But this cost stems precisely from the existence of the quotient. A tax credit with no guarantee of

indexation would see a quick fall in its relative purchasing power, just like the family allowance (*allocation familiale* – AF).

With a credit like this, taking children into account for taxation purposes would lose all sense. As shown in Table 1, families with children would be overtaxed relative to childless couples with the same income (per consumption unit before tax), and their after-tax income would be lower. The Constitutional Council would undoubtedly censor such a provision.

France is the only country to practice a family quotient system. Each family is assigned a number of tax parts or shares, P , based on its composition; the shares correspond roughly to the family's number of consumption units (CU), as these are defined by the OECD and INSEE; the tax system assumes that each family member has a standard of living equivalent to that of a single earner with revenue R/P ; the family is then taxed like P single earners with income R/P .

The degree of redistribution assured by the tax system is determined by the tax schedule, which defines the progressivity of the tax system; it is the same for all categories of households.

The family quotient (QF) is thus a logical and necessary component of a progressive tax system. It does not provide any specific support or benefit to families; it merely guarantees a fair distribution of the tax burden among families of different sizes but with an equivalent standard of living. The QF *does not* constitute an arbitrary support to families, which would increase with income, and which would obviously be unjustifiable.

Let's take an example. The Durand family has two children, and pays 3358 euros less than the Dupont family in income tax (Table 1). Is this a tax benefit of 3358 euros? No, because

the Durands are less well off than the Duponts; they have 2000 euros per tax share instead of 3000. On the other hand, the Durands pay as much per share in income tax as the Martins, who have the same standard of living. The Durands therefore do not benefit from any tax advantage.

The family quotient takes into account household size; while doing this is certainly open for debate, one cannot treat a tax system that does not take into account household size as the norm and then conclude that any deviation from this norm constitutes a *benefit*. There is no reason to levy the same income tax on the childless Duponts and the two-child Durands, who, while they have the same level of pay, do not enjoy the same standard of living.

Table 1. Family size and income taxation in euro

		Monthly wages / by tax share	Annual income taxation	Disposable income by consumption unit
Dupont	Couple	6 000/ 3000	8 472	2 526
Martin	Couple	4 000/ 2000	3 409	1 858
Durand	Couple + 2 children	6 000/ 2000	5 114	1858
Durand*	Couple + 2 children	6 000/ 2000	7 258	1798

* with a uniform tax credit.
Source: author calculations.

In addition, capping the family quotient [\[1\]](#) takes into account that the highest portion of income is not used for the consumption of the children.

Society can choose whether to grant social benefits, but it has no right to question the principle of the fairness of family-based taxation: each family should be taxed according to its standard of living. Undermining this principle would be unconstitutional, and contrary to the Declaration of the Rights of Man, which states that “the common taxation ... should be apportioned equally among all citizens according to their capacity to pay”. The law guarantees the right of couples to marry, to build families, and to pool their resources. Income tax must be family-based and should assess the ability to pay of families with different compositions. Furthermore, should

France's Constitutional Council be trusted to put a halt to any challenge to the family quotient? [\[2\]](#)

The only criticism of the family quotient system that is socially and intellectually acceptable must therefore focus on its modalities, and not on the basic principle. Do the tax shares correspond well to consumption units (taking into account the need for simplicity)? Is the level of the cap on the family quotient appropriate? If the legislature feels that it is unable to compare the living standards of families of different sizes, then it should renounce a progressive system of taxation.

Family policy includes a great variety of instruments [\[3\]](#). Means-tested benefits (RSA, the "complément familial", housing benefit, ARS) are intended to ensure a satisfactory standard of living to the poorest families. For other families, universal benefits should partially offset the cost of the child. The tax system cannot offer more help to poor families than simply not taxing them. It must be fair to others. It is absurd to blame the family quotient for not benefitting the poorest families: they benefit fully from not being taxed, and means-tested benefits help those who are not taxable.

Table 2 shows the disposable income per consumption unit of a married employed couple according to the number of children, relative to the income per consumption unit of a childless couple. Using the OECD-INSEE CUs, it appears that for low-income levels families with children have roughly the same standard of living as couples without children. By contrast, beyond an earnings level of twice the minimum wage, families with children always have a standard of living much lower than that of childless couples. Shouldn't we take into account that having three or more children often forces women to limit their work hours or even stop work? It is the middle classes who experience the greatest loss of purchasing power when raising children. Do we need a reform that would reduce their relative position still further?

Table 2. Living standard of a family according to the number of children and employment status relatively to a couple without children

In euro per month by CU in 2009

Adult 1	MI	MW	MW	MW	2 MW	3 MW	4 MW
Adult 2	Inactive	Inactive	½ MW	MW	1 MW	2 MW	4 MW
1 child	99.9	99.4	89.9	85.0	84.9	85.5	85.2
2 children	102.6	97.5	87.1	79.9	77.1	76.2	75.7
3 children	105.8	98.4	93.6	84.0	75.7	70.6	70.5

MI: minimum income; MW: minimum wage.
Source: author's calculations.

The standard of living of the family falls as the number of children rises. Having children is thus never a tax shelter, even at high income levels. So if a reform of family policy is needed, it would involve increasing the level of child benefit for all, and not the questioning of the family quotient system.

Overall, redistribution is greater for families than for couples without children: the ratio of disposable income between a couple who earns 10 times the minimum wage and a couple who earns the minimum wage is 6.2 if they have no children; 4.8 if they have two children; and 4.4 if they have three. The existence of the family quotient does not reduce the progressivity of the tax and social welfare system for large families (Table 3).

Table 3. Income distribution is more equal between families

	10*minimum wage/ minimum income	10*minimum wage/ 1*minimum wage
0 child	9.2	6.2
1 child	7.8	5.3
2 children	6.8	4.8
3 children	6.0	4.4
4 children	5.7	4.2

Source: author's calculations.

Consider a family with two children in which the man earns the minimum wage and the wife doesn't work. Every month the family receives 174 euros in family benefits (AF + ARS), 309 euros for the RSA and 361 euros in housing benefit. Their disposable income is 1916 euros on a pre-tax income of 1107 euros; even taking into account VAT, their net tax rate is negative

(-44%). Without children, the family would have only 83 euros for the PPE and 172 euros in housing benefit. Each child thus “brings in” 295 euros. Income is 912 euros per CU, compared with 885 euros per month if there were no children. Family policy thus bears the full cost of the children, and the parents suffer no loss of purchasing power due to the presence of the children.

Now consider a large wealthy family with two children where the man earns 6 times the minimum wage and the woman 4 times. Every month this family receives 126 euros in family benefits and pays 1732 euros in income tax. Their disposable income is 7396 euros on a pre-tax income of 10,851 euros; taking into account VAT, their tax rate is a positive 44%. The French system therefore obliges wealthy families to contribute, while financing poor families. Without children, the wealthy family would pay 389 euros more tax per month. Its income per CU is 4402 euros per month, compared with 5819 euros if there were no children. The parents suffer a 24.4% loss in their living standard due to the presence of the children.

Finally, note that this wealthy family receives 126 euros per month for the AF, benefits from a 389 euro reduction in income tax, and pays 737 euros per month in family contributions. Unlike the poor family, it would benefit from the complete elimination of the family policy.

It would certainly be desirable to increase the living standards of the poorest families: the poverty rate for children under age 18 remains high, at 17.7% in 2009, versus 13.5% for the population as a whole. But this effort should be financed by all taxpayers, and not specifically by families.

No political party is proposing strong measures for families: a major upgrade in family benefits, especially the “complément familial” or the “child” component of the RSA; the allocation of the “child” component of the RSA to the children of the unemployed; or the indexation of family benefits and the RSA

on wages, and not on prices.

Worse, in 2011, the government, which now poses as a defender of family policy, decided not to index family benefits on inflation, with a consequent 1% loss of purchasing power, while the purchasing power of retirees was maintained. Children do not vote ...

I find it difficult to believe that large families, and even families with two children, especially middle-class families with children, those where the parents (especially the mothers) juggle their schedules in order to look after their children while still working, are profiting unfairly from the current system. Is it really necessary to propose a reform that increases the tax burden on families, especially large families?

[\[1\]](#) The advantage provided by the family quotient is currently capped at 2585 euros per half a tax share. This level is justified. A child represents on average 0.35 CU (0.3 in the range 0 to 15 year old, and 0.5 above). This ceiling corresponds to a zero-rating of 35% of median income. See H. Sterdyniak: "Faut-il remettre en cause la politique familiale française?" [*Should French family policy be called into question?*], *Revue de l'OFCE*, no. 16, January 2011.

[\[2\]](#) As it has already intervened to require that the Prime pour l'emploi benefit takes into account family composition.

[\[3\]](#) See Sterdyniak (2011), *op.cit.*

Fiscal consolidation wrong-footed

By Sabine Le Bayon

Should deficit reduction be the priority of governments today?

The constraints imposed by the Stability Pact and especially by the financial markets on Europe's governments do not leave them much leeway. But while there is no avoiding the issue of the sustainability of public debt, we also need to take into account the recessionary impact of austerity programs on economic activity, particularly during a period of recovery. The great majority of studies point to a positive multiplier effect, that is to say, a one point cut (expansion) in the budget results in a decrease (increase) in activity. Furthermore, studies have highlighted that in order to maximize a policy's impact, its *timing* is crucial: the impact on growth and on the public deficit (via its cyclical component) depends on whether or not it is supported by monetary policy, on the fiscal policy conducted by other countries, on the phase of the cycle, and so forth.

Fiscal consolidation, for example, has less impact on activity when it is accompanied by a relaxation in monetary policy and by a currency depreciation. But when interest rates are already close to zero (or in the case of a liquidity trap), the impact of fiscal restraint is not cushioned by a fall in base rates. As the central bank cannot counter disinflation, real interest rates rise, which amplifies the fall in activity. Moreover, in a context of generalized tightening, the exchange rate cannot be a means of supporting activity in every area. This is also true when a policy of fiscal restraint is being implemented within a monetary union where the countries trade mainly among themselves. Thus, according to [the IMF](#), the impact on growth of a budget cut of 1 GDP

point can vary between 0.5% and 2%, depending on whether or not an austerity program is synchronized with the response of monetary policy (Table 1).

Ultimately, the impact on growth feeds back into the state of public finances. When monetary policy can counteract the recessionary effects of fiscal policy, a one-off budget cut of a single GDP point reduces activity by 0.5% after two years. The deterioration in the cyclical deficit then comes to 0.25 GDP point, and the balance ultimately improves by 0.75 point. When interest rates are near zero, a one point negative fiscal stimulus in a country reduces growth by one point and worsens the cyclical deficit by 0.5 point, leading ultimately to an improvement in the deficit of only 0.5 GDP point. Finally, when a liquidity trap (or rates of zero) is combined with generalized budget cuts, a one GDP point negative fiscal stimulus reduces growth by 2 points, because neither monetary policy nor exchange rates can offset the impact of the cuts. This widens the cyclical deficit by one point, and there is therefore no improvement in the public deficit despite the one point structural effort.

Tableau 1. Impact of fiscal consolidation on growth based on various IMF hypotheses

	Interest rates greater than zero	Interest rates near zero
Isolated fiscal consolidation	- 0.5	- 1
Global fiscal consolidation	- 0.8	- 2

Source: FMI (2010).

Furthermore, the economy's position in the cycle influences the multipliers. At the bottom of the cycle, for instance, they are amplified: an austerity policy accentuates any deflationary tendencies at work, which intensifies the fall in demand and therefore the impact on activity. However, at the top of the cycle, the disinflationary effects of the austerity measures counteract the inflationary trend usually seen in this phase, thus reducing the multiplier. According to [Creel, Heyer and Plane](#), after one year, and depending on the policy

instruments used, the multiplier lies between 1 and 1.3 points when the economy is in the bottom of the cycle (assuming an output gap of -2%) and between 0.8 and 1.2 points in mid-cycle (an output gap of zero) and the top of the cycle (for an output gap of 2%). At 5 years, the effect is even stronger: between 1 and 1.6 points at the bottom of the cycle, between 0.6 and 1.3 in mid-cycle and between 0 and 1.2 at the top of the cycle. Thus, when the output gap is negative, fiscal consolidation policies are not very effective because they lead to a significant decline in GDP compared to a scenario with no restraint, which limits any fiscal gains to be expected from the austerity policies.

Today everything has come together for the austerity policies to lead to a significant slowdown in growth with little reduction in the deficit, especially in the euro zone. This is why we tried to assess the indirect impact, for France and the major developed countries, of the austerity measures being implemented by their trading partners, in addition to the direct impact of the various national plans. The impact of fiscal restraint (in country A) on demand from its partners (B) depends on the elasticity of imports with respect to the GDP of country A but also on the degree of openness and geographical orientation of exports of the B countries. In the case of France, for a national multiplier of 0.5, the total multiplier is 0.7, once the fiscal restraint policies of the partners are taken into account via foreign trade; for a national multiplier of 1, the total multiplier is 1.5.

Based on the fiscal packages planned in the various countries, we obtain an impact of foreign plans on national activity of between -0.1 and -0.7 point in 2012, depending on the degree of openness of the countries and the orientation of their trade (Table 2). For France, the restraint planned by its trading partners will cut growth by 0.7 point in 2012, which is almost equal to the savings plan set up by the government (1 point). In Germany, the impact of foreign austerity plans

on GDP is close to that calculated for France: even if Germany is more open, it trades less than France does with the rest of the euro zone, and will benefit more from the US stimulus package in 2012. In the other euro zone countries, foreign fiscal cuts will have an impact of the same magnitude (0.6). In the US, the effects of the stimulus package will be undercut by the austerity measures being implemented elsewhere; while the direct effect of the stimulus package on GDP will be 0.7 point, the lower demand addressed to it will cut growth by 0.2 point, limiting the impact of the expansionary fiscal policy. The slower than expected growth could render the deficit reduction goals obsolete. Using our assumptions of national multipliers of between 0.6 and 0.9, a one GDP point negative fiscal stimulus in all the EU countries actually reduces the deficit by only 0.4 to 0.6 GDP point in each country, once the fiscal restraint of the trade partners is taken into account.

Tableau 1. Impact of fiscal consolidation on GDP in 2012

	Direct effect	Effect via external demand	Total
France	- 1.0	- 0.7	- 1.7
Germany	- 0.3	- 0.7	- 1.0
Spain	- 2.3	- 0.6	- 3.0
Italy	- 2.1	- 0.6	- 2.6
United Kingdom	- 1.9	- 0.4	- 2.3
United States	0.7	- 0.2	0.5
Japan	1.4	- 0.1	1.3

Sources: OFCE calculations and forecasts, October 2011.

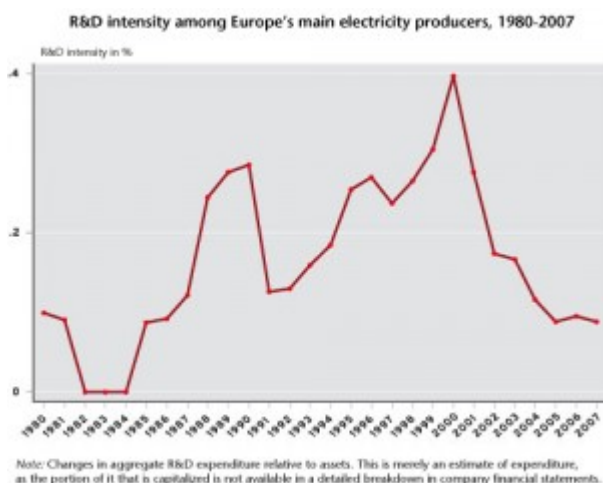
This text refers to the [study of fiscal policy](#) (in French) that accompanies the analysis of the economic situation and the forecast for 2011-2012, available on the [OFCE web site](#).

R&D all at sea: Have electricity producers lost the plot?

By [Evens Salies](#)

Is there an inherent conflict between the technological efforts needed to meet the requirements of environmental policies and the liberalization of electricity markets? In effect, the way R&D spending by European electricity producers has changed over the last three decades can give rise to doubts about the ability of the European Union to meet its goal of reducing greenhouse gas emissions by 80% to 93% by 2050 ([European Commission, COM/2010/0639](#)).

This is shown by the graph below, where we have isolated the expenditure of the 15 main producers. The figure shows a surprising reversal of the trend concomitant with the wave of liberalization in the sector sought by the EU. As concurrence doesn't necessarily mean causation, we took a look at whether the liberalization could be the source of this turnaround.



The R&D spending of Europe's electricity producers has shrunk by 70% between 2000 and 2007, from 1.9 billion euros to 570 million euros (figures adjusted for inflation). The giants EDF and E.ON, which represent the two biggest R&D budgets in the sector, are largely responsible for this decline. R&D spending by the French electricity firm fell 33% from 2000 to 2007, from 568 million euros to 375 million. As readers are probably aware that R&D costs mainly go on personnel, it will come as no surprise that, in the case of EDF, the number of employees engaged in R&D (researchers plus technical support and administration) has fallen by about one-quarter since 2007, but we were not able to break this reduction down by type of activity.

How can producers meet the technical challenge posed by alternative energy while spending so little on R&D? Some people might believe that the situation is not as dramatic as implied by the graph above. Indeed, the R&D expenditures of the large electrical groups constitute only the bare minimum (around 10%) of the total, which is mainly spent by equipment manufacturers and public research laboratories. Looking at the figures for total private spending, it can be seen that there has been a relative increase since 2000 in the shares intended not only to increase energy efficiency, but also to produce electricity from renewable energy sources. This is the result of numerous support measures for innovation (measures to purchase "green" electricity, financing for public / private partnership projects, etc.), without omitting the research tax credit also enjoyed by EDF.

It is nevertheless best to hold off before celebrating the above-mentioned shift in environmental innovation from the producers to the manufacturers, as the competition might well wind up by undermining the ability of the former to acquire these innovations. The question of why R&D spending has been falling thus remains relevant. Were levels abnormally high in

the past, when producers enjoyed the status of public monopolies? It is in any case possible to find objective reasons for the decline, beginning with the liberalization of the markets in the European Union which, as several studies have shown, was the event triggering this radical change in the innovation policy of the electricity producers [1].

The thesis put forward in these studies is that the expected increase in competition following the opening up of these markets makes the value of the producers' future income more uncertain. The argument in support of this thesis is that some research projects directed towards public policy objectives (those reducing emissions) do not any yield short-term cost savings that would benefit the producers. The producers have thus refocused on their core business and abandoned research programs that are not procuring them any tangible benefits, particularly in terms of patents. In Europe, however, these sacrificed environmental innovation projects are now being developed by the manufacturers (for example, Vestas in the field of wind power). Research in nuclear power is being taken over by research providers such as Areva and Siemens. The producers are tending to replace these by programs with shorter research time frames that focus on energy demand management or improvements in energy efficiency. Note that the nature of innovation as a public good makes producers cautious, as they are supposed to bear the costs of the research projects but will not be the only ones to reap their benefits. This encourages some players to engage in "free riding", and therefore leads to underinvestment in R&D at the aggregate level in the sector.

Interestingly, we find that this switchover gives rise to an acceleration of R&D spending in the period just prior to liberalization. First observed in the United States, this phenomenon can be seen clearly in Europe when looking at R&D levels. When the Directive containing the common rules for the internal electricity market was passed in 1996, the decline in

spending that ensued was actually preceded by an increase that was even greater than that observed on average between 1980 and 1995.

However, the establishment of market rules does not explain everything. The restructuring / fragmentation taking place as the sector has opened up is not without consequences for innovation. In a way that is similar to what has been observed in other sectors like ICT, the major electricity groups began to take on debt – which necessarily came at the expense of spending on research and other investments – as they engaged in new acquisitions. Companies reorganized their research by outsourcing. The example in France is that of EDF Energies Nouvelles, since August 2011 a wholly-owned subsidiary of EDF. The industrial organization that exists today in the electrical power sector is an oligopoly with a competitive fringe. Although the activities of the main traditional producers are subject to separate accounting, they still form vertically integrated groups, from production to marketing.

This restructuring and fragmentation evokes a hypothesis that is well-known to economists concerning the advantage of large companies in terms of innovation: the *Schumpeterian hypothesis* [2]. Formally, the question is whether the intensity of R&D – that is to say, the ratio of R&D expenditure to a size variable (the balance sheet, for example) – is positively correlated with size. We were able to demonstrate this link in a sample of 15 major European electricity producers for the period 1980-2007 [3]. However, this result is largely contingent on the period under study, during which most producers were protected from new market entrants and competitive pressure on the territory where they were doing business as public enterprises, then called “natural monopolies”.

This position gave them at least three advantages that have now disappeared. First is a kind of “right of first refusal” on the use of innovations provided by equipment manufacturers,

while they were also less fearful of being imitated on their own innovations. The potential for replication was limited to a very specific area of π activity for each country, usually the country, which made it possible to spread the costs of innovation over all domestic consumers. Moreover, as they were certain not to lose their customers, the traditional producers could take risks in launching basic research projects. Finally, the regulation of tariffs ensured a predictable level of revenue.

This suggests that the Schumpeterian impact of rent appropriation dominated the negative effect on the incentive to innovate due to the lack of actual or potential competition. Once the sector was opened to competition, some of the advantages listed above disappeared. The vast majority of customers remained loyal due to the significant cost of switching, but an increasing share of the electricity produced was sold on weakly regulated wholesale markets at volatile prices. The Schumpeterian hypothesis could therefore disappear, and competition would lead to stifling the innovation fostered by spending on R&D.

An oligopoly of producers with a competitive fringe

Europe's electric power sector is characterized by a small number of large producers (oligopoly) that hold a large share of the market, while a large number of small firms (the competitive fringe) each have a small part of the residual market. Contrary to the received wisdom about competition, the fringe can have an impact on wholesale prices. In practice, since electricity cannot be stored, a producer asked by a carrier that is responsible for balancing production and consumption can offer the output of a power plant with low marginal costs at a price above the cost. An example is a producer at a marginal plant which, in times when demand is running up against production capacity (the peak), is requested to ensure the overall balance as a last resort.

[1] The study by Kammen, D.M. and R. M. Margolis ("Underinvestment: the energy technology and R&D policy challenge", *Science, Energy-Viewpoint*, no. 285, 1999, pp. 690-692) had anticipated this situation for the United States. A study by P. Sanyal ("The effect of deregulation on environmental research by electric utilities", *Journal of Regulatory Economics*, Vol. 31, no. 3, 2007, pp. 335-353) was the first to use econometrics to show how the liberalization of the electricity market was related to the fall in R&D spending.

[2] Please see http://en.wikipedia.org/wiki/Creative_destruction .

[3] "A test of the Schumpeterian hypothesis in a panel of European electric utilities", *Document de Travail de l'OFCE*, no. 2009-19, <http://www.ofce.sciences-po.fr/pdf/dtravail/WP2009-19.pdf>.

What new European austerity plans await us in 2012?

By [Eric Heyer](#)

To meet French commitments vis-à-vis Brussels to a general government deficit in 2012 of 4.5% of GDP, the French Prime Minister Francois Fillon announced a new plan to cut the budget by 7 billion euros. Will the plan, announced 7 November, be sufficient? Certainly not! So what new austerity

plans should we expect in the coming months, and what impact will they have on growth in 2012?

In early October 2011, among the points we indicated in our forecast dossier was that, of all the finance bills approved in Europe, no major country has met its commitment to reduce the deficit.

This will be the case in particular of Italy and the UK, which could face a gap of between 1.5 and 2 percentage points between the final public deficit and their commitment. In the case of France and Spain, the gap will probably be 0.6 and 0.7 point, respectively. Only Germany will come very close to its commitments (Table 2).

Unlike in previous years, the implementation of these commitments would seem probable: in an uncertain financial context, being the only State not to comply with its promise of fiscal consolidation would be punished immediately by more expensive financial terms on the repayment of its debt.

This will therefore require the adoption of new austerity plans in the coming months. But by attempting to reduce their deficits too early, too quickly and in a synchronized fashion, the governments of the European countries are running the risk of a new downturn. Indeed, as we noted in a recent study, tightening budget policy during a cyclical downturn in all the European countries and doing so in a situation of a persistent "liquidity trap" is contributing to the formation of a strong multiplier, close to unity.

How many billion euros will be targeted by the next fiscal savings plans? What impact will they have on economic growth? Several possible cases were considered.

Case 1: Each country respects its commitment alone

In order to isolate the impact on growth of the national savings plan and those of the partners, we have assumed that each country meets its commitment alone. Under this

assumption, the effort would be significant in Italy and the UK, which would present new austerity plans for, respectively, 3.5 and 2.8 points of their GDP (56 and 48.7 billion euros). France and Spain would implement an austerity plan two to three times smaller, about 1.2 points of GDP, representing 27 and 12.1 billion euros, respectively. Finally, the German savings plan would be the weakest, with 0.3 point of GDP (7 billion euros) (Table 1).

Table 1. Amount needed to meet the public deficit commitments in 2012

	Germany	France	Italy	Spain	United Kingdom
If each country meets its commitment alone					
In billions of euros	7.0	27.0	56.0	12.1	48.7
In GDP points	0.3	1.3	3.5	1.1	2.8
If the EU countries respect their commitments					
In billions of euros	22.3	39.8	63.9	19.6	55.2
In GDP points	0.9	2.0	4.0	1.8	3.2
If the euro zone countries meet their commitments					
In billions of euros	16.6	36.1	61.7	17.9	
In GDP points	0.6	1.8	3.9	1.7	

Source: OFCE calculations.

These different national austerity plans, taken in isolation, would have a non-negligible impact on the growth of the countries studied. With the exception of Germany, which would continue to have positive growth in 2012 (0.9%), this kind of strategy would plunge the other economies into a new recession in 2012, with a decline in their GDP ranging from -0.1% for Spain to -2.9% for Italy. France would experience a decline in activity of -0.5% and the British economy of -1.9% (Table 2).

Table 2. Impact on GDP of meeting the deficit reduction commitments in 2012

In %	Germany	France	Italy	Spain	United Kingdom
OFCE forecast					
GDP	1.2	0.8	0.4	0.9	0.7
Public deficit (in GDP points)	-1.4	-5.2	-3.4	-5.0	-8.0
If each country meets its commitment alone					
GDP	0.9	-0.5	-2.9	-0.1	-1.9
Public deficit (in GDP points)	-1.3	-4.5	-1.5	-4.4	-6.5
If the EU countries respect their commitments					
GDP	-0.3	-1.7	-3.9	-1.5	-2.6
Public deficit (in GDP points)	-1.3	-4.5	-1.5	-4.4	-6.5
If the euro zone countries meet their commitments					
GDP	0.1	-1.4	-3.6	-1.2	0.3
Public deficit (in GDP points)	-1.3	-4.5	-1.5	-4.4	-8.2
Remainder of commitments for 2012	-1.3	-4.5	-1.5	-4.4	-6.5

Source: OFCE calculations.

Case 2: All the EU countries meet their commitment

Of course, if all the major European countries were to adopt the same strategy at the same time, then the savings effort would be greater. It would amount to about 64 billion euros in Italy and 55 billion euros in the UK, accounting for 4 and 3.2 percentage points of GDP, respectively. The additional effort would be about 2.0 percentage points of GDP for France and Spain (respectively 39.8 and 19.6 billion euros) and 0.9 GDP point for Germany (22.3 billion euros). In total for the five countries studied, the cumulative savings effort would represent more than 200 billion euros in 2012.

The shock on the activity of these countries would be powerful: it would cause a violent recession in 2012 for some countries, with a fall in GDP of -3.9% in Italy (against -5.1% in 2009), and -2.6 % in the UK (against -4.9% in 2009). France would be close to recession (-1.7%), as would Spain (-1.5%), while German GDP would decline slightly (-0.3%).

Case 3: Only the countries in the euro zone meet their commitment

As the UK has already implemented a substantial austerity program, and given that their constraints in terms of the deficit are more flexible than those of countries in the euro zone, we assumed that only the major countries in the euro zone complied with their commitments on the public deficit. Under these conditions, the cumulative savings effort would represent more than 130 billion euros in 2012, almost half of which would be from Italy alone (61.7 billion).

The recessionary shock would thus be focused on the euro zone, with a recession in all the countries studied except Germany (0.1%). The British economy would avoid a new period of recession (0.5%), but it would not meet the target of 6.5 percentage points of GDP for the public deficit, which would come to 8.2 GDP points.

The G20 Summit in Cannes: Chronicle of a Disappointment Foretold?

By [Jérôme Creel](#) and [Francesco Saraceno](#)

Too long and too technical, the [final declaration](#) of collective action of the G20 Summit in Cannes shows that no clear and shared vision of the economic and financial turmoil that is rocking the global economy has emerged at the Summit. And as Seneca reminds us, the disappointment would have been less painful if success had not been promised in advance.

According to the official announcements, the disappointment was palpable at the end of a G20 summit in which no significant progress was achieved – on the most important issues of the moment, the revival of growth in particular. The crucial issues of agriculture and finance gave rise simply to declarations of intent, with a reminder of the commitments made on these ... in 2008! The disappointment must be kept in perspective, however, as the G20 is primarily a forum for discussion rather than for decisions. Indeed, what remains of the commitments made in April 2009 by the G20 in London, mired in global recession? The expansionary fiscal policies? Forgotten, as a result of the public debt that they have produced – debt, by the way, that was perfectly predictable. Strengthened financial regulation? Repeatedly trotted out, but still not implemented, despite the determination displayed in Paris on 14 and 15 October 2011. The desire to avoid protectionism? Barely mentioned, nor did this succeed in

preventing the outbreak of 36 [trade disputes](#) brought before the WTO, including 14 involving China, the EU and / or the United States. All that remains is a monetary policy that is “expansionary as long as necessary”, in the words of the pre-Summit statements. So does the fate of the international monetary system depend simply on the good will of the central bankers, independent as they are?

The meeting was also troubled by the crisis hitting the euro zone, which virtually forced off the agenda such important issues as the resurgence of protectionism, which was relegated to paragraphs 65 to 68 of a 95-paragraph document. At Cannes, the emerging economies and the US were spectators of a drama unfolding between Paris, Berlin, Rome and Athens.

The crisis hitting the euro zone is a result of the heterogeneity of its constituent countries, much as the financial crisis triggered in 2007 was a result not just of a lack of financial regulation but also of the increasing heterogeneity between mercantile countries and countries presumed to be the El Dorados of investment, on the one hand China and Germany, and on the other, the United States and Ireland. This European heterogeneity, one of four deficiencies of the euro zone, has led countries with a surplus in their current accounts to finance countries running a deficit. Alone, and with its priority on the fight against inflation imposed by the Treaty of the EU, the ECB is unable to promote convergence within the euro zone. However, in the short term it can end the crisis in the euro by agreeing to provide full coverage of public debts in the euro zone (see [\[1\]](#), [\[2\]](#) or [\[3\]](#)), and by significantly increasing its [purchases of government debt in Europe](#). This would maintain European financial stability and perhaps generate inflationary expectations, thereby helping to lift Europe's economy out of the [liquidity trap](#) in which it has been mired since the beginning of the financial crisis. Note that despite its activism, the US Federal Reserve has not so far managed to

create such expectations and remains caught in the same kind of liquidity trap.

In the longer term, it is necessary to review European economic governance. The active use of economic policy in the United States and China contrasts with the caution displayed by the ECB and with the European reluctance to pursue expansionary fiscal policies, and more generally with the decision to build European economic governance on a refusal of discretionary policies. It would be desirable for the ECB, while preserving its independence, to be able to pursue a [dual mandate](#) on inflation and growth, and for the [rules that discipline](#) fiscal policy to be “smarter” and more flexible.

Giving the economic policy authorities an opportunity to implement discretionary policies should not mean forgetting about the risks posed by the absence of a coordinated approach, which may lead the US Congress to threaten unilateral compensatory taxes on goods imported from countries whose currency is undervalued. This move is evoking the specter of protectionism, and the G20 countries should consider a mechanism to coordinate policy so as to avoid the trade wars that are already being more or less explicitly declared.

Furthermore, a currency war does not seem to be an effective way to protect our economies: the under-or overvaluation of a currency is a complex concept to apply, and the impact of a currency's value on exports and imports is made very uncertain by the international fragmentation that characterizes the production of goods and services. Rather than employing a defensive policy, it is definitely better to substitute an [active industrial policy](#) to take advantage of new technological niches that create business and jobs.

Finally, for words to have real meaning – to “build confidence and support growth” in the advanced economies and “support growth” while “containing inflationary pressures” in the

emerging economies ([G20 Communiqué](#), Paris, 14-15 October 2011) – we must challenge the “contagion of [fiscal contraction](#)” that is now shaking the euro area and, rather than an additional phase of rigor, put recovery plans on the agenda in the advanced economies while interest rates are still low. These plans must be targeted in order to generate growth and not jeopardize the solvency of public finances: it is thus necessary to encourage public investment. To maximize their overall impact, these plans need to be coordinated, including with the actions of the central banks, so that the latter can support them by maintaining low interest rates. The Summit in November 2011 was very timely for this kind of coordinated approach to emerge. Unfortunately, it didn't.

Can the central banks influence the expectations of private agents?

By Paul Hubert

Can the forecasts of a central bank influence the expectations of private agents, and if so what are the reasons for this? A few hours after the press conferences of Ben Bernanke and Mario Draghi, here are some explanations.

The awarding of the [2011 Nobel Prize in Economics](#) to Thomas Sargent and Chris Sims for “their empirical research on causal effects in macroeconomics” highlights the role of the expectations of private agents in economic policy decisions. Because the expectations of businesses and households about

inflation and growth affect their decisions on investment, consumption, savings, and wage demands, these are at the heart of the interaction between economic policies and their effects.

Since the 1980s, the main instrument of monetary policy has been the interest rate set by the central bank. Changes in this affect the economy and allow the central bank to arbitrate between economic growth and inflation through [several channels](#), and in particular interest rates, credit, asset prices, exchange rates and, finally, expectations. Indeed, in the course of their daily decision-making, businesses and households base themselves on numerous expectations about consumption, investment, future capacity and future wages and prices, etc. These expectations then play a central role in the determination of economic variables. Changes in the central bank rate thus send signals about the future state of the economy and future monetary policy, and alter the expectations formed by private agents.

However, the expectations channel is ambiguous, and changes in the base rates can be understood in different ways: private agents may respond to lower rates by consuming and investing more, which may indicate that growth will be stronger in the future, bolstering their confidence and their willingness to consume and invest. In contrast, the same agents may feel that current growth is lower than expected, prompting the central bank to intervene, which reduces their confidence, and hence their willingness to consume and invest.... Since the 1990s, the central banks have been complementing interest rates with the [effect of announcements](#) to clarify their future intentions. Communication seems to have become a [tool of monetary policy](#), and two types can be distinguished. Qualitative communication includes interviews and speeches, while quantitative communication consists of the publication of the central bank's forecasts of inflation and growth.

In a [recent working paper](#), we analyze the effect of the

forecasts of inflation and growth published quarterly by the central banks of Canada, Sweden, the UK, Japan and Switzerland. With the help of surveys conducted by Consensus Forecasts of professional forecasters from financial and non-financial sectors, we show that the inflation forecasts of the central banks of Sweden, the UK and Japan are a significant factor in the inflation forecasts of private agents. In other words, the publication of the central bank inflation forecasts leads to a revision of the forecasts of private agents. It also appears that the opposite is not true: the central bank forecasts do not respond to the forecasts of private agents.

Two factors could explain the central bank's influence: first, the inflation forecasts of the central bank could be higher quality, making it rational for private agents to be influenced by them so as to improve their own forecasts of macroeconomic variables. Second, the inflation expectations of the central bank can influence private agents because they transmit signals, either about future decisions on monetary policy, or about the private information available to the central bank. This type of influence is independent of the forecasting performance of the central bank.

To determine the sources of this influence, we evaluated the relative forecasting performance of the central banks and private agents and tested whether the central bank's influence on private expectations depends on the quality of its forecasts. Estimates showed that, in our sample of central banks, only the central bank of Sweden produced significant, regular and robust inflation forecasts that were better than those of private agents. We also found that the degree of influence depends on the quality of the inflation forecasts. In other words, the inflation forecast over a short horizon (1 or 2 quarters), which a historical analysis of forecast performance tells us are of low quality, do not influence private agents, whereas those of higher quality do influence them. Furthermore, the longer-term inflation forecasts of

Sweden's central bank managed to influence private expectations even when their quality was low, and the better the quality, the stronger the influence.

While the central banks in the United Kingdom, Japan and Sweden all succeed in influencing private expectations by publishing their macroeconomic forecasts, it appears that the reasons for this influence differ. The first two use the transmission of signals, while the Swedish central bank uses both possible sources for influencing private expectations: its greater forecasting capability and the sending of signals. The consequence of these results is that the publication by the central bank of its macroeconomic forecasts could facilitate and render more effective the establishment of the desired monetary policy by shaping private expectations. This transmission channel, which is faster because it relies only on the provision of forecasts, could thus allow the central bank to affect the economy without changing its key interest rate, in practice making it an additional policy instrument.