What is a weaker euro likely to mean for the French economy?

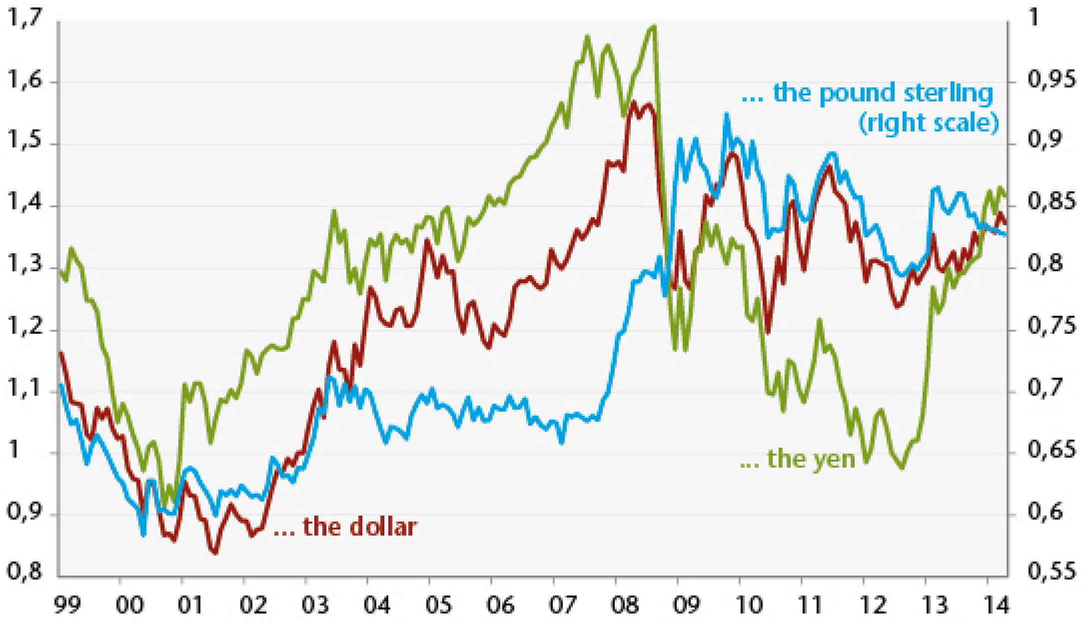
By Bruno Ducoudré and Eric Heyer

Faced with the rising risk of deflation in the euro zone, which has been reinforced since mid-2012 by the continued appreciation of the euro against other currencies, the heads of the European Central Bank have begun to change their tone in their communications with the financial markets: they are now evoking the possibility of conducting a new round of quantitative easing. These measures are likely to lower the exchange rate of the euro. This would provide valuable support for the euro zone economies by shoring up their price competitiveness vis-à-vis competitors outside the zone, in a context where fiscal consolidation policies will continue to dampen the growth expected in the zone in 2014 and 2015. What are the likely consequences for the French economy from reducing the euro's value against other currencies? We briefly review past episodes of exchange rate changes, and then present the impact expected from a 10% depreciation of the euro against other currencies using the *emod.fr* model. These effects are more moderate than those projected by the government.

Quantitative easing measures have been used extensively by the US Federal Reserve, the Bank of England and the Bank of Japan. Since mid-2012, the balance sheets of these three banks has continually increased, by respectively 6.5 percentage points of GDP, 1.3 GDP points and 15.3 GDP points. During this same period, the ECB balance has on the contrary declined by 8.4 GDP points. This difference in strategy has led to a continued rise in the strength of the euro: now at 1.38 dollars, the euro has seen its value against the dollar increase by 12%

since June 2012. During the same period, the single currency has appreciated 49% against the yen and about 3% against the pound sterling (Figure 1).

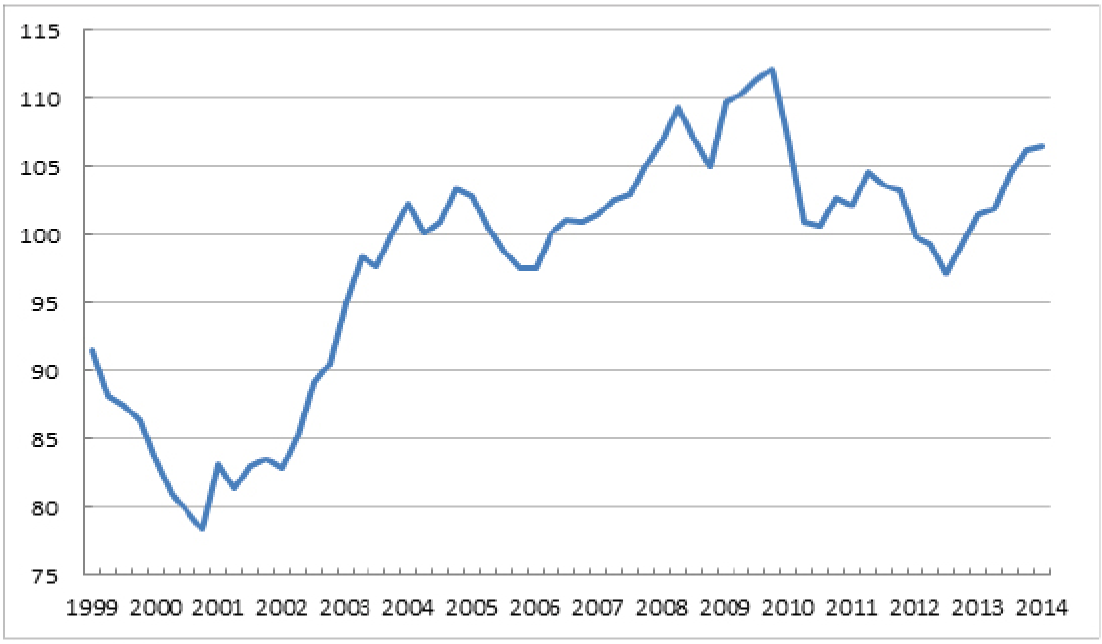
Figure 1. Exchange rate of the euro against…



Source : Datastream.

The nominal effective exchange rate of the euro, which weights the different exchange rates depending on the structure of trade in the euro zone, has thus appreciated by 9.5% since the third quarter of 2012 (Figure 2). This appreciation, combined with austerity policies and the competitive disinflation carried out within the euro zone, has held down GDP growth in the zone, which was negative in 2012 and 2013, as well as inflation. The absence of inflationary pressures and the past appreciation of the euro have now given the ECB leeway to try to influence the course of the euro against other currencies.

Figure 2. Nominal effective exchange rate of the euro



Source : OECD.

What would be the impact of a devaluation of the euro against all currencies?

The depreciation of the euro would have a dual effect:

– **An income effect**: a weak euro would increase the prices of imports. This would result in higher energy costs, a rise in companies' prices of production and a loss of household purchasing power;

– **A substitution effect**: a weak euro would decrease the prices of exports and increase their volume. Depreciation would also decrease the competitiveness of rival manufacturers, causing a decline in imports in favour of domestic production.

These opposite effects would apply only to trade outside the euro zone. Trade with our European partners would not be directly impacted, as the prices of imports and exports to and from this area would remain unchanged. On the other hand, intra euro zone trade would be impacted by a weaker euro. But this involves the channel of addressed demand.

Table 1. Impact on the French economy of a 10% depreciation in the exchange rate of the euro against all currencies combined

(Difference with the reference scenario in %)	n	n+1	n+2	n+8
GDP	0,3	0,4	0,5	0,0
Total waged employment (1000s)	22	53	74	34
Household consumer prices	0,9	1,4	1,9	3,9
Public financing capacity (% of GDP)	0,0	0,2	0,3	0,2

Note: The euro's depreciation would be favourable to short-term activity due to an improvement in France's price competitiveness relative to countries outside the euro zone. The positive impact of the euro's depreciation on the activity of our euro zone partners and the negative impact on our partners outside the zone are taken into account.
Source : emod.fr

As is summarized in Table 1, a 10% depreciation of the euro against all currencies leads to a gain in price competitiveness for French exports vis-à-vis the rest of the world. Other countries in the euro zone would benefit from the same gain in competitiveness across all export markets. In this case, the impact on activity would amount to 0.3% in the first year, 0.5% after three years, and none after nine years. The increase in demand due to this improvement in the activity of our European partners would be broadly offset by a reduction in demand addressed to France from the rest of the world. As for the labour market, this depreciation would create 22,000 jobs in the first year and 74,000 jobs after 3 years. The public deficit would in turn improve by 0.3 GDP point within 3 years.

These results, while more moderate than those published by the DG Treasury[1], are nonetheless significant and are welcome in an economic situation like today's that is marked by sluggish growth and the risk of deflation. A depreciation of the single currency would also undercut the process of competitive deflation engaged in by countries in the euro zone.

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[1] The publication of the DG Treasury argues that a 10% decrease in the effective exchange rate of the euro (against all currencies) would do the following: increase our GDP by

0.6 percentage point of GDP in the first year and 1.2 GDP points after three years; create 30,000 jobs in the first year and 150,000 jobs within three years; and reduce the government deficit by 0.2 GDP point in the first year and 0.6 GDP point after three years.

Abenomics and the new monetary policy

This post summarizes a paper written by Mahito Uchida, in *Revue de l'OFCE,* n° 135.

With the arrival of Shinzo Abe at the end of 2012, Japan's economic policy started clearly focusing on the risk of deflation. This new policy combines a highly accommodative monetary policy with a fiscal stimulus based on public investment. In an article published by the OFCE, Mahito Uchida of SEIJO University, analyses the first stage of implementation of the new Japanese monetary policy. In that paper, Mahito Uchida investigates the Bank of Japan's (BOJ) monetary policy effects under Abenomics at the initial stage. First, he describes briefly what is "Abenomics" and "New monetary policy under Abenomics" since April 2013. He also examines the causes of the sharp response of the yen and Japanese stock prices, the increase in consumer price index and the change in public's expectations of the economic activity and prices from surveys. In the second part he explains why the new monetary policy was effective in 2013, comparing the previous policy until 2012. Although there is not much difference between monetary policies before and after

2012 theoretically, he points out the importance of the strong commitment by central bank, the cooperation with the government and "psychological impact" on public. The third part discusses the durability of the new monetary policy. The policy effects will be sustainable if a price becomes lastingly positive, which needs a durably positive output gap. Therefore, Abenomics' growth strategy plays an important role. He also points out that the BOJ has to perform the policy over side effects such as the impact on the government bond markets, the impact on other financial markets and on capital flows overseas.

Elections and the (first) derivative of unemployment: the turnaround strategy

By Guillaume Allègre, g_allegre

A ministerial adviser recently explained to me what he thinks is the strategy of the French President on macroeconomic management and unemployment, which could be called a turnaround strategy: "In relation to the presidential elections, the goal is to reduce unemployment in 2016-2017. The way people vote is based on the way unemployment has been changing just in the last year or even the last 6 months. Like for Jospin in 2002." The belief that for unemployment and the economy in general what counts is the derivative, *i.e. the* recent evolution and not the actual level, has deep roots in the technocratic-political milieu: "it's the derivative, stupid!" is the new "*it's the economy, stupid!*" (the maxim of Bill Clinton's election strategist in 1992).

This belief stems in part from an intuition confirmed by a well-known psychological experiment. Participants in the study were subjected to two painful experiences during which one of their hands is immersed in ice water. One version lasts 60 seconds and the other 90 seconds. In the second experiment, the first 60 seconds are the same as in the first, while the 30 added seconds are a bit less painful (the experimenter pours some warm water into the container). Later, the participants must choose which of the two experiments to repeat: 80% chose the longer one. This seems irrational, because in the longer experiment the total amount of pain is greater. To an objective observer, this is what should count ("the area under the curve, or the integral"). But the participants have a selective memory: they are more strongly influenced by the representative moments of the experience and in particular here by the improvement at the end of the test. Daniel Kahneman, the 2002 Nobel Prize-winner in economics for his work on biases in judgment, which is popularized in a book that can be found here, distinguishes two representative moments during an unpleasant episode: the peak of suffering and the end [1].

Economists, especially in America, have developed econometric models of electoral forecasts to estimate the links between election results and the economy. The popularity of these models varies with their predictive power for the election: in 1992, half of the models predicted an easy re-election for George Bush; in 1996, the re-election of Clinton was reliably predicted; but in 2000, virtually all the models forecast a landslide victory for Al Gore … And the model that had the closest forecast in that election (0.6%) was off by 5 points in the next one. Of course, thanks to the proliferation of predictions, it is always possible to find a model with a good record for the time-being, such as Paul the Octopus (see Wiki).

Despite this motley record, these politico-econometric models have been imported into France. In their generic form, they attempt to explain the percentage of the vote going to a candidate or a party based on economic variables (GDP, unemployment, or levels or changes in income) and political variables (popularity of the President and the Prime Minister). The vast majority of models adopt as an economic variable changes in unemployment over a relatively short horizon, on average one year. The conclusion drawn from these empirical estimates is that French voters seem to have limited memories (Dubois, 2007).

But these studies are faced with a major problem: the low number of observations (nine presidential elections and thirteen legislative elections between 1958 and 2011). "We don't vote often enough to suit the econometricians," says Lafay (1995) [2]. In other words, the law of large numbers cannot be applied in this type of configuration. This is compounded by the fact that the number of variables that change in the context of these elections is almost as high as the number of elections (the existence of a government of multiple party "cohabitation"; legislative elections on their own or coupled to the presidential elections; the presence or absence of an incumbent in the presidential election; parliamentary elections held before the deadline; the presence or absence of a leftist candidate in the second round of the presidential elections; the importance of tactical voting when there are three candidates in the second round of legislative elections [*triangulaires*]; etc.).

There are other technical problems confronting the econometricians. In a comprehensive review of the literature analyzing 71 political-economic studies on voting in France between 1976 and 2006, Dubois describes the way these problems are handled – "if at all" – as "relatively frustrating". Just as in the United States, the predictions meet with "varied success". There is also the problem of what econometricians call "endogeneity": the politico-economic models attempt to explain or predict the outcome of elections using economic variables (unemployment) and the popularity of the executive. However, there is little doubt that the popularity of the executive depends in part on unemployment levels and trends: given this, the lack of significance of changes in the longer-term economic variables may be explained by the fact that their impact is already included in the popularity of the executive. In short, these empirical studies are not sufficient to conclude that in economic terms, voters have short memories.

In the words of Kahneman, a machine for jumping to conclusions is at work: an intuition (the memory of voters is selective) that relies on psychological studies (whose object is distant) and is confirmed by econometric studies (not robust and therefore merely reproducing the researchers' *a priori* assumptions). The story told is consistent, and it seems to be supported by facts … Upon reflection, it may seem scary that this kind of rhetorical cocktail is influencing the actions of politicians. This is even more frightening since, from an outside observer's viewpoint and from the perspective of social welfare and hence the goals of public policy, what matters is obviously the level of unemployment over several years (its integral) and not the way it has changed in the last year (its first derivative)!

Many rules have been implemented at the European level, and now the national level too, to prevent the politicians heading up government from trying to win elections by pursuing policies that, while they may reduce short-term unemployment, also build up long-term deficits. From the Maastricht criteria (government deficit of less than 3% of GDP) to the recent European multiannual financial framework, these rules are justified by the belief that politicians are encouraged to pursue a lax fiscal policy since it does not take into account future generations, who, by construction, don't vote. But if governments begin to believe that it is short-term economic developments that count, then the incentives are reversed, especially if it is easier to reduce unemployment after having first increased it, which would lead to a trajectory of weak growth and of excessively high unemployment. [3] In this case, the solution cannot come from governance through new binding rules, which in any case have so far proved to be ineffective. It is necessary to rely on the fact that this kind of turnaround strategy can work in electoral terms only if the citizens fail to understand that they are being manipulated. Exposing the manipulation is then more efficient than implementing rules. Duly noted.

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[1] Consequently, those who follow this theory today should also deal with unemployment at its peak, and not merely with the way it is changing at the end of their mandate.

[2] Lafay J.-D. 1995, “Note sur l’élection présidentielle de 1995 et les apports de l’analyse économétrique des comportements électoraux”, mimeograph, LAEP, University of Paris 1. Cited by Dubois.

[3] This post – link – emphasizes that it was possible to achieve the same ratio of debt to GDP in 2032 by taking a path that would have reduced unemployment in the euro zone by 3 points in 2013.

What Reforms for Europe?

by *Christophe Blot [1], Olivier Rozenberg [2], Francesco Saraceno [3] et Imola Streho [4]*

From May 22 to May 25 Europeans will vote to elect the 751

Members of the European Parliament. These elections will take place in a context of strong mistrust for European institutions. While the crisis of confidence is not specifically European, in the Old Continent it is coupled with the hardest crisis since the Great Depression, and with a political crisis that shows the incapacity of European institutions to reach decisions. The issues at stake in the next European elections, therefore, have multiple dimensions that require a multidisciplinary approach. The latest issue of the *Debates and Policies Revue de l'OFCE* series (published in French and in English), gathers European affairs specialists – economists, law scholars, political scientists – who starting from the debate within their own discipline, share their vision on the reforms that are needed to give new life to the European project. Our goal is to feed the public debate through short policy briefs containing specific policy recommendations. Our target are obviously the candidates to the European elections, but also unions, entrepreneurs, civil society at large and, above all, citizens interested by European issues.

In the context of the current crisis, the debate leading to the next European elections seems to be hostage of two opposing views. On one side a sort of self-complacency that borders denial about the crisis that is still choking the Eurozone and Europe at large. According to this view, the survival of the euro should be reason enough to be satisfied with the policies followed so far, and the European institutions evolved in the right direction in order to better face future challenges.

At the opposite, the eurosceptic view puts forward the fundamental flaws of the single currency, arguing that the only way out of the crisis would be a return to national currencies. The different contributions of this volume aim at going beyond these polar views. The crisis highlighted the shortcomings of EU institutions, and the inadequacy of economic policies centered on fiscal discipline alone. True, some reforms have been implemented; but they are not enough, when they do not go in the wrong direction altogether. We refuse nevertheless to conclude that no meaningful reform can be implemented, and that the European project has no future.

The debate on Europe's future and on a better and more democratic Union needs to be revived. We need to discuss ways to implement more efficient governance, and public policies adapted to the challenges we face. The reader nevertheless will not find, in this volume, a coherent project; rather, we offer eclectic and sometimes even contradictory views on the direction Europe should take. This diversity witnesses the necessity of a public debate that we wish to go beyond academic circles and involves policy makers and citizens. Our ambition is to provide keys to interpret the current stakes of the European debate, and to form an opinion on the direction that our common project should take.

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