Recovery aborted

By Christophe Blot

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

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

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

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

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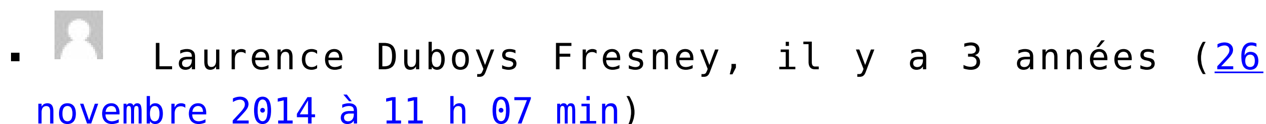
-  Laurence Duboys Fresney, il y a 3 années (26 novembre 2014 à 11 h 07 min)

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Commentaires

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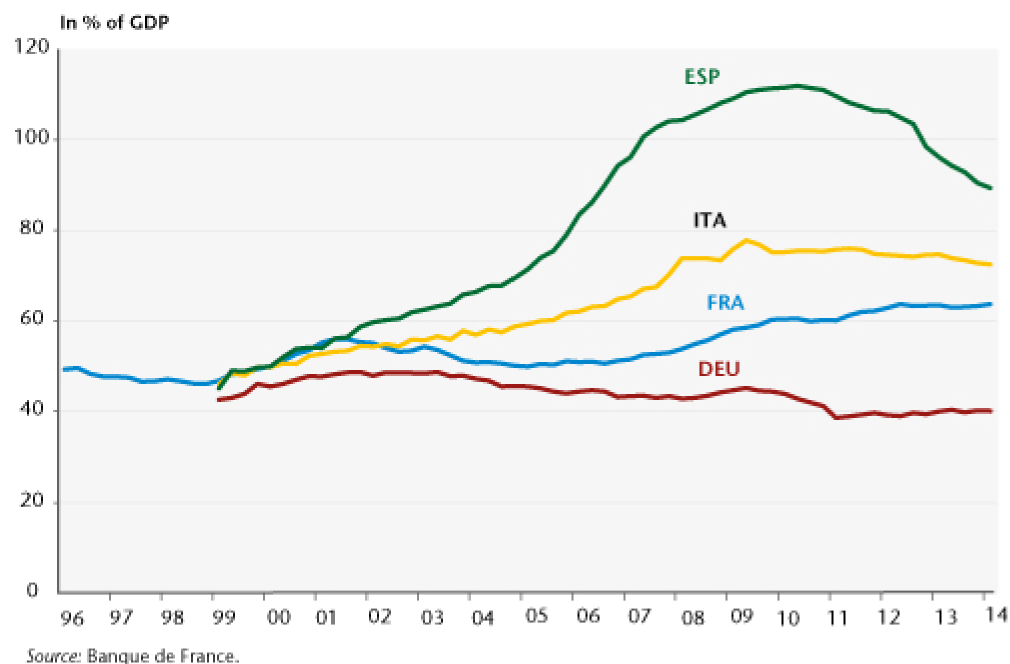
(TSCG) requiring Member countries to make fiscal adjustments to bring public debt down to the 60% threshold within 20 years[3].

These conditions could push a recovery further down the road, and the euro zone could wind up locked in the trap of deflation. A lack of growth and high unemployment are creating downward pressure on prices and wages, pressure that is being exacerbated by internal devaluations, which are the only solutions being adopted to improve competitiveness and regain market share. This reduction in inflation is making the deleveraging process even more protracted and difficult, thus undercutting demand and strengthening the deflationary process. The Japanese experience of the 1990s shows that it is

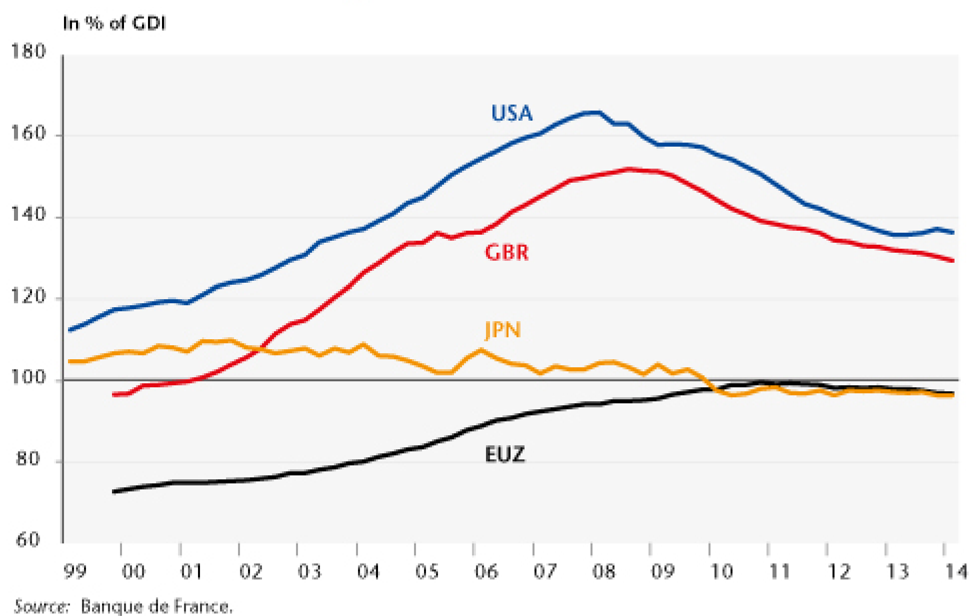
not easy to pull out of this kind of situation.

Figure 1. Debt of non-financial corporations



Source: Banque de France.

Figure 2. Household debt



Source: Banque de France.

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

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

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

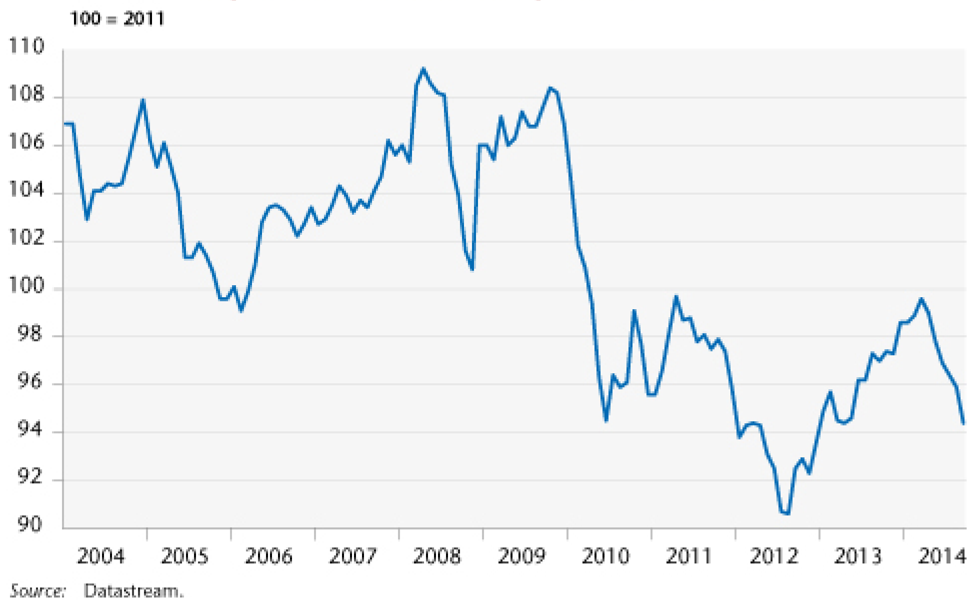
Decline of the euro and competitive disinflation: who's going to gain the most?

By Bruno Ducoudré and Eric Heyer

For nearly two years, between mid-2012 and mid-2014, the euro appreciated against the world's major currencies. Having reached a level of USD 1.39 in May 2014, the euro had increased in value since July 2012 by more than 12% against the dollar. During the same period, the euro appreciated by 44% against the yen and more than 3% against the pound sterling.

Since May 2014, this trend has reversed: after rising by nearly 10% between mid-2012 and mid-2014, the real effective exchange rate for the euro, which weights the different exchange rates based on the structure of euro zone trade, has depreciated by 5.2% over the last six months (Figure 1). In fact, within a few months, the euro has lost nearly 10% against the dollar, more than 3% against the yen and 4% against the British pound. The weakening against the pound sterling actually began in August 2013, and has reached over

9% today. We expect the euro to continue to depreciate up to the beginning of 2015, with the single currency's exchange rate falling to 1.20 dollars in the second quarter of 2015.



For many business people and economics experts, this decline in the euro represents an opportunity to escape the deflation trap currently threatening the euro zone. Faced with sluggish growth in the zone and an inflation rate that is falling dangerously low, the announcement by the European Central Bank of a quantitative easing programme indicates its willingness to devalue the euro against other currencies in order to support Europe's growth and meet its inflation target.[1] The French government also expects a great deal from the euro's depreciation.[2] The Treasury Department believes[3] that a 10% decrease in the effective exchange rate of the euro (against all currencies) would increase our GDP in the first year by 0.6 percentage point, creating 30,000 jobs, reducing the public deficit by 0.2 GDP point and pushing up consumer prices by 0.5%.

The revival of short-term growth in the euro zone through a depreciation of the euro's effective exchange rate would also limit the non-cooperative policy of competitive disinflation

being implemented in southern Europe (Greece, Spain, Portugal). While European countries trade mostly with each other and compete sharply for export markets, the effort to improve competitiveness through a disinflation policy is bound to fail in the euro zone if all the members adopt the same strategy. This is, however, the strategy chosen by the European Commission, *i.e.* by pushing the countries in crisis to reform their labour markets and cut labour costs. In this light, the depreciation of the euro is needed to support structural reform in Europe and support demand [4] even as fiscal austerity policies are further undermining it.

In a recent study, we attempted to assess the effects expected from the depreciation of the euro. We are interested not in the reasons for the variations in the euro (differential performance, behaviour of central banks) but in its macroeconomic implications (in particular its impact on GDP, prices and employment). To assess the sensitivity of exports to price competitiveness for six major OECD countries (France, Germany, Italy, Spain, United States, United Kingdom), we made estimates using new foreign trade equations that distinguish, within the euro zone, intra-zone trade and extra-zone trade. The elasticities obtained are consistent with the existing literature on this subject. It is necessary to make a joint estimation of the equations for export volumes and import prices: this provides a feedback loop in partial equilibrium for a change in the effective exchange rate on import volumes and export volumes. Taking into account the marginal behaviour of importers and exporters tends to limit the effect of a change in the effective exchange rate on the volumes of imports and exports when these have little market power. Simulations show that, in the euro zone, Spain would have the most to gain from a depreciation in the euro’s exchange rate against other currencies, but also from a policy of competitive disinflation (case where Spain’s export prices grow more slowly than the export prices of its euro zone rivals) (Table 1).

Table 1. Breakdown for the euro zone of a 10% depreciation of the nominal effective exchange rate

Long-term impact …				
… of a 10% depreciation of the euro against other currencies (in %)				
	DEU	FRA	ITA	ESP
Exports	1.3	1.1	1.1	1.7
Imports	-3.2	-2.1	-1.1	-2.3
Export prices	1.4	2.1	1.5	2.0
Import prices	4.3	2.9	2.0	2.9
… of a 10% rise in the prices of competitors in the euro zone (%)				
	DEU	FRA	ITA	ESP
Exports	1.6	1.6	2.1	2.8
Imports	-2.8	-3.3	-1.3	-4.0
Export prices	1.7	3.1	2.9	3.4
Import prices	3.4	4.3	2.3	4.7

Source : OFCE.

For the French economy, we also carried out a more detailed analysis using the OFCE's macroeconomic model *emod.fr*, with the goal of comparing our results with those obtained by the French DG Treasury with the *Mésange* model.

Our results show that a 10% depreciation of the euro against all currencies leads to a gain in price competitiveness for export to France vis-à-vis the rest of the world. The other euro zone countries experience the same gain in competitiveness across all export markets. In this case, the effect on activity would be +0.2% the first year, and +0.5% after three years. Excluding the effect due to the change in price competitiveness, the increased demand resulting from the pick-up in activity among our European partners would be broadly offset by lower demand addressed to France from the rest of the world. On the labour market, the depreciation would create 20,000 jobs in the first year, and 77,000 jobs after three years. The public deficit would improve by 0.3 GDP point in three years (Table 2).

Table 2. Impact on the French economy of a 10% depreciation in the exchange rate of the euro against all currencies

(% difference from level in reference scenario)	n	n+1	n+2	n+7
GDP	0.2	0.5	0.5	0.1
Total salaried employment (in 1000s)	20	53	77	43
Household consumption prices	0.9	1.4	1.8	3.6
Public financing capacity (in % of GDP)	0.0	0.2	0.3	0.2

Note: A depreciation of the euro would be favourable to short-term activity via an improvement in France's price-competitiveness vis-à-vis non euro zone countries. The positive effect of the euro's depreciation on the activity of our euro zone partners and the negative effect on our non euro zone partners is taken into account.
Source : emod.fr.

Finally, we simulated the effect of a 10% increase in the prices of our competitors in the euro zone on the whole of France's export markets. This 10% improvement in price competitiveness vis-à-vis the other euro zone countries would have a positive effect on activity via an increase in exports, investment and employment (Table 3). The impact on activity would be +0.4% in the first year and +0.9% after three years. It would be zero after 10 years. Nearly 130,000 jobs would be created in a period of 3 years and the government deficit would improve by 0.5 GDP point over this period.

Table 3. Impact on the French economy of a 10% improvement in France's price competitiveness relative to the euro zone countries

(% difference from level in reference scenario)	n	n+1	n+2	n+7
GDP	0.4	0.8	0.9	0.2
Total salaried employment (in 1000s)	33	90	129	82
Household consumption prices	1.0	1.7	2.3	5.2
Public financing capacity (in % of GDP)	0.0	0.3	0.5	0.5

Note: A 10% deterioration in France's price competitiveness relative to the rest of the world is understood to mean a 10% decline in the prices of all France's rivals on its export markets.
Source : emod.fr

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[1] See C. Blot and F. Labondance, "Why a negative interest rate?", *Blog de l'OFCE*, 23 June 2014.

[2] See the speech by Prime Minister F. Hollande on 5 February 2013 to the European Parliament.

[3] Economic and Social Report of France's 2014 draft budget bill.

[4] See the speech by M. Draghi "Unemployment in the euro area", Jackson Hole, 22 August 2014.

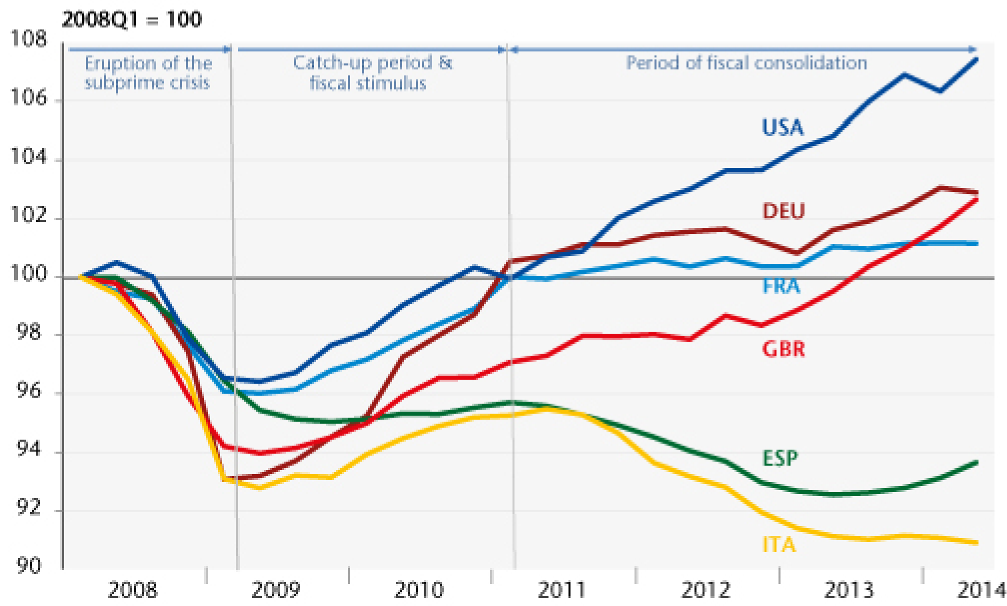
France: duty-free growth

By Bruno Ducoudré , Éric Heyer, Hervé Péléraux, Mathieu Plane

This post summarizes the 2014-2015 outlook for the French economy

In early 2011, France was one of the few developed countries to have regained its pre-crisis level of GDP. Economic growth exceeded 2%, even reaching 3% yoy in the first quarter of 2011. Since then the situation has changed: the recovery was interrupted, and while the economy is experiencing positive growth, the rate is close to zero (Figure 1). Four types of shock explain why the post-recession recovery in 2011 died out. Growth was already being battered by austerity and by deteriorating credit conditions, and was then also hit by fluctuations in oil prices and by the impact of price competitiveness in 2012 as a result first of wage deflation in France's competitors and then in 2013 of the rise of the euro (Table 1).

Figure 1. Comparative development of GDP in France and in its main partners



Sources: National accounts.

In 2014, the improvement expected on the economic front did not occur: the stimulus due to the gradual easing of austerity is being offset by the powerful brake exerted by the significant appreciation of the euro that has taken place since mid-year as well as by the collapse in consumer investment in housing. As in the previous two years, growth is expected to come to 0.4%, which is not enough to reverse the rise in unemployment or to reduce the public deficit significantly. Worse, while the public deficit has been cut by over 3 GDP points since 2009, it is now expected to rise slightly once again, reaching 4.5% of GDP (Tables 1 and 2).

Table 1. The brakes on French growth (2013 – 2015)

In points of growth

	2013	2014	2015
GDP growth	0,4	0,4	1,1
Impact on GDP of			
... changes in oil prices	-0.1	0.0	0.0
Direct impact on the French economy	*-0.1*	*0.0*	*0.0*
Impact via addressed demand	*0.0*	*0.0*	*0.0*
... price competitiveness	-0.1	-0.4	0.2
Impact of change in euro exchange rate	*-0.1*	*-0.2*	*0.1*
Effect of Intra-euro zone competitiveness	*0.0*	*-0.2*	*0.1*
... credit conditions	-0.1	-0.2	-0,1
Direct impact on the French economy	*-0.1*	*-0.1*	*-0.1*
Impact via addressed demand	*0.0*	*-0.1*	*0.0*
... austerity measures	-1.5	-1.2	-1.0
Direct impact on the French economy	*-0.9*	*-0.8*	*-0.6*
Impact via addressed demand	*-0.6*	*-0.4*	*-0.4*
Achievement	-0.1	0.3	0.1
Cumulative effect of shocks	-1.9	-1.6	-0.8
Other factors (housing investment, underestimation of accounts, declining potential, etc.)	-0.1	-0.4	-0.5
Spontaneous growth rate (excluding shocks)	2.4	2.4	2.4

Sources: INSEE, quarterly accounts; OFCE emod.fr forecast 2014-2015, made in October 2014.

In 2015, growth will pick up some, to +1.1%, due to the weakening of the negative factors that have stifled it since 2010, in particular credit conditions and austerity. Furthermore, the effect of price competitiveness, a factor that has played a very negative role in 2014, will be reversed, due first to the depreciation of the euro, and second to the rising impact of the CICE tax credit, whose primary goal is to ensure lower export prices. But with GDP growth of 1.1% next year, the path towards expansion is still a long way from what can usually be seen during a post-crisis recovery (i.e. 2.4%). As the output gap is not closing, the anticipated growth cannot be deemed a recovery. Companies will benefit from this renewed pick-up to gradually restore their financial situation. This strategy is based primarily on increasing productivity, which will help to reduce surplus capacity and restore profit margins. The unemployment rate in metropolitan France will rise slightly to 9.9% in late 2015,

and to 10.3% for France as a whole. The counterpart to loosening the austerity reins is a public deficit that is higher than what was originally programmed. It is expected to be 4.3% of GDP in 2015, departing significantly from its path back towards 3%.

Table 2. Summary of forecast for 2014 and 2015

%, annual average

	2010	2011	2012	2013	2014*	2015*
GDP growth rate	2.0	2.1	0.4	0.4	0.4	1.1
Imports	8.5	6.5	-1.2	1.9	2.4	1.2
Household consumption	1.7	0.3	-0.5	0.3	0.2	1.3
Government consumption	1.2	1.0	1.7	2.0	1.8	1.1
Total investment	1.9	2.1	0.3	-0.8	-2.2	-1.6
Exports	8.6	7.1	1.2	2.4	2.5	2.6
Contribution to growth						
Domestic demand excl. inventory	1.8	1.0	0.3	0.4	0.0	0.6
Change in inventory	0.3	1.1	-0.6	-0.2	0.4	0.1
Trade balance	-0.1	0.0	0.7	0.1	0.0	0.4
Growth rate of euro zone GDP	1.9	1.6	-0.6	-0.4	0.9	1.4
Other indicators						
Inflation *(consumption deflator)*	1.2	1.8	1.4	0.6	0.6	0.7
Savings rate *(% of GDI)*	15.8	15.7	15.3	15.1	15.5	15.2
Unemployment rate	8.9	8.8	9.4	9.9	9.7	9.8
Public deficit *(GDP points)*	-6.8	-5.1	-4.9	-4.1	-4.5	-4.3
Public debt *(GDP points)*	81.5	85.0	89.2	92.2	95.4	97.4
GDP growth rate (year-on-year)	2.2	1.5	0.0	0.8	0.4	1.4

*OFCE e-mod.fr forecast for 2014 and 2015

Sources: INSEE, quarterly accounts; OFCE.

In order to meet its commitments on structural efforts and nominal deficits, the government could decide to vote to make an additional effort of 8 billion euros. This would correspond to a 1.2 point hike in the standard rate of VAT. If that happens, GDP would grow no more than 0.8% next year, and the deficit would be reduced by only 0.2 GDP point, compared to our baseline scenario (Table 3).

Table 3. Impact on the French economy of an 8 billion euro hike in VAT

In %, difference from central accounts

Impact on ...	2015
... GDP	-0.3
... General government financing capacity (% GDP)	0.2
... Market sector employment (%)	-0.1
... Unemployment rate (percentage points)	0.1

Source: OFCE emod.fr forecast 2014-2015, made in October 2014.

Austerity without end – or, how Italy found itself trapped by European rules

By Raul Sampognaro

If the budget submitted by France is out of step with the rules on fiscal governance in the euro area (see the recent posts on this subject by Henri Sterdyniak and Xavier Timbeau), Italy is also in the hot seat. The situations of France and Italy are, however, not directly comparable: the case of Italy could be far more restrictive than that of France, once again reflecting the perverse effects of Europe's new governance. While, unlike France, Italy is no longer subject to an Excessive Deficit Procedure (EDP), with its budget deficit at the 3% threshold since 2012, it is still covered by the Stability and Growth Pact's preventive arm and thus enhanced surveillance with respect to the debt criterion. The country's debt of 127% of GDP is well above the 60% level set by EU rules and, according to its medium-term budgetary objective (MTO), Italy must come close to balancing government spending.

While the French budget deficit for 2015 will be the highest in the entire euro area (excluding countries subject to a

programme [1]), since the latest announcements on October 28, Italy has a deficit of 2.6%, which should not trigger a new EDP. However, the Pact's preventive arm puts constraints on changes in the country's structural balance:

– (i) in the name of convergence towards its MTO, Italy must make a structural adjustment of 0.5 percentage point per year for 3 years (i.e. cut its structural deficit by 0.5 point per year),

– (ii) if the structural deficit defined in the MTO is not sufficient to reach a debt level of 60% within 20 years, the country must make an extra effort under the *debt criterion*. According to the latest forecast by the Commission, Italy must provide an average annual structural effort of 0.7 point in 2014 and 2015.

Yet the government is counting on a *deterioration* in the structural balance of 0.3 point in 2014, followed by an *improvement* of 0.4 point in 2015.

Thus, while according to the Commission the treaties require Italy to make a cumulative effort of 1.4 point in 2014 and 2015 (for its part the Italian Government considers that this effort should instead be 0.9 point), Italy is announcing an *improvement* in its structural balance of 0.1 point during the period, a difference of 1.3 points from that demanded by the Commission. From this perspective, Italy is further from European requirements than France, and will have to justify its lack of a structural adjustment. In addition, Italy is not expected to reach its MTO in 2015, even though at the end of the European Semester in July 2014 the Council had recommended it stick to the 2015 target.

Italy is the first country to be constrained by the *debt criterion* and is serving as a laboratory for the application of the rules by showing some of their adverse effects. Indeed, the adjustment required under the *debt criterion* is changing

in line with several parameters, some of which were not really anticipated by the legislator. For example, the amount of the adjustment depends on a forecast of the ratio of nominal debt / nominal GDP at the end of the transition phase. However, the fall in prices currently underway in Italy is lowering the nominal GDP forecast for the next three years, without any change in fiscal policy. Thus, the debt criterion is tightening mechanically without any government action, endlessly increasing the need for structural adjustment as the new adjustments induce more deflation. In addition, the procedures used to find deviations from the debt criterion are slower because the controls are carried out essentially *ex post*, based on the accumulated deviations observed over two years. However, the magnitude of the deviation announced by the Italian government could spark procedures based on *ex ante* control. Recall, however, that unlike France, Italy is not currently in a procedure. This would have to be opened before any sanctions could be envisaged against Italy. This preliminary and necessary step gives the Italian government time to take suitable measures or to justify its deviation from the MTO.

Furthermore, the EDP’s preventive arm provides more opportunities for deviation than the corrective arm. In addition to the clause on exceptional economic circumstances, Italy can argue major structural reforms that will improve the future sustainability of the debt. This argument, which is also raised by the French government, is not set out in the EDP text (the Commission could accept some flexibility). Here, however, the Renzi government is drawing on its reputation as more of a reformer than the French government.

Both governments have requested the application of the exceptional economic circumstances clause in order to break their commitments. The Commission could be more sensitive to the Italian request because its economic situation has deteriorated: Italy has seen 3 years of falling GDP, which is

continuing in the first half of 2014. The country’s GDP is 9 points below its pre-crisis peak, while in France it is one point higher. The latest survey indicators, for example on industrial production, do not augur well for recovery in the short term. Finally, Italy is suffering deflation.

In summary, while the Italian gap seems larger than that of France, it could benefit from greater indulgence. The procedures applied to each country differ and give Italy more time before any sanctions can be applied. The country’s willingness to reform could win it higher marks than France from the Commission. Finally, the most important point in the discussion is that Italy’s economic situation is much more serious, with an uninterrupted recession since the summer of 2011 and with prices falling.

But in both cases the reinforced pact, whether it is corrective or preventive, implies endless structural adjustment. Italy demonstrates that getting out of the excessive deficit procedure will demand continuing efforts to meet the debt criterion. If France leaves the EDP in 2017, its debt will be, according to government forecasts, around 100% of GDP. It must then continue with adjustments of more than 0.5%. Confirmation of deflation will make the Pact’s rules even more recessive and absurd. Ultimately, the fiscal pact meant to preserve the euro by chasing free-riders or stowaways could lead to blowing it apart through an endless recession.

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[1] Greece, Ireland and Portugal have received European aid and thus have been subject to joint monitoring by the ECB, the IMF and the European Union. Ireland and Portugal are now out of their bailout programme.