Britain's referendum of 23 June 2016: The leap into the unknown

By Catherine Mathieu

On 23 June 2016, the British people decided (by 52% to 48%) to leave the European Union. After having long criticized the functioning of the EU and the constraints that it placed on the United Kingdom, on 19 February 2016 David Cameron obtained an agreement intended to allow the UK to remain in the EU – but it was not enough to convince the voters. In an OFCE Policy Brief (No. 1 of 13 July), we analyze how the British people's concerns went beyond economic issues and that what counted was their desire to maintain (or regain) their political sovereignty.

The departure from the EU is, in the words of David Cameron, "a leap into the unknown", and all that is possible now is to develop scenarios based on hypotheses about the outcome of the negotiations to be undertaken with the EU: from a rosy scenario in which both sides want to maintain as much as possible of the existing relations, to a dark scenario where the EU wants to set an example and the UK becomes a tax and regulatory haven.

As of early July, the UK clearly had not yet decided to formally leave the EU (by triggering Article 50), and will probably not do so before September. The resignations of the Brexit camp's leaders and continuing changes in the political situation are leaving a fog over the establishment of negotiations: the pound has lost more than 10% against the euro and 12% against the dollar, and may not stabilize until the UK's situation is clarified. It seems that we are entering

into a grey scenario where the various shades are still unknown.

In the short term, depending on the hypotheses adopted, the impact of a Brexit could be slightly negative for the British economy, on the order of 0.2 point of GDP in 2016 according to the National Institute of Economic and Social Research (NIESR), but this could reach several percentage points of GDP after two years depending on the scenario, with the UK Treasury entertaining the gloomiest prospects (-3.6% to -6%).

In the long term, again depending on the hypotheses adopted, the economic impact of the UK's exit would be decidedly negative, especially according to the British Treasury, but the assumptions of a sharp decline in British trade are undoubtedly exaggerated.

Europe is dead – Long live Europe!

By Maxime Parodi and Xavier Timbeau

The British people's vote for Brexit merely reinforces the political logic that has become an imperative. On the one hand, people want to be consulted, while on the other, Europe is summoned to change. François Hollande believes that, "the vote of the United Kingdom is putting Europe to the test"; Alain Juppé holds that, "we must write a new page, a new chapter, in the history of Europe"; the leaders of France's National Front, but not they alone, are calling for a referendum on France's membership in the EU and in the euro. Throughout Europe, debate along these same lines is underway.

A few days ago, we wrote on the Terranova Foundation site: "The referendum on the UK's membership in the European Union will lead to a shock that is more political than economic. It will be difficult to contain demands for similar consultations. Meeting these demands by 'more Europe' will only heighten the distance between the peoples and European construction. To think that referendums could on the other hand legitimize the status quo would also be a mistake. We propose responding to the democratic need not by a 'all or nothing' approach but by a process of democratic ownership that helps to legitimize European integration and to imagine future possibilities."

This method of democratic ownership of Europe and the euro has to be taught. Referendums "for or against" won't cut it. The federal leap now acts as a foil for probably a large majority of Europeans. But a public domain does nevertheless exist in Europe. Articulating what today are the sites of democracy, the EU Member States, with the need, for some subjects, of a supranational legitimacy is the alternative to the invention of the European citizen. But it is the method that counts. And all the levers of participatory democracy, of broad national and transnational debates, including through citizen juries, must be mobilized to take stock of the current state of Europe and propose reforms that will render it more democratic. **This could lead to concrete advances such as a parliament of the euro zone or an extension of the European Parliament's powers.** It is also the way to reverse the trend towards the breakdown of Europe.

Brexit: What are the lessons for Europe?

By Catherine Mathieu and Henri Sterdyniak

The British vote to leave the European Union is aggravating the political crisis in Europe and in many European countries. Leaving the EU has become a possible alternative for the peoples of Europe, which may encourage parties advocating national sovereignty. The United Kingdom's departure automatically increases the weight of the Franco-German couple, which could destabilize Europe. If Scotland leaves the UK to join the EU, independence movements in other regions (Catalonia, Corsica, etc.) could seek a similar outcome. But the fragility of Europe also stems from the failure of the strategy of "fiscal discipline / structural reforms".

The departure of the United Kingdom, a fierce advocate of economic liberalism and opponent of any increase in the European budget and in the powers of Europe's institutions, as well as of a social Europe, could change the dynamics of the debate in Europe, but some East European countries, the Netherlands and Germany have always had the same position as the UK. The departure will not, by itself, cause a shift in European policy. On the other hand, the liberalization of services and the financial sector, which the UK has been pushing for, could be slowed. The British Commissioner, Jonathan Hill, head of financial services and capital markets, should be promptly replaced. This will raise the sensitive issue of British EU officials, who in any case can no longer occupy positions of responsibility.

This will also open up a period of economic and financial uncertainty. The reaction of the financial markets, which do not like uncertainty and are in any case volatile, should not be accorded an excessive importance. The pound sterling has of

course rapidly depreciated by 10% against the euro, but it was probably overvalued, as evidenced by the British current account deficit of around 6.5% of GDP in 2015.

According to Article 50 of the European Constitution, any country that decides to leave the EU should negotiate a withdrawal agreement, which sets the exit date[1]. Otherwise, after two years the country is automatically outside the Union. The negotiations will be delicate, and must of necessity deal with all the issues. During this period, the UK will remain in the EU. European countries will have to choose between two attitudes. An understanding attitude would be to sign a free trade agreement quickly, with the goal of maintaining trade and financial relations with the UK as a privileged partner of Europe. This would minimize the economic consequences of Brexit for both the EU and the UK. However, it seems difficult to see how the UK could simultaneously enjoy both complete freedom for its own economic organization and full access to Europe's markets. The UK should not enjoy more favourable conditions than those of the current members of the European Free Trade Association (EFTA – Norway, Iceland and Liechtenstein) and Switzerland; like them, it should undoubtedly integrate the single market legislation (in particular the free movement of persons) and contribute to the EU budget. The issue of standards, such as the European passport for financial institutions (this is now granted to the EFTA countries, but not to Switzerland), etc., would be posed very quickly. The UK may have to choose whether to comply with European standards on which it will not have a say or to be subject to regulatory barriers. The negotiations will of course be open-ended. The UK could argue for a Europe that is more open to countries outside the EU. But how much weight will it have once it's out?

A tough attitude intended to punish London so as to set an example and deter future candidates from leaving would instead require the UK to renegotiate all trade treaties from scratch

(i.e. from WTO rules) so as to encourage multinational companies to relocate their factories and headquarters to mainland Europe and close British banks' access to the European market in order to push them to repatriate euro zone banking and financial activity to Paris or Frankfurt. But it would be difficult for Europe, a supporter of the free movement of goods, services, people and business, to start erecting barriers against the UK. The euro zone has a current account surplus of 130 billion euros with the UK: does it want to call this into question? European companies that export to the UK would oppose this. Industrial cooperation agreements (Airbus, arms, energy, etc.) could only be challenged with difficulty. A priori it would seem unlikely that London would erect tariff barriers against European products, unless in retaliation. Conversely, London could play the card of setting up tax and regulatory havens, particularly in financial matters. It could not, however, avoid international constraints (agreements such as at COP21, on the fight against tax avoidance, on the international exchange of tax and banking information, etc.). The risk would be to start a costly game of mutual reprisals (one that it would be difficult for Europe, divided between countries with different interests, to lead).

Upon leaving the European Union, the United Kingdom, a net contributor to the EU, would a priori save about 9 billion euros per year, or 0.35% of its GDP. However, the EFTA countries and Switzerland contribute to the EU budget as part of the single market. Again, everything depends on the negotiations. It would seem that the savings for the UK will be only about 4.5 billion euros, which the other Member countries will have to make up (at a cost of around 0.5 billion euros for France).

Given the uncertainty of the negotiations (and of exchange rate trends), all assessments of Brexit's impact on other EU countries can only be very tentative. Moreover, this will

necessarily have only a second-order impact on the EU countries: if tariff or non-tariff barriers reduce French exports of cars to the UK and of British cars to France, French manufacturers can supply their national markets while facing less competition and can also turn to third countries. It is nevertheless useful to have an order of magnitude: in 2015, exports from France (from the EU) to the UK represented 1.45% of GDP (respectively 2.2%); exports from the UK to the EU represented 7.1% of British GDP. A priori, an equivalent impact on UK / EU trade will have 3.2 times less impact on the EU than on the UK.

According to the OECD[2], the fall in EU GDP will come to 0.8% by 2023 (against 2.5% for the UK), whereas remaining in the EU, participating in the deepening of the single market and signing free trade agreements with the rest of the world would lead to a rise in GDP for all EU countries. But how credible is this last assertion, given the euro zone's current poor performance and the cost for the economic and social cohesion of European countries of opening the borders? But if Europe is functioning poorly, then leaving should improve market prospects. The UK's foreign trade would suffer a contraction, which would hurt its long-term productivity, but despite its openness the British economy's productivity is already weak. The OECD does not raise the question of principle: should a country give up its political sovereignty to benefit from the potential positive effects of trade liberalization?

According to the Bertelsmann Foundation[3], the reduction in EU GDP (excluding the UK) in 2030 would range from 0.10% in the case of a soft exit (the UK having a status similar to that of Norway) to 0.36% in the worst case (the UK having to renegotiate all its trade treaties); France would be little affected (-0.06% to -0.27%), but Ireland, Belgium and Luxembourg more so. The study multiplied these figures by five to incorporate medium-term dynamics, with the reduction in foreign trade expected to have adverse effects on

productivity.

Euler-Hermes also reported very weak figures for the EU countries: a fall of 0.4% in GDP with a free trade agreement and of 0.6% without an agreement. The impact would be greater for the Netherlands, Ireland and Belgium.

Europe needs to rebound, with or without the United Kingdom…

Europe must learn the lessons from the British crisis, which follows on the debt crisis of the southern European countries, the Greek crisis, and austerity, as well as from the migrant crisis. It will not be easy. There is a need to rethink both the content of EU policies and their institutional framework. Is the EU up to the challenge?

The imbalances between EU Member countries grew from 1999 to 2007. Since 2010, the euro zone has not been able to develop a coordinated strategy enabling it to restore a satisfactory level of employment and reduce the imbalances between Member states. The economic performance of many euro zone countries has been poor, and downright catastrophic in southern Europe. The strategy implemented in the euro zone since 1999, and strengthened since 2010 – "fiscal discipline / structural reforms" – has hardly produced satisfactory results socially or economically. On the contrary, it gives people the feeling of being dispossessed of any democratic power. This is especially true for countries that benefited from assistance from the Troika (Greece, Portugal, Ireland) or the European Central Bank (Italy, Spain). The Juncker plan that was intended to boost investment in Europe marked a turning point in 2015, but it remains timid and poorly taken up: it was not accompanied by a review of macroeconomic and structural policy. There are important disagreements in Europe both between nations and between political and social forces. In the current situation, Europe needs a strong economic strategy, but it has not been possible to agree on one collectively in today's Europe.

There are two fundamental reasons for this morass. The first concerns all the developed countries. Globalization is creating a deeper and deeper divide between those who benefit from it and those who lose[4]. Inequalities in income and status are widening. Stable, well-paid jobs are disappearing. The working classes are the direct victims of competition from low-wage countries (Asian countries and former Soviet bloc countries). They are being asked to accept cuts in wages, social benefits, and employment rights. In this situation, the elite and the ruling classes can be open-spirited, globalist and pro-European, while the people are protectionist and nationalist. This same phenomenon underlies the rise of France's National Front, Germany's AFD, UKIP, and in the US the Republican Donald Trump.

Europe is currently operated according to a liberal, technocratic federalism, which seeks to impose on people policies and reforms that they are refusing, sometimes for reasons that are legitimate, sometimes questionable, and sometimes contradictory. The fact is that Europe in its current state is undermining solidarity and national cohesion and preventing countries from choosing a specific strategy. The return to national sovereignty is a general temptation.

Furthermore, Europe is not a country. There are significant differences in interests, situations, institutions and ideologies between peoples, which render progress difficult. Because of the differences in national situations, many arrangements (the single monetary policy, the free movement of capital and people) pose problems. Rules that had no real economic foundation were introduced in the Stability Pact and the Budgetary Treaty: these did not come into question after the financial crisis. In many countries, the ruling classes, political leaders and senior civil servants have chosen to minimize these problems, so as not to upset European construction. Crucial issues concerning the harmonization of taxes, social welfare, wages and regulations have been

deliberately forgotten. How can convergence towards a social Europe and a fiscal Europe be achieved between countries whose peoples are attached to structurally different systems? Given the difficulties of monetary Europe, who would wish for a budgetary Europe, which would take Europe further from democracy?

In the UK-EU Agreement of 19 February, the UK has recalled the principles of subsidiarity. It is understandable that countries concerned about national sovereignty are annoyed (if not more) by the EU's relentless intrusions into areas that fall under national jurisdiction, where European intervention does not bring added value. It is also understandable that these countries refuse to constantly justify their economic policies and their economic, social or legal rules to Brussels when these have no impact on the other Member states. The UK noted that the issues of justice, security and individual liberties are still subject to national competence. Europe needs to take this feeling of exasperation into account. After the British departure, it needs to decide between two strategies: to strengthen Europe at the risk of further fuelling people's sense of being powerless, or to scale down the ambition of European construction.

The departure of the United Kingdom, the de facto distancing of some Central European countries (Poland, Hungary) and the reticence of Denmark and Sweden could lead to an explicit switch to a two-tiered EU. Many national or European intellectuals and politicians think that this crisis could provide just such an opportunity. Europe would be explicitly divided into three groupings. The first would bring together the countries of the euro zone, which would all agree to new transfers of sovereignty and to build a stronger budgetary, fiscal, social and political union. A second grouping would bring together the European countries that do not wish to participate in such a union. The last grouping would include countries linked to Europe through a free trade agreement

(currently Norway, Iceland, Liechtenstein and Switzerland, and later the UK and other countries).

Such a project would, however, pose many problems. Europe's institutions would have to be split between euro zone institutions operating on a federal basis (which need to be made more democratic) and EU institutions continuing to operate in the Union manner of the Member states. Many countries currently outside the euro zone are opposed to this kind of change, which they feel would marginalize them as "second-class" members. The functioning of Europe would become even more complicated if there were both a European Parliament and a euro zone Parliament, euro zone commissioners, euro zone and EU financial transfers, and so on. This is already the case for instance with the European Banking Agency and the European Central Bank. Many questions would have to be decided two or three times (once in the euro zone, again at the EU level, and again for the free trade area).

Depending on the issue, the Member country could choose its grouping, and things would quickly head towards an à la carte union. This is hardly compatible with the democratization of Europe, as soon there would be a Parliament for every question.

The members of the third grouping would then be in an even more difficult situation, with the obligation to comply with regulations over which they had no power. Should our partner countries be placed in the dilemma of either accepting heavy losses of sovereignty (in political and social matters) or being denied the benefits of free trade?

There is clearly no agreement between the peoples of Europe, even within the euro zone, on moving towards a federal Europe, with all the convergences that this would imply. In the recent period, the five Council Presidents and the Commission proposed new steps towards European federalism: creating a European Budget Committee, establishing independent

Competitiveness Councils, conditioning the granting of Structural Funds on respect for budgetary discipline and the implementation of structural reforms, establishing a European Treasury and a euro zone minister of finance, moving towards a financial union, and partially unifying the unemployment insurance systems. These developments would reinforce the technocratic bodies to the detriment of democratically elected governments. It would be unpleasant if these were implemented, as is already partially the case, without the people being consulted.

Furthermore, no one knows how to proceed with convergence on tax and social matters. Upwards or downwards? Some proposals call for a political union in which decisions are taken democratically by a euro zone government and parliament. But can anyone imagine a federal authority, even a democratic one, that is able to take into account national specificities in a Europe composed of heterogeneous countries? What about decisions concerning the French pension system taken by a European Parliament? Or a finance minister for the zone imposing spending cuts on Member countries (as the Troika did in Greece)? Or automatic standards on public deficits? In our opinion, given the current disparity in Europe, economic policies must be coordinated between countries, not decided by a central authority.

Europe needs to reflect on its future. Using the current crisis to move forward towards an “ever closer union” without more thought would be dangerous. Europe must live with a contradiction: the national sovereignties that peoples are attached to have to be respected as much as possible, while Europe must implement a strong and consistent macroeconomic and social strategy. Europe has no meaning in itself, but only in so far as it implements the project of defending a specific model of society, developing it to integrate the ecological transition, eradicating mass unemployment, and solving the imbalances within Europe in a concerted and united manner. But

there is no agreement within Europe on the strategy needed to achieve these goals. Europe, which has been unable to generally lead the Member countries out of recession or to implement a coherent strategy to deal with globalization, has become unpopular. Only after a successful change of policies will it regain the support of the peoples and be able to make institutional progress.

[1] See in particular the report of the French Senate by Albéric de Montgolfier*: Les conséquences économiques et budgétaires d'une éventuelle sortie du Royaume-Uni de l'Union Européenne [The economic and budgetary consequences of a future withdrawal of the United Kingdom from the European Union],* June 2016.

[2] OECD, 2016, *The Economic Consequences of Brexit: A Taxing Decision*, April. Note that to treat leaving the euro as a tax increase does not make economic sense and represents a communication that is unworthy of the OECD.

[3] *Brexit – potential economic consequences if the UK exits the EU*, Policy Brief, 2015/05.

[4] See, for example, Joseph E. Stiglitz, 2014, "Le prix de l'inégalité", *Les Liens qui libèrent*, Paris.

The effects of the oil counter-shock: The best is

yet to come!

By Eric Heyer and Paul Hubert

After falling sharply over the past two years, oil prices have been rising once again since the start of the year. While a barrel came in at around 110 dollars in early 2014 and 31 dollars in early 2016, it is now close to 50 dollars.

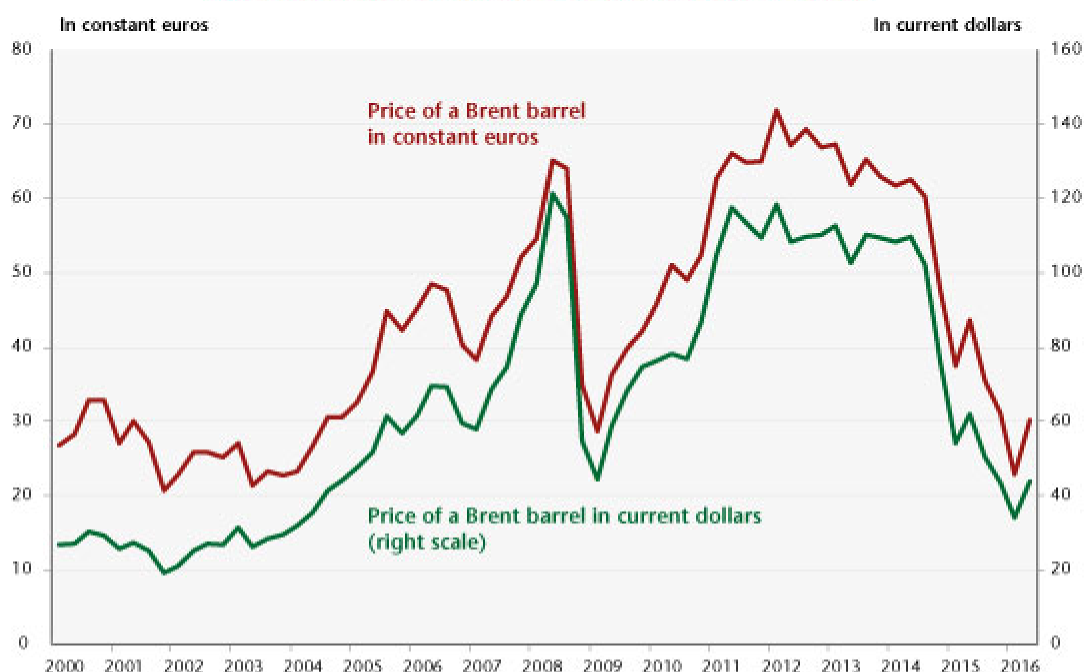
Will this rise in oil prices put a question mark over the gradual recovery that seems to have begun in France in 2016?

In a recent study, we attempted to answer three questions about the impact of oil prices on French growth: will a change in oil prices have an immediate effect, or is there a time lag between the change and the impact on GDP? Are the effects of rises and falls in oil prices asymmetrical? And do these effects depend on the business cycle? The main results of our study can be summarized as follows:

1. There is a time lag in the impact of oil price variations on French GDP. Over the period 1985-2015 the lag was on average about 4 quarters;

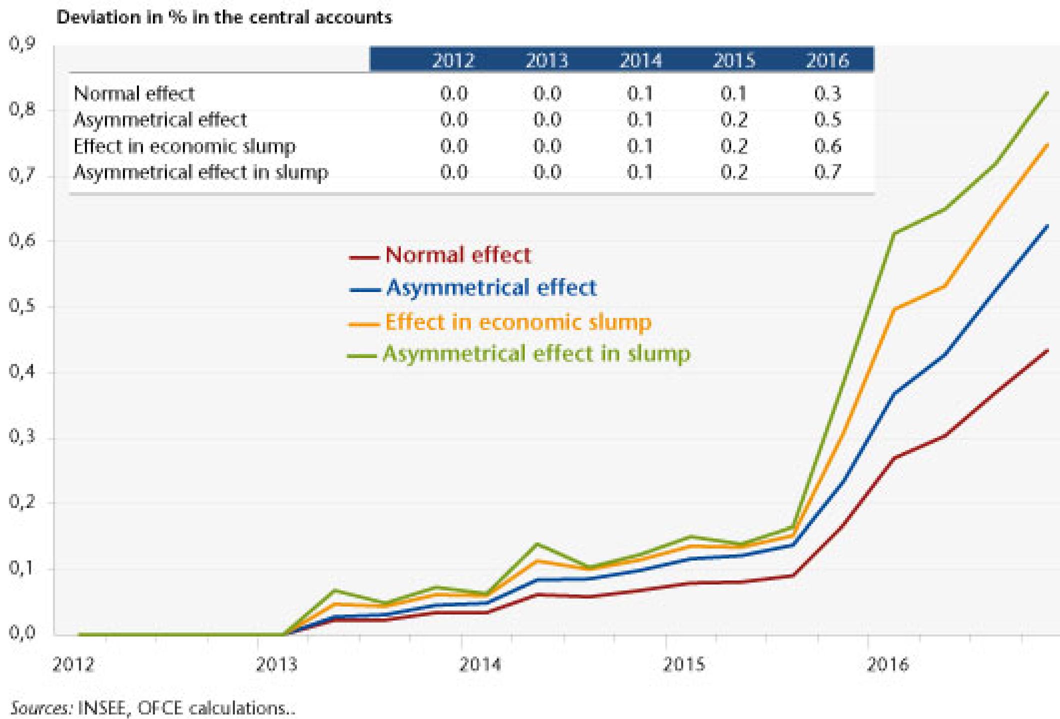
1. The impact, whether downward or upward, is significant only for variations in oil prices greater than 1 standard deviation;
2. The asymmetric effect is extremely small: the elasticity of growth to oil prices is the same whether the price rises or falls. Only the speed at which the impact is transmitted differs (3 quarters in the case of a rise, but 4 in the case of a fall);
3. Finally, the impact of oil price changes on economic activity depends on the phase in the business cycle: the elasticity does not differ significantly from zero in situations of a “crisis” or a “boom”. However, the elasticity is much greater in absolute terms when the economy is growing slowly (an economic slump).

Let us now apply these results to the situation since 2012. Between the first quarter of 2012 and first quarter of 2016, the price of a barrel of Brent crude plummeted from 118 dollars to 34 dollars, a fall of 84 dollars in four years. If we factor in the euro/dollar exchange rate and changes in consumer prices in France, the fall amounts to a 49 euro reduction over the period (Figure 1).



We evaluated the impact of a decline like this on France's quarterly GDP, taking into account the above-mentioned time lag, asymmetry and phase of the business cycle.

Factoring all this in indicates that the oil counter shock ultimately did not show up much in 2015. As illustrated in Figure 2, the impact should make itself felt from the first quarter of 2016, regardless of the hypotheses adopted. The positive effect of the oil counter-shock is yet to come!



	2012	2013	2014	2015	2016
Normal effect	0.0	0.0	0.1	0.1	0.3
Asymmetrical effect	0.0	0.0	0.1	0.2	0.5
Effect in economic slump	0.0	0.0	0.1	0.2	0.6
Asymmetrical effect in slump	0.0	0.0	0.1	0.2	0.7

What Donald Trump’s economic programme reveals

By Xavier Ragot

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

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

The success of Donald Trump, who circumvented the Republican

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

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

On this last point, I personally think that defaulting on public debt is a bad idea. This amounts to an uncontrolled tax, without assumption of responsibility, and it can also add to banking instability. Much better would be to impose a tax

after a democratic debate. Furthermore, to ease the public debt burden, it is always possible to lower real interest rates on the public debt for a number of years using an accommodative monetary policy, without financial repression (see the article by Blanchard, Dell'Ariccia and Mauro).

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

It is obviously difficult to answer these questions. However, it could be argued that Kocherlakota's own work did not make

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

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

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

Is the decline of industry due to the growth of services?

By Sarah Guillou

On Friday, April 8 2016, the Observatoire Français des Conjonctures Economiques (OFCE) began a series of quarterly seminars on the analysis of France's productive network. The purpose is to bring together researchers and discussion of the situation, the diversity and the heterogeneity of the companies making up France's production system. This discussion is now being fed by the increasing use of business data. We hope in this way to enrich the analysis of the strong and weak points in the country's production fabric, with a view to guiding the development of public policies aimed at strengthening it.[1]

The first seminar took up the role of services in deindustrialization as measured by the decline of industrial employment as a share of total employment. Since 2000, the manufacturing industry in France has lost more than a quarter of its work force, i.e. more than 900,000 jobs. A recent note by the INSEE (Insee Première, No 1592) points out that manufacturing's weight in the economy has been halved from 1970 to today. Even though deindustrialization has aroused greater attention in France than elsewhere, probably because of the country's interventionist tradition and the challenges facing its labour market, it is taking place in all the developed economies. This raises questions about underlying

structural trends common to all these countries.

However, the decline in industrial employment is being accompanied by net job creation in services. It also appears that the growth of services is being driven in part by changes in industrial production methods. Products are incorporating an increasingly large component of services, and companies are expanding their portfolio of service products. The fragmentation of production processes – fuelled by the opportunities provided by globalization – is isolating low value-added manufacturing units from high value-added services units.

These changes in production methods need to be analysed to understand the extent of this phenomenon. It seems that the changes occurring within industry are just as much factors driving the decline of industry as the rise of services in employment. In other words, there is a question of how much deindustrialization finds a mirror image in the growth of services, or even its explanation.

Three contributions helped to provide some answers to the following questions: which manufacturers are producing services and with what impact on their performance? What is the role of services in the development of global value chains? Are flows of international services replacing flows of goods? Three main lessons emerge.

1 – "Servitization" and the decline in manufacturing jobs are clearly correlated

Manufactured products are incorporating an increasingly significant amount of services. This can be seen both by the growing share of companies that produce services (Crozet and Millet, 2015) and export them (Castor *et al.*, 2016) and by the rising content of services in exports (Miroudot, 2016)[2].

The growth in companies' value-added "services" may well push all their jobs into the service sector, including what are

strictly speaking manufacturing jobs, if the added value of the services becomes dominant. Today an average of 40% of manufacturing employment corresponds to service activities. Furthermore, the fragmentation of production processes is intensifying, as is the distribution around the world of outsourced activities based on the comparative advantages of different locations. If the company maintains an anchor in the home country, it usually keeps only the higher value-added jobs there, in line with the cost of the related work and qualifications, meaning jobs often characterized as services.

Note that these changes in production methods clearly reflect a decrease in manufacturing functions in a product's added value, which translates into a decline of manufacturing in the sources of the wealth of nations. But it is important not to underestimate the impact of the fragmentation of production units. Thus, jobs in services, formerly attributed to manufacturing, are being reclassified as service jobs even though the underlying production task has not changed, and this is happening regardless of outsourcing abroad.

However, this reclassification is all the more likely as "servitization" accelerates and becomes a must for companies to remain competitive.

2 – The servitization of manufacturing is a competitive factor

Servitization, which is associated with qualitative improvements in products and more generally the creation of value in manufacturing, is a factor in competitiveness.

As is shown by Crozet and Millet (2015), the production of services by manufacturing enterprises is a factor that enhances their performance. There are actually many French manufacturing companies that produce services, with 70% producing these for third parties (2007 data). The decision to produce services represents an important turning point, and clearly boosts performance. The authors' estimates thus show

that taking this decision raises profitability, employment, total sales and sales of goods. Even though there are sectoral variations, the impact on performance is positive, whatever the industrial sector in question.

At the aggregate level, the share of imported services in the export of goods is also growing. In France's exports, the share of services ranges from 30% to 50%, depending on the sector. The fragmentation of production processes is leading to outsourcing certain service functions and to the provision of imported services. This dynamic goes hand in hand with the integration of economies in international trade, with the benefit of globalization opportunities and ultimately with the competitiveness of economies (see De Backer and Miroudot, 2013).

3 – The direct and indirect export of services will continue to make a positive contribution to the trade balance

The developments described above directly affect the trade in services. It is indeed increasingly services that are the subject of trade in intermediate products, with the latter being estimated at nearly 80% of world trade. Digitalization, along with differentiation through services, is leading to the fragmentation of production with the inclusion of more and more services.

Trade in services in France has not experienced a decline since the crisis of 2007. Even though the trade balance in services has shrunk slightly since 2012, it has remained positive since the start of the 21st century, and the export of services has been rising faster than for goods. As the world's third largest exporter of services – especially because of tourism – France will see service exports increase as a share of its trade balance. Admittedly, for the moment, the volume of exported services has not offset the negative balance for goods, but the development of intra-firm trade in services and of intermediary services will eventually reverse

their respective shares.

Trade in services is even more concentrated than trade in goods. It is mainly carried out by French or foreign multinational corporations, which account for more than 90% of this trade. While just over half of trade takes place with the European Union (EU), this component is running a deficit, while non-EU trade is running a surplus. It is interesting to note that the balance is positive for companies that are part of a French group, but negative for companies belonging to a foreign group (Castor *et al*., 2016).

In conclusion

It seems that the dichotomy between industry and services is becoming increasingly inappropriate to describe the dynamics of employment and the productive specialization of economies. An approach in terms of productive functions that breaks down the job properly based on whether it involves manufacturing activities strictly speaking or other activities, such as transportation and logistics, administrative support or R&D services, would allow a better understanding of a country's skills and comparative advantages.

More generally, the growth of services and their increasing role in production and exports is giving them an increasingly central role in economic growth. Getting better statistics on the production and export of services and improving the methods of assessing productivity in services are prerequisites for a better understanding of the role of services in growth and of the levers to be activated to achieve this.

[1] A scientific committee responsible for the organization of the OFCE seminar on the Analysis of the Production System is composed of V. Aussilloux (France Stratégie), C. Cahn (Banque de France), V. Charlet (La Fabrique de l'Industrie), M. Crozet

(Univ. Paris I, CEPII), S. Guillou (OFCE), E. Kremp (INSEE), F. Magnien (DGE), F. Mayneris (Univ. Louvain), L. Nesta (OFCE), X. Ragot (OFCE), R. Sampognaro (OFCE), and V. Touzé (OFCE).

[2] Miroudot, S. (forthcoming), "Global Value Chains and Trade in Value-Added: An Initial Assessment of the Impact on Jobs and Productivity", *OECD Trade Policy Papers*, no. 190, OECD Publishing.

Small recovery after a big crisis

By the Analysis and Forecasting Department

This text summarizes the 2016-2017 outlook for the global economy and the euro zone. Click here to consult the complete version [in French].

Global growth is once again passing through a zone of turbulence. While growth will take place, it is nevertheless being revised downwards for 2016 and 2017 to 2.9% and 3.1%, respectively. The slowdown is first of all hitting the emerging countries, with the decline in Chinese growth continuing and even worsening (6.1% anticipated for 2017, down from 7.6% on average in 2012-2014). The slowdown in Chinese demand is hitting world trade and fuelling lower oil prices, which in turn is exacerbating the difficulties facing oil and commodity producers. Finally, the prospect for the normalization of US monetary policy is resulting in a reflux of capital. The dollar is appreciating even as the currencies

of the emerging countries of Asia and Latin America are depreciating. While the industrialized countries are also suffering from the Chinese slowdown through the demand channel, growth is resilient there thanks to falling oil prices. The support provided by monetary policy is being cut back in the US, but is strengthening in the euro zone, keeping the euro at a low level. Countries are no longer systematically adopting austerity policies. In these conditions, growth will slow in the US, from 2.4% in 2015 to 1.9% in 2016 and then 1.6% in 2017. The recovery will pick up pace slightly in the euro zone, driven mainly by the dynamism of Germany and Spain and the improved outlook in France and Italy. For the euro zone as a whole, growth should come to 1.8% in 2016 and 1.7% in 2017. This will push down the unemployment rate, although by year-end 2017 it will still be 2 points above its pre-crisis level (9.3%, against 7.3% at year-end 2007).

While the United States seems to have avoided the risk of deflation, the euro zone is still under threat. Inflation is close to zero, and the very low level of expectations for long-term inflation reflects the ECB’s difficulty in regaining control of inflation. Persistent unemployment indicates some continuing shortcomings in managing demand in the euro zone, which has in fact been based entirely on monetary policy. While the ECB’s actions are a necessary condition for accelerating growth, they are not sufficient, and must be supplemented by more active fiscal policy.

At the level of the euro zone as a whole, overall fiscal policy is neutral (expansionary in Germany and Italy in 2016 but restrictive in France and even more so in Greece), whereas it needs to be more expansionary in order to bring unemployment down more rapidly and help to avert deflationary risks. Furthermore, the continuing moderate growth is leading to the accumulation of current account surpluses in the euro zone (3.2% in 2015). While imbalances within the euro zone

have been corrected to some extent, this mainly took place through adjustments by countries in deficit prior to the crisis. Consequently, the surplus in the euro zone's current account will eventually pose risks to the level of the euro, which could appreciate once the monetary stimulus ends, thereby slowing growth.

Table. Outlook for world growth

Annual growth rate (%)

	Weight in the total(1)	GDP in volume		
		2015	2016	2017
DEU	3,7	1,4	1,9	1,6
FRA	2,6	1,2	1,6	1,6
ITA	2,3	0,6	1,2	1,0
ESP	1,6	3,2	3,3	2,4
EUZ	13,4	1,5	1,8	1,7
GBR	2,4	2,3	2,1	1,7
NPM(2)	2,4	3,8	3,1	3,2
UE 28	18,6	1,9	2,0	1,8
USA	17,2	2,4	1,9	1,7
JPN	4,8	0,5	0,7	0,4
Developed countries	44,5	1,9	1,7	1,6
RUS	3,6	-3,7	-1,0	1,0
CHN	14,9	6,9	6,3	6,1
Other Asian countries	16,6	5,2	5,2	5,4
Latin America	8,8	-0,4	-0,9	1,5
World	100	2,9	2,9	3,1

(1) Weight according to GDP and PPP estimated by the IMF for 2008.
(2) Poland, Hungary, Czech Republic, Romania, Bulgaria and Croatia.
Sources: IMF, OECD, national sources, OFCE calculations and forecast, April 2016.

Unemployment: beyond the (good) figures from France’s job centre

Analysis and Forecasting Department (France team)

The 60,000 person decline in March for the number of people registered in Category A at France’s Pôle emploi job centre is exceptional. One has to go back to September 2000 to find a fall of this magnitude. There is some natural volatility in the monthly statistics for job seekers, but the fact remains that the trajectory has changed noticeably. In the last year, the number registered in Category A at the job centre rose by 17,000. A year earlier, from March 2014 to March 2015, the increase was 164,000. Better yet, over the last six months the number registered fell by 19,000.

Nevertheless, the number of Category A job seekers is a relatively poor reflection of the multiple dynamics at work in the labour market. If, in addition to job seekers registered in Category A, we add those working reduced hours (categories B and C), the March upturn remains visible, but smaller. The number registered in categories A-B-C falls slightly in March (8700 people) but also over 3 months (down 23,900).

Once again, however, beyond the good results in March, given the continuing deterioration of the labour market and the emergence of more precarious situations with regard to employment over the last eight years, there will be no lasting improvement in households’ job situation until these “good figures” have accumulated over a medium-term horizon.

More relevant statistical sources …

These monthly figures provide only a partial representation of unemployment. They omit in particular people seeking

employment who are not registered at the job agency. As for those registered in Category A, people are also counted who are not performing a real job search because they are close to retirement (see The elimination of the job search exemption: When governments voluntarily increase the jobless count! – *in French*). In addition, the figures released by the job centre can be distorted by changes in administrative practices and by occasional technical problems that affect the management of the job centre's files.

The quarterly figures provided by the INSEE are a more reliable source for the analysis of unemployment. According to the employment survey, a person is considered "unemployed within the meaning of the International Labour Office (ILO)" if he or she meets the following three conditions:

- being unemployed, that is to say, not having worked at least one hour during the reference week of the survey;
- being available to take a job within 15 days;
- having actively sought work in the month preceding the survey or having found a job that begins within three months.

Based on these criteria, the unemployment rate in metropolitan France in the fourth quarter of 2015 stood at 10% of the active population (+871,000 people since Q4 2007).

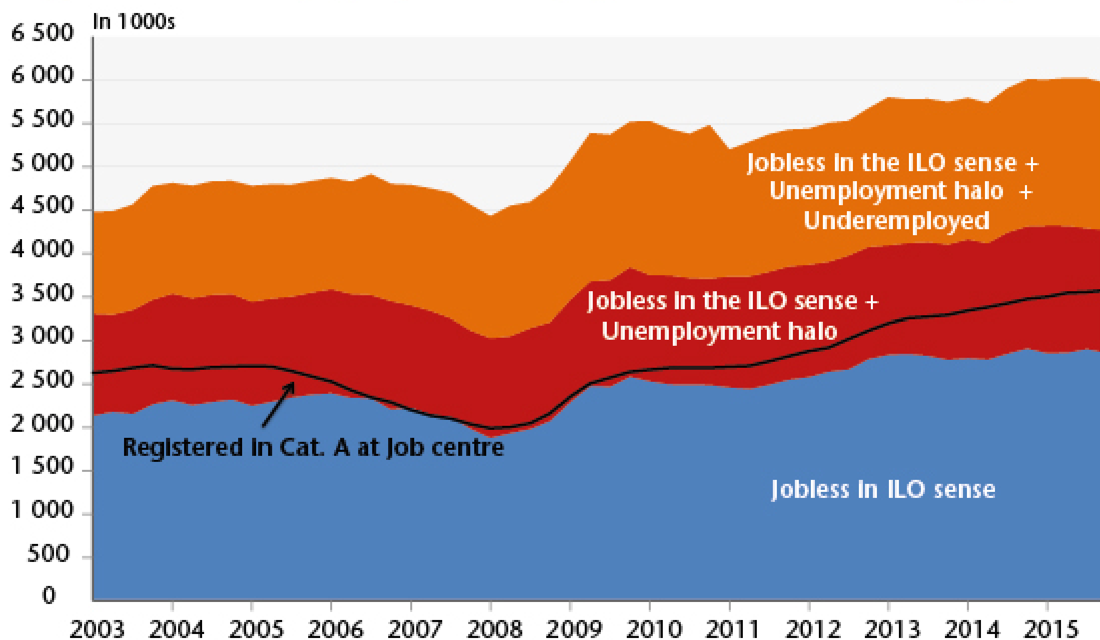
…that help to better measure the precarity of the labour market

But this definition is still restrictive. It still fails to take into account situations at the margins of unemployment. Thus people who want to work but are considered inactive in the ILO sense, either because they are not readily available for work (within two weeks) or because they are not actively seeking a job, form what is called the unemployment "halo". In the fourth quarter, this halo included 1.41 million people (+25% over the fourth quarter of 2007, i.e. an additional

279,000 people).

Similarly, the strict ILO definition does not include people who are working part-time but want to work more, or people who are in a situation of partial unemployment. In the fourth quarter of 2015, these situations of “underemployment” involved 1.7 million people (up 18% compared to the fourth quarter of 2007, i.e. by 254,000).

In total, by incorporating underemployment and the “halo” into the strict definition of ILO-measured unemployment, 5.9 million people are in a weakened position with regard to employment, 31% more than eight years ago, i.e. 18.8% of the workforce broadly speaking (Figure 1) [1].



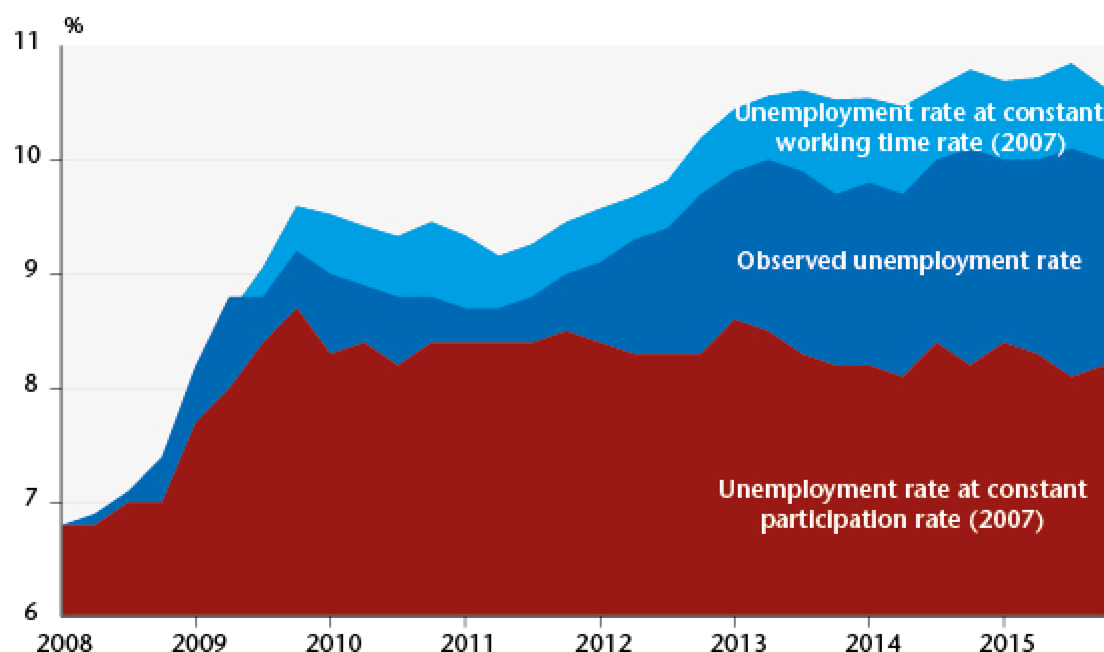
Multiform unemployment, with a transforming labour market

The analysis of the unemployment rate does not therefore include all the dynamics at play in the labour market. The increase in the number of people experiencing underemployment is partly explained by adjustments in the effective working time, via the policy on partial unemployment, the reduction of overtime and the use of working-time accounts, but also

through the expansion of part-time work, including on an involuntary basis. While these adjustments increased underemployment, they also helped slow the rise in unemployment (in the strict sense) that started in mid-2008. Without these adjustments, in other words, if the hours worked had remained stable between 2007 and 2015, the ILO-based unemployment rate in France would have been 0.6 points higher in the fourth quarter of 2015 (Figure 2).

Along with these adjustments in working time, since the beginning of the crisis France has also experienced greater growth in the labour force (employed + unemployed) than in its overall population. This is attributable partly to the implementation of pension reforms that delay seniors' exit from the workforce. Mechanically, without the creation of new jobs, this growth in the labour force has had the effect of pushing up the unemployment rate. In the case of France, the impact has been massive. Indeed, if the participation rate had remained at its 2007 level, the unemployment rate in France would be, all else being equal, 8.2%, i.e. 1.6 points lower than the unemployment rate observed in the fourth quarter of 2015.

Figure 2. Observed and "theoretical" unemployment rate



Source : INSEE.

It must nevertheless be noted that while these adjustments are important, the developments on which they are based are not fully due to the crisis. Indeed, there has been a tendency for working time to decrease since 1990. Between 1990 and 2002, the effective working time decreased on average by 0.9% per year. While this decline has certainly been less rapid since 2003, it is continuing (-0.2% per year). At the same time, the participation rate has been rising continuously, due to the combined effects of the increase in women's participation in the labour market and the successive reforms of the pension system. The participation rate in France, which stood at 67.1% in 1990, reached 69.7% in 2007, and in the fourth quarter of 2015 had risen to 71.5%.

The national living wage: a new means to boost low wages in the United Kingdom

By Catherine Mathieu

On 1 April 2016, a national living wage (NLW) took effect in the United Kingdom. This may come as a surprise to France, where the UK labour market is considered the epitome of a deregulated market. This new minimum wage, the NLW, adds 50 pence to the existing minimum hourly wage (the National Minimum Wage, NMW) for those over age 25, meaning a rise from £6.70 to £7.20, or 7.5%. This follows a 3.1% increase in the minimum wage in October 2015 for those over age 25 (from £6.50 to £6.70), for a total increase in one year of 10.8%. This sharp increase in the minimum wage does not represent a sudden

change of course by the government. The Conservative election platform for the 2015 parliamentary elections already promised a raise in the minimum wage and pointed towards the introduction of a living wage. The announcement that the NLW would be established was made in July 2015, during the presentation of the budget by George Osborne, Chancellor of the Exchequer, following the Conservatives' election victory. This is simply the first step in an effort to raise low wages, as the government has a target of increasing the NLW to 60% of the median wage by April 2020 (up from 55% at present), to about 9 pounds.[1]

This boost for low wages is part of a broader strategy of the British government: first, the government says it wants to "reward work"; not only has the minimum wage been increased, but eventually employees at the minimum wage level will no longer pay income tax (this was one of the Tories' campaign promises in 2015). Furthermore, the government is taking measures to reduce taxes on business, including a symbolic cut in the corporation tax rate, which will be only 17% in 2020 (instead of only 20% currently), which will offset the increase in wages, at least for some companies (those that are most profitable). Finally, the government has set an ambitious target for reducing the public deficit, i.e. from 5% of GDP in 2015 to a balanced budget in 2020, in part by lowering public spending, particularly on social welfare. Raising the minimum wage would thus seem to be intended to offset, at least partially, a future reduction in benefits.

The UK's process for setting the minimum wage is well codified. Every year the government revises the minimum wage on October 1st, based on the recommendations of the Low Pay Commission (LPC), an independent body composed of academics and representatives of employee trade unions and employers. The UK has had a minimum wage only since 1999. It was implemented according to the recommendations of the Low Pay Commission at levels that matched the low wages of that time,

after broad consultation with the business sectors concerned. The implementation of the minimum wage failed to spark waves of protests from employers, nor did it have a significant impact on employment, according to various assessments by the LPC over the years. The minimum wage level was initially low, and included separate rates for adults and young people. The LPC is mandated to produce an annual report on low wages and to make recommendations to the government on adjusting the minimum wage so as to ensure that low wages do not have significant adverse impacts on the employment of the employees concerned. The government has now also charged the LPC with monitoring the implementation of the NLW and proposing future adjustments, which will take place every year in April.

The NLW applies only to those over age 25. The minimum wages of young people remain at the level set last October. There are currently five minimum wages: for apprentices (£3.30 per hour); for age 16-17 (£3.87 per hour); age 18-20 (£5.30); age 21-25 (£6.70); and over 25 (£7.20). These differences are substantial; the analyses by the LPC since 1998 have argued for lower wage rates for young people, so as to prevent them from being squeezed out of the labour market because of high salaries. This gap has won acceptance, unlike the situation in France, on the grounds that it promotes the growth of "odd jobs" for young people. The employment rate of British young people (15-24 years old) is very high (51.4% at end 2015, against 27% in France and 31% in the euro zone), and it is up significantly (it was 46.8% at end 2010).

In its March 2016 report, [2] the LPC drew some initial conclusions on the possible impacts of the NLW. In April 2016, about 1.8 million employees (out of 29 million salaried jobs) benefited from the NLW, while in 2015 one million adults over age 25 earned the minimum wage. The NLW represents an increase in the annual salary of 680 pounds (for the average working hours of the persons concerned, 1360 hours per year, 26h15 per week). The impacts will vary greatly depending on the sector.

It is in the service sectors that low wages are most common (40% of jobs are paid the minimum wage in cleaning companies, 30% in the hotel-café-restaurant sector, and 34% in hairdressing). According to the LPC, this year the implementation of the NLW will impact payroll by around 0.7 billion pounds over the full year, i.e. 0.1% [3]; raising the NLW to 60% of the median wage will cost another 2.4 billion pounds, which by April 2020 will represent 0.4% of the total annual payroll. These figures include a diffusion effect on the first 25 percentiles of wage-earners. The impact of introducing the NLW on wages paid will be close to 4% in the cleaning sector and 3% in the hotel-café-restaurant and hairdressing sectors. Assuming a similar diffusion effect, the Bank of England [4] also estimated that the NLW would lead to a gradual increase in payroll of less than 0.5% in five years. About 3 million people would receive the NLW in 2020.

In July 2015, the Office for Budget Responsibility estimated that by 2020, the introduction of the NMW could result in the loss of 60,000 jobs, according to average assumptions of the elasticity of employment to its cost of – 0.4 [5], while also forecasting that over that same period the UK economy would create 1.1 million jobs. The national living wage is coming into force after several years of growth and job creation that has reduced the unemployment rate (by the ILO definition) to its pre-crisis level (5.2%), meaning that any job losses in certain sectors should be very manageable.

Criticism of the NLW is currently coming from two camps: first, the trade unions are accusing the measure of further widening the gap between the wages of young people and adults; and second, employers, particularly in low-wage sectors, are warning of the risk of expanding the informal economy if the NMW is effectively increased to 9 pounds per hour by 2020, although the current level of the NLW is generally considered acceptable.

These adjustments in the British minimum wage have led the UK

to join the ranks of the OECD countries with the highest minimum wage levels, although it remains behind France, for example (Figure 1). The new national living wage still leaves the British minimum wage lower than the French minimum wage (the SMIC, which represents 60% of the median wage). At £7.20, or 9 euros, the hourly rate of the British national living wage is currently almost 7% lower than the level of France's SMIC. After taking into account employer social contributions, the hourly cost of the NLW is also below the SMIC, because, even though France has enacted important exemptions from employer social contributions (Fillon exemption, Responsibility Pact, CICE credit, prime zero charge) on low wages, social contributions are also very low in the UK. Take the case of an adult over age 25, unmarried and childless, who works 35 hours per week (Table). The hourly cost to the employer is 9.48 euros in the UK against 10.43 euros in France; the hourly cost to the employer falls to 9.21 euros in the UK if the employee works 26h15 per week, which represents the average working time of employees on the minimum wage in the UK. If we now consider the salary received by the employee, net of employee social contributions and income tax, the NLW is higher than France's SMIC, especially if the employee works more than 30 hours per week, which makes them eligible for the Working tax credit, which is more generous than France's *prime d'activité* credit. On the other hand, French employees are entitled to a much more generous public system of pension and unemployment benefits.

The establishment of the national living wage in the UK thus represents an effort to catch wages up in sectors where low wages and part-time and precarious work are most common. This increase, in its current form, will have only a marginal macroeconomic impact on the British economy.

Table. Minimum hourly wage in the United Kingdom and in France, April 2016 (case of an adult over age 25, single and childless)

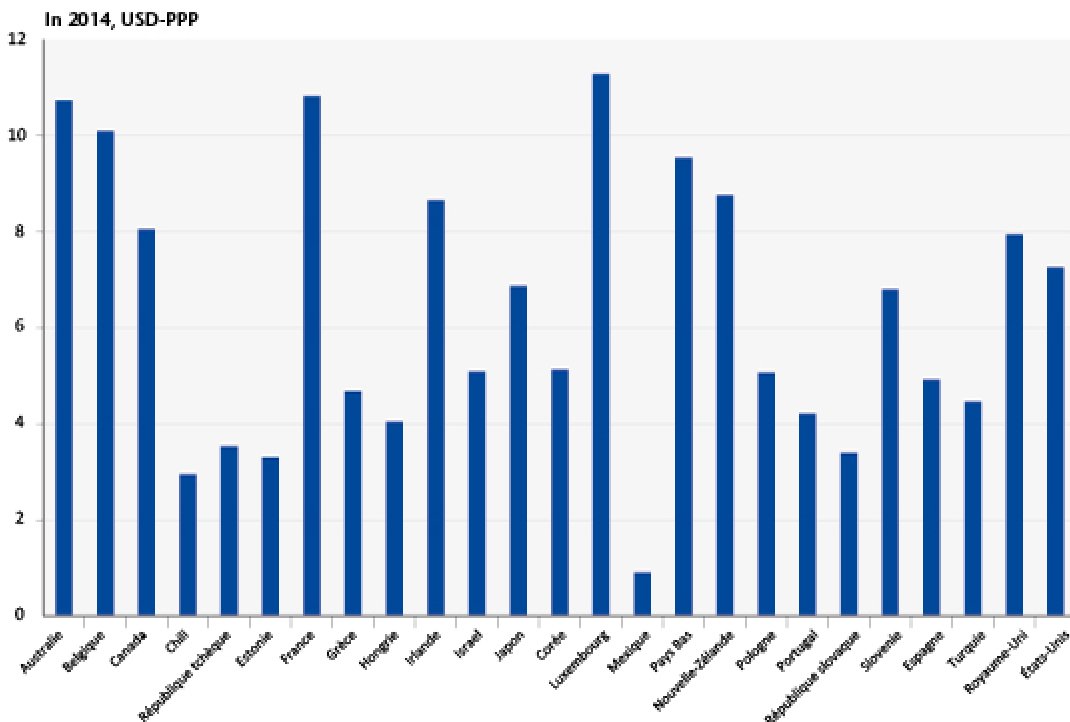
In euros*

	United Kingdom NLW, 26h**	United Kingdom NLW, 35h***	France 35h****	Difference UK-Fr 35h
Gross hourly wage, euros	9,0	9,0	9,67	-6,9 %
Rate of employer social charges	2,4 %	5,3 %	8,6 %	
Rate of employee social charges/CSG	2,1 %	4,6 %	22,9 %	
(Income tax) - (Working tax credit or French PA credit*****	0 %	3,2 % – 11,7%	-7 %	
Hourly cost (employer)	9,21	9,48	10,43	-9,6%
Hourly gain (employee)	8,80	9,35	8,13	15 %

Note: * Based on an exchange rate for the pound sterling at start April 2016 of 1.25 euros. If the average exchange rate for 2015 is used, which is similar to the average exchange rate since 1999, the gross British wage would currently be 2% higher than the French rate.
** Average working time of an employee on the minimum wage, which does not give a right to the Working tax credit for an unmarried person over age 25 without a child.
*** Based on an average working time of 35 hours per week.
**** I would like to thank Henri Sterdnyiak, who provided me the apparent contribution rates for France. The employer contribution rate takes into account the Fillon exemption, the Responsibility Pact, the CICE credit and the "prime zero" charge.
***** *Income tax - Working tax credit / Income tax - PA credit.*

Source : Author's calculations.

Figure. Hourly minimum wage rates in the OECD countries



Source : OECD.

[1] As the aim is to reach 60% of the median wage, this figure of £9 is simply indicative, based on the projections of wage increases performed in March by the Office for Budget Responsibility (OBR). The OBR is an independent body that has been responsible since 2010 for performing the medium-term macroeconomic forecasts used for drawing up the UK budget and

for analysing the UK public finances.

[2] See National minimum wage, *Low Pay Commission Report Spring 2016*, March 2016.

[3] Given the low levels of working hours and hourly wages, workers on the minimum wage earned only a quarter of the average salary at end 2015. The minimum hourly wage represented only 42.8% of the average hourly wage (£6.70 against £15.70).

[4] See Inflation report, Bank of England, August 2015.

[5] This elasticity corresponds to the median of the empirical estimates made using British data. Job losses rise to 110,000 if we use the hypothesis of an elasticity of -0.75 but are only 20,000 for an elasticity of -0.15.

Can steel revive Europe's industrial policy?

By Sarah Guillou

The situation of the European steel industry was on the agenda of the European Council's Competitiveness session held on Monday, 29 February 2016. One of the Council's conclusions was to issue a demand to speed up the anti-dumping investigations by two months. This demand follows a letter sent on 5 February to the European Commission by ministers from seven European countries, including France, Germany, Italy and the United Kingdom, urging it to take measures to protect the steel sector vis-à-vis what was deemed unfair competition from China

and Russia.

The steel industry, which successively pushed forward Europe’s industrial development and then European cohesion through the European Coal and Steel Community (ECSC), subsequently became a theatre for the violent winds of globalization and a symbol of Europe’s industrial decline – will it now be the sector that leads a revival of Europe’s industrial policy?

In retrospect, a question arises as to whether the difficulties facing the European steel industry, which is subject both to the fussy oversight of the European Competition Commission and to low-cost Chinese imports, are partly a symptom of failings in Europe’s industrial policy, which is wedged between a very active competition policy and a timid trade policy?

The history of Europe’s steel industry does in fact fall closely in line with the history of Europe’s industrial policy: from a central and highly sectoral industry at the time of the ECSC, with a great deal of state aid going to the sector under various exemptions, it then became primarily horizontal and subject to competition policy. The sector only found its way by means of trade policy in response to increased competition from emerging countries. No steps have been taken in the steel industry towards European alliances or regroupings since the 1980s, and there have been no Europe-wide plans to rationalize production capacity so as to hold down the decline in jobs in the industry. This decline went hand in glove with the development of the continent’s specialization in high-tech steel products. But today even those jobs are under threat. Could a different industrial policy save them?

The state of the industry in Europe

Steel now accounts for 360,000 jobs in the European Union. The European sector has lost nearly a quarter of its workforce

since 2009, with job losses accelerating: 3,000 jobs lost in the last 6 months.

In terms of production, the steel industry generates a turnover of 180 billion euros, with an output of 170 million tons from 500 production sites in 23 Member States. If countries are ranked individually in terms of international steel producers, Germany comes in 7th place, Italy 11th and France 15th. The sector is dependent on the import of iron ore, alumina and coal. Fortunately, the decline in steel prices has gone hand in hand with lower prices for these commodities. The industry is highly capital-intensive, requiring major investments. At the same time, the transport of steel coils and flat products is inexpensive, making it easier to import them.

The 2008 economic crisis cascaded through the sector, as steel products constitute intermediate consumption for many other industrial sectors as well as for construction. Steelmakers in Europe also face stricter environmental constraints than elsewhere. The steel industry is a major source of CO2 emissions, and is very sensitive to carbon prices and to regulatory changes. It is also a key player in the EU's emissions trading system (ETS) for greenhouse gas quotas, and while the crisis has enabled the industry to make profits from the sale of surplus emissions rights, steelmakers who are currently experiencing problems vis-à-vis their non-European competitors will be very sensitive to the forthcoming reform of the system for the 2020-2030 period.

Some companies are now in real trouble, such as Arcelor Mittal, which announced a record loss for 2015 (nearly 8 billion euros), partly due to the need to depreciate its mines and steel stocks. The company, which is heavily in debt because of its many acquisitions in Europe, plans to close some plants. Tata Steel, for its part, has closed sites in Britain. In Japan, Nippon Steel, which just acquired an interest in the capital of the French firm Vallourec and is

preparing to buy the Japanese Nisshin Steel, is doing better.

The difficulties facing a sector that built up excess capacity during the crisis have been aggravated by the economic downturn in China. Thus, 2015 was the first year to experience a decline (-3%) in global production (1,622 million tons), after 5 years of growth. Global production did not adjust immediately to falling demand, with prices initially acting as the adjustment variable. The decline in production was the signal for the closures of steel factories and mining operations. This has marked the end of a cycle of rising Chinese production that strongly destabilized the market.

The Chinese tornado

Chinese production doubled in volume between 2000 and 2014, and on its own now accounts for more than twice the combined output of the next four major producing countries, Japan, India, Russia and the United States. This performance is the result of several factors: massive government support; dynamic growth in construction, in infrastructure investment, and in the Chinese market's production of cars and machinery; and favourable access to iron ore. China produces nearly 50% of the world's steel, i.e. approximately 800 million tons of steel. The second-largest producer is Japan, with 100 million tons. India and the United States are contending for third place, at around 5% of global production. If we count the Europe-28 as a single entity, then it would take second place with 10% (Source: World Steel Association). But the slowdown in the Chinese economy and the strong inertia characterizing production capacity in the steel industry have created substantial excess capacity, which the authorities are now trying to reduce. Domestically, China needs only about half of its output, so it exports the other half.

The 400 million tons China exports represent twice Europe's output. The price of the Chinese offer is therefore likely to greatly upset the balances in other countries. Any excess

capacity is directed onto foreign markets to be gotten rid of at low prices, as Chinese exporters are not going to fail to sell off their steel products. Hence China’s exports to Europe rose from 45 million tons in 2014 to 97 million tons in 2015, which exceeds the 43 million tons produced by Germany.

China is also likely to experience a significant decline in its workforce, and some production sites, drowning in massive debt, have already closed. Chinese steelmakers are losing money, and small units are going bankrupt. Large units, however, are often state property, and are weathering the storm (at the cost of heavy indebtedness) and becoming aggressive predators, in terms not only of price but also of acquisition capabilities. The weak position of Europe’s firms is also leaving them vulnerable to foreign takeovers. China Hebei Iron and Steel Group is, for instance, about to acquire a Serbian steelmaker, which would be yet another means of entering Europe.

The policy response

The public authorities have long been heavily involved in the steel sector. It was a strategic sector for post-war economic development, and was the source of European economic construction at a time when the “small steps” policy of Robert Schuman led to putting the coal and steel production of France and Germany under a common authority, later joined by other countries. For a long time the sector then benefited from various public aid measures and subsidies that kept up excess capacity relative to demand, now estimated at 10-15% of output. The sector then was gradually freed from public tutelage, and in the mid-1990s was excluded from the list of sectors in difficulty that were eligible for aid for restructurings and bailouts. Nevertheless, state support never disappeared completely, but today, the European Commission, through the Competition Commission, is relatively strict about applying the market investor principle to assess the legality of public support.

While tracking distortions in competition on the market, the European Commission recently opened an investigation into Italy's support for the steelmaker Ilva (2 billion euros), and demanded that Belgium repay 211 million euros of aid paid to the steelmaker Duferco. In 2013, the Commission opened an investigation into aid awarded by "Belgian Foreign Strategic Investments Holding" (FSIH), a body created in 2003 by the Walloon management and investment company Sogepa to invest in the steel industry. This aid, paid between 2006 and 2011 by the Walloon government [a Belgian regional government], was considered to constitute unfair competition on the European market. Indeed, for the Commission, private investors would not have voluntarily made such investments.

These subsidies by the Walloon government therefore constituted aid that put competitors at a disadvantage. The Commission recognized that there is very strong foreign competition, but it considered that the best way to cope with this is to have strong, independent European players. It noted that despite the government aid, the Duferco group wound down all its activities in Belgium, meaning that the aid merely postponed the departure of a company that was not viable. The Commission is currently supporting the retraining of workers in the Walloon region through the European Globalisation Adjustment Fund. The point is to combat the recourse to public funding in Europe, which would ultimately be detrimental to the sector.

At the same time, so-called "anti-dumping" trade retaliation measures were implemented by the European Commission. In May 2014, following a complaint from Eurofer (the European steel association), the Commission imposed temporary anti-dumping duties of up to 25.2% on imports of certain steel products from the People's Republic of China and duties of up to 12% on imports from Taiwan. The EC investigation ultimately concluded that China and Taiwan were selling at dumping prices. More recently, Cecilia Malmström, the head of trade policy at the

European Commission, wrote to her Chinese counterparts warning them that she was launching three anti-dumping investigations against Chinese exporters (February 2015) in the field of seamless pipes, heavy plates and hot-rolled steels. Provisional anti-dumping duties (of between 13% and 26%) were also set on 12 February 2016 (complaints in 2015) with respect to China and Russia.

Some thirty anti-dumping measures protect the European steel industry, but the Member States where steel has been hit particularly hard by Chinese competition are calling for stronger measures. Politicians are railing against China's loss-making exports and demanding that Europe take steps. They envy the US, which has acted more quickly and not skimped on the level of the duties it's enacted, i.e. up to 236%. But the nature of these measures depends on the economic status accorded to China. Anti-dumping measures are not defined in the same way. As long as China is not a market economy, it is assumed that it provides strong support for its economic sectors, and that its prices are thus not market prices. Italy is struggling in Europe to prevent China from being granted this status, while the United Kingdom is supporting China at the WTO (even though the industry is also in trouble in Britain). The Commission has postponed its decision until summer.

What policy for tomorrow?

Should we allow the production of steel to disappear in Europe? It still represents more than 300,000 jobs there, though this is of course out of more than 35 million jobs in manufacturing in 2014. The sector is symbolic of heavy industry, and a supplier of the transportation and defence industries as well as construction – its disappearance would definitively turn a new page in European industry.

Do we need to recognize that, according to the theory of comparative advantage, it is better to buy cheaper Chinese

steel and use the revenue freed up for other, more profitable uses? For example, shouldn’t it be used to upskill employees? In theory yes, but the revenue freed up goes to the purchasers of steel, so it is they who should supply the European conversion fund. What about taxing the consumption of the now cheaper steel? The flaw in the reasoning shows up when you realize that what is true with respect to macroeconomic balances is difficult to reconcile with microeconomic imbalances: those who are losing their jobs today are not the consumers who are benefitting. Ultimately, the microeconomic articulations can unsettle the macroeconomic balances.

The loss of know-how is indeed the main challenge, as it is here that resources are really wasted. In so far as skills are a competitive factor, difficulties related to a lack of demand should be considered transitional problems that need to be managed as well as possible. Neither contributions of foreign capital nor government support should be excluded. What justifies these investments are the returns expected from the use of human capital. To deal with these challenges, alliances on market segments that are not in trouble might be possible, even if they confer excessive market power, so long as they allow margins that make it possible to maintain the business during cyclical difficulties.

This is why competition policy has to be opened up to considerations of industrial policy (which is concerned about expertise) and trade policy (which appreciates the cyclical and / or unfair character of competition).

European actors need to be brought around a table – they are already grouped in Eurofer – and together with the European Commission develop a European plan for managing excess capacity and forging alliances. The Competition Directorate of the European Commission needs to relax its intellectual rigidity and adapt its reading of competition to the nature of contemporary globalization. Although it is based on an indisputable logic in the name of the single market, the

approach of the Competition Directorate is sometimes no longer suited to the way that competition is unfolding on the global value chain today, which has no precedent on the 20th century European market. Who would believe that the market power resulting from a European merger would not be challenged very quickly by foreign forces if the new enterprise began to take advantage of its market power? The limits on market power are much stronger in the 21st century, with low inflation and depressed commodity prices an illustration of this. The risk that multinationals might abuse their power is posed less in terms of excessive prices than excesses in the capture of customers and in tax avoidance. This last point seems to have been understood clearly by the European Commission. In addition to this, there is the added competition from new applications driven by the digital industry, which manufacturers cannot escape. In other words, competition is no longer what it used to be: companies' excessive power is no longer expressed much in prices or restrictions on quantities.

Competition policy, industrial policy and trade policy need to be developed in coordination, with a strengthened Competition Directorate that includes an element of industrial policy and trade policy. While strict controls on competition were a clear priority during the period of forging the single market when competition was essentially focused between the developed countries, today it is urgent to review the linkages between these three policy fields in order to consolidate the future of industry in Europe.