

The spirit of the letter of the law ... to avoid a “Graccident”

Raul Sampognaro and [Xavier Timbeau](#)

The noose, in the words of Alexis Tsipras, is getting tighter and tighter around the Greek government. The last tranche of the aid program (7.2 billion euros) has still not been released as the Brussels Group (the ex-Troika) has not accepted the conditions on the aid plan. The Greek state is therefore on the brink of default. It might be thought that this is simply one more episode in the drama that Greece has been acting out with its creditors and that, once again, at the last moment the money needed will be found. But if Greece has managed to meet its deadlines up to now, it has been at the price of expedients that it is not at all certain can be used again.

While tax revenues since the start of the year have been almost one billion euros behind the anticipated targets, the expenses for wages and pensions still have to be paid each month. This time the wall is getting closer, and an agreement is needed if the game is to continue. In June, Greece must pay 1.6 billion euros to the IMF in four tranches (5, 12, 16 and 19 June). On 28 May an IMF spokesperson confirmed the existence of a rule that would make it possible to group these payments on the last day of the month (a rule last used by Zambia in the 1980s). Since it would then take six weeks for the IMF to consider Greece in default, the country could still gain a few days after 30 June before the deadline with the ECB (with 2 tranches for a total 3.5 billion euros by 20 July 2015).

Historically very few countries have failed to honour their

payments to the IMF (currently only Somalia, Sudan and Zimbabwe are in arrears to the IMF, for a few hundred million dollars). As the IMF is the last resort in case of a crisis in liquidity or the balance of payments, it has, as such, the status of preferred creditor, so defaulting on its debt may trigger cross defaults on other securities, in particular, in the Greek case, those held by the [European Financial Stability Facility](#) (EFSF). This could make them due immediately. A Greek default with the IMF could well jeopardize Greece's entire public debt and force the ECB to reject Greek bonds as collateral in the Emergency Liquidity Assistance (ELA) operations, the only firewall remaining against the collapse of the Greek banking system.

The legal consequences of such a default are difficult to grasp (which says a lot about the modern financial system). [An article published by the Bank for International Settlements, dated July 2013](#), whose author, Antonio Sainz de Vicuña, was then Director General of ECB Legal Services, is very informative about this issue in the context of the Monetary Union.

In presenting the legal framework, Sainz de Vicuña focuses on Article 123 of the [Treaty on the Functioning of the European Union \(TFEU\)](#), a pillar of the Monetary Union, which prohibits the ECB or the national central banks from financing government^[1]. In a footnote, the author concedes that there are two exceptions to this rule:

– “Credit institutions controlled by the public sector, which may obtain central bank liquidity on terms identical to private credit institutions.” This exception appears explicitly in paragraph 2 of Article 123 of the TFEU^[2].

– “The financing of state obligations vis-à-vis the IMF.”

This second aspect has attracted our attention because it is little known to the general public, it does not appear explicitly in the Treaty and it could be a solution, at least in the short term, to avoid Greece being put in default by the IMF .

In searching the corpus of European law, this exception is defined more precisely in [Council Regulation no. 3603/93](#), which clarifies the terms of Article 123 of the TFEU, which it is authorized to do under paragraph 2 of Article 125 of the TFEU[3]. More specifically, in Article 7:

The financing by the European Central Bank or the national central banks of obligations falling upon the public sector vis-à-vis the International Monetary Fund or resulting from the implementation of the medium-term financial assistance facility set up by Regulation (EEC) No 1969/88 (4) shall not be regarded as a credit facility within the meaning of Article 104 of the Treaty[4].

The justification for this article is that: during quota increases in the IMF, the financing by the central bank was accepted because it had as a counterpart an asset comparable to international reserves. In the spirit of the law, financing Greek borrowing from the IMF by a credit from the central bank (the ECB or the Bank of Greece) should not be permitted. The obligations falling upon the Greek state probably only concern, according to the spirit of the text, the contribution to the IMF quotas. Nevertheless, the spirit of the law is not the law, and the proper interpretation of the phrase “obligations falling upon the public sector vis-à-vis the International Monetary Fund” could open another door for Greece. Given the consequences of a default with the IMF – in particular the continuity of the ELA – invoking this could be justified as preserving the functioning of the Greek payment system, a role falling within the mission of the ECB.

Beyond the legal possibility of a central bank financing

Greece's debt to the IMF, which would certainly be challenged by some governments, this action would open up a political conflict. A MemberState could be accused of violating (the spirit of) the Treaties, even though that is not a reason to exclude it ([according to the ECB's Legal Services](#)). But is this really an obstacle in view of the importance a default on Greece's debt would have for the sustainability of the single currency?

Greece's cash flow problems are not new. Since January, the government has been financing its expenditure through [accounting transactions that allowed it to offset tax losses](#). In particular, on 12 May, the Greek government was able to repay an IMF loan tranche by drawing on an emergency fund that was essentially international reserves. The Eurosystem was able to use this exception to give Greece extra time in order to continue the negotiations and avoid the accident.

[\[1\]](#) Paragraph 1 of the article stipulates that, "Overdraft facilities or any other type of credit facility with the European Central Bank or with the central banks of the Member States (hereinafter referred to as "national central banks") in favour of Union institutions, bodies, offices or agencies, central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of Member States shall be prohibited, as shall the purchase directly from them by the European Central Bank or national central banks of debt instruments."

[\[2\]](#) Which stipulates that, "Paragraph 1 shall not apply to publicly owned credit institutions which, in the context of the supply of reserves by central banks, shall be given the same treatment by national central banks and the European Central Bank as private credit institutions."

[\[3\]](#) Which stipulates that, "The Council, on a proposal from

the Commission and after consulting the European Parliament, may, as required, specify definitions for the application of the prohibitions referred to in Articles 123 and 124 and in this Article.”

[4] Article 104 became Article 123 in the TFEU.

On the search to “recapture the industrial spirit of capitalism”: From patient shareholders to shared governance

By [Jean-Luc Gaffard](#) and Maurizio Iacopetta

The government, buoyed by the law to recapture the real economy, [the Florange act](#), which establishes the possibility of double voting for patient shareholders (who have held their shares at least two years), has just taken two significant decisions by temporarily increasing its holdings in the capital of Renault and Air France in order to ensure that in a general shareholders meeting the double voting option is not rejected by the qualified majority authorized under the law. The objective spelled out by France’s Minister of the Economy in [Le Monde](#) is to help “recapture the industrial spirit of capitalism” by favouring long-term commitments in order to promote investment that will foster solid growth.

Under the impulse of the Florange law, that has recently introduced the institute of the double voting for 'patient' shareholders (shareholders who have held their company's shares for at least two years), the government has taken the important decision of increasing temporarily its equity shares into two major French companies: Renault and Air France.

The increased government's stake into the two companies aims at preventing attempts of the shareholders general assembly to block the adoption of the double voting institute, which would require the approval of a qualified majority. The France's Minister of the Economy explained in [Le Monde](#) that the government's action is intended to help "revive the industrial spirit of capitalism" by favouring long-term commitments that promote investments and foster robust growth.

This initiative has led to renewed discussions about the governance of joint-stock companies and corporations (Pollin, 2004, 2006), to consider the problems that afflict them, possible remedies, and what one could expect from the government.

Because corporations have the ability to attract abundant savings and because of their power in choosing where to direct these savings, they are undeniably at the heart of the investment process. They can be governed in various ways, depending on the institutional contexts, which are related in turn to significant differences in productivity and growth (Bloom and Van Reenen, 2010 ; De Nicolo', Laeven and Ueda, 2008 ; La Porta, Lopez-de-Silanes, Shleifer and Vishny, 2000). So the question arises as to which governance model is best able to promote entrepreneurial activity and innovation, and thus ultimately to ensure growth ([OECD 2012](#)).

There is evidence that the big corporations do not suffer from a lack of long-term financing. The development of the stock and bond markets since the 1980s has allowed corporations to reduce their dependence on bank financing and its cyclical

character. Investment problems thus mainly reflect major breakdowns in the governance of companies, whether large, medium or small, as well as in the governance of financial institutions ([Giovannini et al., 2015](#)).

Traditionally, the focus has been on the ways controlling shareholders' choose managers, *i.e.* the conditions under which the capital owners get the yield on their investment that is justified by their special position as residual claimant (Shleifer and Vishny, 1997). But this ignores that other company stakeholders (creditors, employees, suppliers or even customers) also incur risk, and that the long-term performance of the company depends on the conditions in which the shareholders' engagement controls the commitment of the other stakeholders (Mayer, 2013). It is not certain, in this regard, that the distribution of voting rights between different classes of shareholders is decisive.

Control and engagement

The central issue is how capital owners affect management's decision-making. Thus, the goals and values of family businesses reflect the interests and inclinations of the family owners, which can become inconsistent with productive efficiency, especially with the rise of rentier capitalism, when it is no longer the founders who are at the head of the company but their heirs or, more surreptitiously, a self-perpetuating caste (Philippon, 2007). While there is a positive relationship between the wealth of self-made millionaires and GDP and growth, the relationship to GDP turns negative when this concerns the wealth of millionaire heirs (Morck, Stangeland, and Yeung 2000). Faced with this potential problem, the existence of dispersed ownership would seem to be beneficial in so far as it replaces special interests with what can be likened to a collective interest.

This vision of the corporation nevertheless faces an objection formulated by Berle and Means (1932), who view the separation

between ownership and control as a source of inefficiency. It creates problems of agency, meaning that the managers are likely to act in their own interests rather than in those of the shareholders, just like families or owning castes. Empirically, the Tobin's Q (the ratio of capital's market value to its replacement cost) increases, then decreases before increasing again as the power of the managers grows (Morck *et al.*, 1988). It is then possible that shareholders have less incentive to subscribe new shares or keep the ones they hold, resulting in lower share prices and less access by companies to external financing. The provisions that make it possible to protect large enterprises can have the effect of hindering the market entry of new businesses and introducing significant distortions into the investment decision-making of established firms (Iacopetta, Minetti and Peretto, 2015).

Solving these problems requires creating institutional arrangements to ensure that shareholders become active in corporate management.

These arrangements have involved improving the quality of audits, of risk management and of communications between the company and its shareholders. They have led to greater transparency in executive compensation policy and linking pay to performance. This process has spurred the development of "markets for corporate control" and for shareholder activism, and indeed of a particular class of shareholders consisting of investment funds, including pension funds, whose management methods (the delegation of investment decisions to fund managers) emphasizes the immediate performance of their portfolios.

In the light of the financial crisis, these arrangements seem questionable to say the least (Giovannini *et al.*, 2015). Financial institutions, although subject to the "best" governance rules ensuring genuine shareholder control, have been scenes of conflict between shareholders who have benefited from upside positive performance and creditors (and

taxpayers) who have had to bear any losses. What was true of the financial institutions also held true for manufacturing companies, which have been arenas of conflict between shareholders and the other stakeholders (creditors, employees, suppliers and customers).

The real problem is that the while arrangements that were designed to solve agency problems have strengthened the control exercised by shareholders over company management, they have also reduced the shareholders' level of engagement (Mayer, 2013).

Notwithstanding their particular interests, family owners can ensure a stability and long-term engagement vis-à-vis other stakeholders that is not guaranteed by dispersed shareholding. The same is true of managers with delegated authority who have acquired sufficient independence vis-à-vis the shareholders to be open not only to their own interests but also to the interests of the employees (and sub-contractors). After all, the constitution of industrial empires is far from a bad thing so long as they are economically viable and do not violate the rules of competition. But the advantages conferred on managers are being offset by the development of markets for corporate control and shareholder activism, which has led to judging managerial effectiveness on the grounds of current performance. There is indeed a trade-off between the requirements of control and engagement. The problem is perhaps not so much to align the interests of managers with those of shareholders as to make shareholders responsible for what happens in the long run to the companies in which they invest.

The measure of engagement

The degree of commitment of financiers, lenders and shareholders is critical since it determines that of the other stakeholders in the company. It is reflected in the attitude chosen in response to fluctuations in performance, and more specifically in the degree of tolerance of poor business

results. A low tolerance is a sign of a low degree of engagement, and usually a sign of hostile takeovers and pension fund activism.

It is also necessary to agree on the meaning of poor results. This could be the result of bad management, in which case investors' power to provide financing conditioned on management's ability to make the changes they require does not necessarily indicate a lesser degree of engagement. It may even prevent the financial crises that could result from serious agency problems – at least if consistent performance is the norm. But this is exactly not the case when the relevant industrial activities have a cyclical dimension. Companies can deal with this by offsetting the results of several activities against each other provided that their cycles are different. But the attitude of investment funds is to emphasize the diversification of their portfolio on the valuation of the diversification of their activities by the companies themselves, prompting the latter to refocus on what is sometimes described as their core business. A series of dismantling operations, in particular, in the cases of Alstom, Alcatel and Thomson, constituted one of the reasons for the deindustrialization seen in France (Beffa, 2012).

Nor does the consistency of performance prevail when companies choose to innovate by introducing new products or new production techniques and exploring new markets. Because firms incur the costs long before increased in revenue, these are irrevocable costs, that is to say, whose recovery is contingent on the success of the decision to innovate (“sunk costs”). Any form of governance that would have the effect of favouring immediate results and eliminating tolerance of a temporarily poor performance would then only hold back innovation by penalizing long-term investment. But this is exactly where the possibility of hostile takeovers and the activism of investment funds are leading.

The institutional prescriptions

The debate has thus been opened on the ins and outs of the conflict between different classes of shareholders established in relation to the volume of securities held and the length they are held (Samama and Bolton, 2012). Many companies have adopted mechanisms that financially reward shareholders' loyalty or that grant them additional voting rights in return for this loyalty. Some countries (France and Italy in particular) have legislated in this regard. It is difficult to assess the results. In theory, the principle of "one share – one vote" does not rule out the existence of several classes of shares involving different voting rights. It does of course reduce the agency problems involving the holders of blocs of shares, but it also reduces the beneficial effects of the stability that these blocs provide (Burkart and Lee, 2008). Moreover, empirical studies reach mixed conclusions, further indicating the complexity of the problem (Adams and Ferreira, 2008).

Nevertheless, numerous empirical studies do confirm that companies that have a more stable ownership structure and meet performance indicators that do not refer merely to financial capital have better outcomes in the long run (Clark et al., 2014). The existence of stable shareholder blocs or of restrictions on voting rights may be mechanisms that are likely to ensure this sustainability and strengthen the degree of commitment made by the capital providers, thereby justifying that other stakeholders – employees, suppliers and customers – do likewise in turn.

The difficulty with mechanisms for restricting voting rights is that they do not allow shareholders to indicate the length of time that they want to keep their shares and to indicate their level of engagement (Mayer, 2013). In fact, those who intend to hold their shares only briefly (possibly milliseconds in case of high-frequency trading) have the same influence on managers' decisions as those who intend to keep their shares for many years. The first bear the consequences

of their votes only momentarily, unlike the latter, but both have the same influence on current decision-making, which may affect the company's performance for a long time to come. Basically, establishing different classes of shares does not necessarily substitute for the constitution of a stable bloc of shareholders that is able to deal with hostile takeovers motivated by the quest for short-term capital gains.

Things may be different when past loyalty is rewarded financially by an increase in the dividends paid, since in this case selling the shares leads to losing the financial advantage acquired. There is therefore an incentive to hold the shares even longer. Nevertheless, the payment of dividends is never equivalent to the retention of profits. The proceeds from new issues are under the control of the shareholders, whereas undistributed profits are still under the control of the managers. The higher the dividends, the more companies are dependent on their ability to draw on the stock market. There is still an issue of too much dependence vis-à-vis impatient shareholders, pulling companies towards short-term investments.

Accordingly, one potential relevant mechanism might be to establish voting rights based not on the time the shares have been held, but on the future period to which the shareholders are committed (Mayer, 2013). Under this proposal, shareholders would be able to register the period for which they intend to hold their shares and to be paid in the form of votes that are set according to the length of time remaining before they are able to dispose of them. At the moment, "loyalty and the double vote of the shares remunerate shareholders for the period the shares have been held and, consequently, fail to make them more responsible for the future consequences of their decisions. Really, since shareholders who have held their shares a long time are more likely to sell them, this potentially rewards a lack of commitment" (Mayer, 2013, pp. 208-9). It is clear, however, that it would be difficult to

implement this institutional arrangement in practice, not least due to its credibility, and it would be preferable to explore other forms of governance that involve other stakeholders in the decision-making process.

On the expectations of government

In light of the analysis above, the question arises of what the government can expect from its decision to impose double voting rights. The answer is that this could be mainly to reduce, even if in a limited way, the public debt, without losing its influence in the companies in which it holds shares. The intention to revive industrial capitalism by this measure, laudable as this may be, is unlikely to have any real impact. This is true in particular because there is nothing to suggest that in the future the State would behave differently from any other shareholder, despite double voting rights, and could impose or contribute to imposing management decisions that are not necessarily in the long-term interest of the companies and their stakeholders.

Also, without wishing to neglect what the existence of several classes of action could mean for making decisions about business strategy, including possibly introducing protection against hostile takeovers, it seems a more fundamental measure would be to revise the business model as a whole.

The degree of engagement of the capital providers commands the commitment of the other stakeholders. Intermediated financing is the primary source of funds for owners who want to keep control of their business. It enables companies to innovate and grow without the need to dilute ownership. But it is necessary for such financing to exist, i.e. for banks to commit over a long term to these companies. Yet banks too are afflicted with problems of governance, leading to a conflict between the two main types of investors, shareholders and creditors (Giovannini et al., 2015). If institutional progress is to take place, it should therefore concern the financial

system and be based on a return of intermediation (Pollin 2006). And if action is to be taken on the conditions of governance of the corporations themselves, this should be based on the proposals by Mayer (2013): perhaps, subject to feasibility, by instituting voting rights in proportion to the time for which shares are held in the future, but especially by establishing “boards of trustees” that set broad guidelines, acting as the guardians of values common to the various stakeholders (shareholders, creditors, employees and even suppliers and customers) instead of acting merely as representatives of the shareholders. These common values do nothing more than express the recognition of the strategic complementarities that exist between all the actors who are the source of value creation.

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Equality at risk from simplification

By [Françoise Milewski](#) and [Hélène Périvier](#)

Legislating to promote equality

The laws on equality in pay and in the workplace have come a long way since 1972, from the affirmation of the principle of equality to the production of a detailed numerical diagnosis that puts flesh on the bones of inequality (via the Comparative Situation Reports that have been drawn up since 1983 under the Roudy law) as well as to the duty to negotiate. The 2006 law paved the way for hitting recalcitrant companies with financial penalties, as set out in an article in the 2009 law on pensions. There were numerous attempts to limit the scope of the law up to 2012, when things were more or less clarified: companies are now obliged to produce a CSR, which reports annually on the state of inequality in well-defined areas; they must then conduct negotiations on occupational equality and equal pay and, if there is no agreement, they are required to take unilateral action. There are exhaustive controls, with agreements or plans to be filed with the government (no longer on a one-off basis as in the first formulations of the implementing decree). Companies that fail

to comply with the law are put on notice to remedy this on pain of financial penalties of up to 1% of payroll.

The duty to negotiate entails collective management of the issue. Since 2012, the number of agreements signed has increased, as have formal notices and sanctions. While the content of the agreements and plans is often too general, it's a start. The framework law of 4 August 2014 on equality has complemented and strengthened these arrangements.

Simplification: naïveté or retreat?

On the occasion of the Rebsamen bill on social dialogue, this long legislative process is suddenly being called into question under the pretext of simplification. In the bill's initial version, the requirement to produce a detailed diagnosis in a CSR is gone, having melted into the company's single database. The duty to negotiate on occupational equality also disappears, integrated into other negotiations (quality of life at work).

Given the extent of the reaction (associations, individuals, unions, researchers, etc.), the three ministries concerned issued a statement reaffirming certain principles, including that "it shall continue to be obligatory to transmit all the information that is currently found in the CSR". Amendments will be tabled to that effect. But nothing is settled. The gender indicators remain integrated into the single database, so the CSR loses its specificity. Negotiations that focus on equality are not restored, and their frequency remains unclear (annual? triennial?). Uncertainty remains.

Whatever the outcome of the parliamentary debate that is starting up on social dialogue, business has been given the signal that equality policy can be challenged, that previous requirements are ultimately not all that imperative, and that the measures taken in recent years can be relativized in the name of simplification.

If, by leaving it up to the social partners to negotiate on gender equality, this issue had emerged on its own and led to significant progress, no law on the subject would have been necessary. It was in response to inertia and persistent inequality that constraints were imposed on companies. It is because our society needs to make gender equality a fundamental principle that laws, coupled with constraints, were approved. The complexity of the social dialogue on this subject reflects the resistance of the different parties. This simplification is at best naive, and at worst a refusal to come up with public policy to promote equality.

In the field of equality, vigilance is vital. Removing the constraints means going back on the principle of equality. A desire for equality requires clear, ongoing political will: continuity and coherence in public policy is crucial.

This is the meaning of a statement by men and women researchers that was published on the *Les Echos* website on 19 May.

Oil: carbon for growth

By [Céline Antonin](#), [Bruno Ducoudré](#), Hervé Péléraux, Christine Rifflart, [Aurélien Saussay](#)

This text is based on the [special study of the same name](#) [Pétrole : du carbone pour la croissance, in French] that accompanies the OFCE's 2015-2016 Forecast for the euro zone and the rest of the world.

The 50% fall in the price of Brent between summer 2014 and

January 2015 and its continuing low level over the following months is good news for oil-importing economies. In a context of weak growth, this has resulted in a transfer of wealth to the benefit of the net importing countries through the trade balance, which is stimulating growth and fuelling a recovery. Lower oil prices are boosting household purchasing power and driving a rise in consumption and investment in a context where companies' production costs are down. This has stimulated exports, with the additional demand from other oil-importing economies more than offsetting the slowdown seen in the exporting economies.

That said, the fall in oil prices is not neutral for the environment. Indeed, the fall in oil prices is making low-carbon transportation and production systems less attractive and could well hold back the much-needed energy transition and the reduction of greenhouse gas emissions (GHG).

This oil counter-shock will have a favourable impact on growth in the net oil-importing countries only if it is sustained. By 2016, the excess supply in the oil market, which has fuelled by the past development of shale oil production in the United States and OPEC's laissez-faire policy, will taper off. Unconventional oil production in the United States, whose profitability is uncertain at prices of under 60 dollars per barrel, will have to adjust to lower prices, but the tapering off expected from the second half of 2015 will not be sufficient to bring prices down to their pre-shock level. Brent crude prices could stay at about 55 dollars a barrel before beginning towards end 2015 to rise to 65 dollars a year later. Prices should therefore remain below the levels of 2013 and early 2014, and despite the expected upward trend the short-term impact on growth will remain positive.

To measure the impact of this shock on the French economy, we have used two macroeconometric models, *e-mod.fr* and *ThreeMe*, to carry out a series of simulations. These models also allow us to assess the macroeconomic impact, the transfers in

activity from one sector to another, and the environmental impact of the increased consumption of hydrocarbons. The results are presented in detail in the [special study](#). It turns out that for the French economy a 20 dollar fall in oil prices leads to additional growth of 0.2 GDP point in the first year and 0.1 point in the second, but this is accompanied by a significant environmental cost. After five years, the price fall would lead to additional GHG emissions of 2.94 MtCO₂, or nearly 1% of France's total emissions in 2013. This volume for France represents nearly 4% of [Europe's goal](#) of reducing emissions by 20% from 1990 levels.

The simulations using the French *e-mod.fr* model can be extended to the major developed economies (Germany, Italy, Spain, the USA and UK) by adapting it to suit characteristics for the consumption, import and production of oil. With the exception of the United States, the oil counter-shock has a substantial positive impact that is relatively similar for all the countries, with Spain benefitting just a little more because of its higher oil intensity. Ultimately, considering the past and projected changes in oil prices (at constant exchange rates), the additional growth expected on average in the major euro zone countries would be 0.6 GDP point in 2015 and 0.1 point in 2016. In the US, the positive impact would be partially offset by the crisis that is hitting the unconventional oil production business^[1]. The impact on GDP would be positive in 2015 (+0.3 point) and negative in 2016 (-0.2 point). While lower oil prices are having a positive impact on global economic growth, this is unfortunately not the case for the environment ...

^[1] See the post, [The US economy at a standstill in Q1 2015 : the impact of shale oil](#), by Aurélien Saussay, from 29 April on

the OFCE site.

Greece on a tightrope

By [Céline Antonin](#), Raul Sampognaro, [Xavier Timbeau](#) and [Sébastien Villemot](#)

[This text summarizes the special study, "Greece on a tightrope"](#)

Since early 2015, Greece's new government has been facing intense pressure. At the very time that it is negotiating to restructure its debt, it is also facing a series of repayment deadlines. On 12 May 2015, 750 million euros was paid to the IMF by drawing on the country's international reserves, a sign that liquidity constraints are becoming more and more pressing, as is evidenced by [the letter](#) sent by Alex Tsipras to Christine Lagarde a few days before the deadline. The respite will be short: in June, the country has to make another payment to the IMF for 1.5 billion euros. These first two deadlines are only a prelude to the "wall of debt" that the government must deal with in the summer when it faces repayments of 6.5 billion euros to the ECB.

Up to now, Greece has made its payments despite its difficulties and the suspension of the bailout program negotiated with the "ex-Troika". Thus, 7.2 billion euros in remaining disbursements have been blocked since February 2015; Greece has to come to an agreement with the former Troika before June 30 if it is to benefit from this financial windfall, otherwise it will fail to meet its payment deadlines to the ECB and IMF and thus default.

Besides Greece's external repayments, the country must also meet its current expenses (civil servant salaries, retirement pensions). But the news on the fiscal front is not very encouraging (see [State Budget Execution Monthly Bulletin, March 2015](#)): for the first three months of the year, current revenue was nearly 600 million euros below projections. Only the use of its European holding funds, combined with an accounting reduction in expenditures (1.5 billion euros less than forecast) allowed the Greek government to generate a surplus of 1.7 billion euros and to meet its deadlines. So by using bookkeeping operations, the Greek government was able to transfer its debt either to public bodies or to its providers, thus confirming the tight liquidity constraints facing the State. Preliminary data at the end of April (to be taken with caution because they are neither definitive nor consolidated for all government departments) seem nevertheless to qualify this observation. [At end April](#), tax revenues had returned to their expected level; however, the government's ability to generate cash to avoid a payment default is due to its holding down public spending through the accounting operations described above. These accounting manipulations are simply emergency measures, and it is high time, six years after the onset of the Greek crisis, to put an end to this psychodrama and finally find a lasting solution to Greece's fiscal difficulties.

Our study, ["Greece on a tightrope"](#), considers what would be the best way to resolve the Greek debt crisis over the long term and the potential consequences of a Greek exit from the euro zone. We conclude that the most reasonable scenario would be to restructure the country's debt, with a significant reduction in its present value (cutting it to 100% of Greek GDP). This is the only way to significantly reduce the likelihood of a Grexit, and is in the interest not only of Greece but also of the euro zone as a whole. Furthermore, this scenario would reduce the scale of the internal devaluation needed to stabilize Greece's external position.

If the Eurogroup were to refuse to restructure Greece's debt, a new assistance program would then be needed in order to deal with the current crisis of confidence and to ensure funding for the cash needs of the Greek State over the coming years. According to our calculations, this solution would require a third bailout plan of around 95 billion euros, and its success would depend on Greece being able to generate major primary budget surpluses (of around 4% to 5% of Greek GDP) over the coming decades. Historical experience shows that, due to political constraints, there is no guarantee of being able to run a surplus of this magnitude for such a long time, so this commitment is not very credible. A new assistance program would not therefore eliminate the risk that the Greek State would face yet another financial crisis in the coming years.

In other words, the full repayment of the Greek debt is based on the fiction of running a budget surplus for several decades. Accepting a Greek exit from the euro zone would imply a significant loss of claims that the world (mainly Europe) holds both on the Greek public sector (250 billion euros) and on the private sector (also on the order of 250 billion). To this easily quantifiable loss would be added the financial, economic, political and geopolitical impact of Greece's departure from the euro zone and possibly the European Union. This might look like an easy choice, since writing off 200 billion euros in loans to the Greek State would make it possible to end this psychodrama for once and for all. But the political situation is deadlocked, and it is difficult to give up 200 billion euros without very strong counterparties and without dealing with the issue of moral hazard, in particular the possibility that this could induce other euro zone countries to demand large-scale restructurings of their own public debt.

The planetary alignment has not always been favourable to the euro zone countries

By [Eric Heyer](#) and Raul Sampognaro

In 2015, the euro zone economies will benefit from a favourable [“planetary alignment”](#) (with the euro and oil prices down and financial constraints on the economy easing), which should trigger [a virtuous circle of growth](#). Over the previous four years (2011-2014), the “planetary alignment” that existed was in a diametrically opposite direction: the euro and oil prices were high, with financing conditions and the fiscal stance very tight.

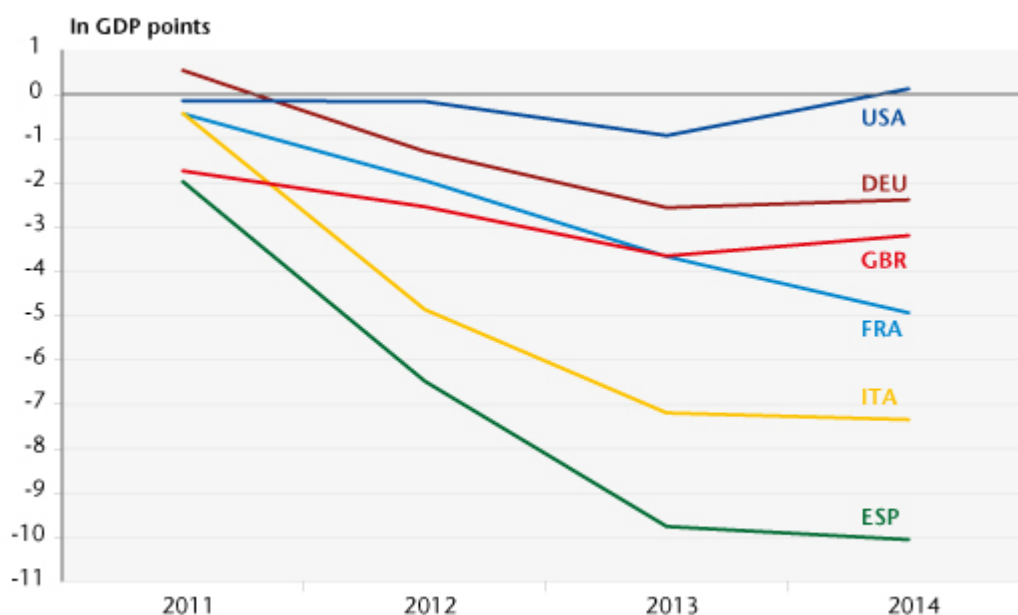
In [a recent article](#), we propose an evaluation of the impact of these four factors on the economic performance of six major developed countries since 2011 (France, Germany, Italy, Spain, the UK and USA).

It is clear from our analysis that the combination of these shocks explains a large part of the differences in growth recorded during the period 2011-2014 between the United States and the major European economies. A non-negligible part of this performance gap is explained in particular by the difference in the economic policies adopted, with a policy mix that has been much more restrictive in the euro zone than in the case of the US. In particular, a very sharp fiscal adjustment took place in the countries experiencing pressure on their sovereign debt, such as Spain and Italy. In addition, the effects of the pressure on sovereign debt were multiplied by financial fragmentation, which can be seen in the

deterioration of private sector financing terms, whereas the quantitative easing measures taken by the Fed and the Bank of England helped to prop up financing conditions in these countries. It was not until Mario Draghi's speech in July 2012 and [the announcement of the OMT programme](#) in September 2012 that the ECB's actions were sufficient [to reduce the financial pressure](#). While exchange rate trends tended to support activity in the euro zone throughout 2011-2014, the contribution of this factor depended on the way the various countries were integrated with global trade flows [\[1\]](#) and on the scale of wage disinflation, which was particularly pronounced in Spain. Finally, the rise in oil prices held back Europe's growth, while it had less impact in the United States, which [benefited from the exploitation of shale oil](#).

The cumulative loss in GDP was very significant in Spain (-10 points between 2011 and 2014), Italy (-7.5 points) and France (-5 points) and more moderate in the UK (-3 points) and Germany (-2.5 points). In contrast, the cumulative impact since 2011 on growth in the United States was zero, suggesting that real growth in the US was in line with spontaneous growth [\[2\]](#) (Figure 1).

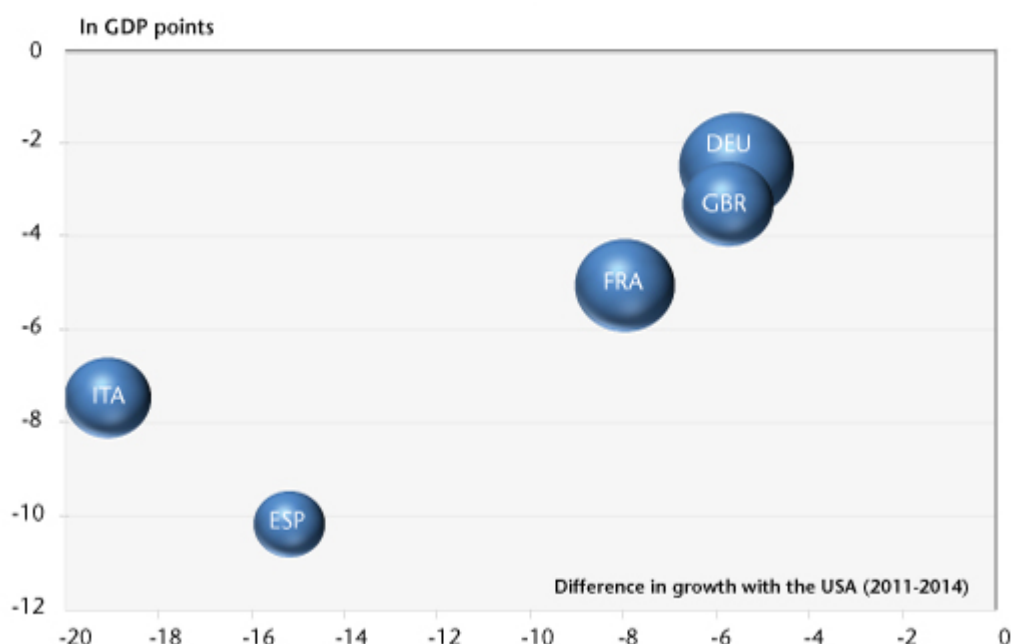
Figure 1. Cumulative impact on GDP of various shocks since 2011



Sources: National accounts, OFCE calculations.

Thus, in the absence of these shocks, Europe's spontaneous growth could have exceeded the rate of potential growth, as in the United States (Figure 2). This would have led in the euro zone countries in particular to a long-term convergence of GDP with its potential level, to a reduction in imbalances on the labour market, to the normalization of capacity utilization, and to a recovery in the public accounts.

Figure 2. Difference in growth and the cumulative impact on GDP of various shocks for countries over the period 2011-2014



Sources: OECD eo96 for the output gap, national accounts, OFCE calculations for the impact of the shocks.

[Go to the full version of our study.](#)

[1] The impact of these competitiveness shocks differs across countries because of differences in the elasticity of foreign trade, but also due to variations in the countries' degree of exposure to trade and to intra / extra euro zone competition. For more on this, see [Ducoudré and Heyer \(2014\)](#).

[2] An economy's spontaneous growth results from its long-term potential growth (which depends on structural factors that

determine in particular changes in the global productivity of the factors and the labour force) and the rate of closing the output gap, which was deepened in most countries by the 2008-2009 crisis and which depends on an economy's capacity to absorb the shocks that hit it.

The British elections: border questions (2/2)

By [Catherine Mathieu](#)

David Cameron has put the economy at the forefront of his electoral campaign, making the British economy's good performance a trump card in the Conservative programme (see "[The UK on the eve of elections ...](#)"). But, according to the polls, when May 7 comes to a close no party will be able to govern alone. While in 2010, the uncertainty was whether the Liberal Democrats would choose to ally with the Conservatives or the Labour Party, this time there is even greater uncertainty, as several parties are likely to be in a position to swing the outcome. The Liberal Democrats have lost popularity following five years of participation in government and are likely to receive less than 10% of the votes, behind the nationalist United Kingdom Independence Party (UKIP, with about 12% of voting intentions), which calls for the United Kingdom to leave the EU and won the last European elections. Faced with rising euro-scepticism, particularly in the ranks of his own Conservatives (the "Tories"), David Cameron has promised to hold a referendum on the UK's membership in the EU by the end of 2017 if he becomes Prime Minister again. As for

Labour, if it is able to form a coalition government, it could ally with the Scottish National Party (SNP). But Labour has excluded this possibility in the face of attacks by David Cameron, who has raised the spectre of the fragmentation of the UK among the British electorate, which has barely recovered from its fright at the possibility of seeing Scotland become independent in the September 2014 referendum. Labour would nevertheless benefit from the support of the SNP and could form a coalition with the Liberal Democrats. The Lib-Dems have drawn several red lines with respect to entering a coalition government: less fiscal austerity if they ally themselves with the Conservatives or more fiscal restraint if they join with Labour, except in education where the Liberal Democrats want more resources than the two major parties.

Economic and social programmes of the main parties: similarities, with some slight differences ...

The Conservatives are welcoming the rebound in growth and employment, and have halved the public deficit relative to GDP in 2018/2019. They feel they have “put the house in order” and now want to “repair the roof while the sun is shining”. They say they want this to benefit everyone. They therefore want to increase spending on the health system (NHS), maintain spending on education and increase the number of places in university. They are committed to continue to raise pensions by at least 2.5% per year. They will make significant public investments in transport. They will not increase VAT, income tax, or social contributions. On the other hand, they will further reduce the cap on income assistance so as “to make work pay”.

The Conservatives want to promote apprenticeships, encourage business, regulate the right to strike, cut paperwork, and get disabled people into the workplace. They wish to control and reduce immigration from the EU (bringing it down to “tens of thousands” per year instead of “hundreds of thousands” now). The right to social benefits will be cut back (it will be

necessary to have resided in the country for at least four years to qualify for tax credit and child benefit, and social housing will be reserved for British citizens). They want to provide cheap energy to households by developing energy savings and renewable energies, especially nuclear.

The Tories have set themselves the goal of bringing the public deficit into a small surplus (0.2 percent of GDP) through a combination of cutting public spending and social spending and combatting tax evasion and avoidance (taking action on non-domiciled status – “non-doms” – and the taxation of multinational firms).

For Labour, “Britain only succeeds when working people succeed”. A national renewal is needed so that “the economy works for working people”. Labour is denouncing the increase in inequality and in precarious jobs and the fall in the purchasing power of working families.

But the Labour Party is also proclaiming their commitment to reducing the public deficit every year. Their goal is to bring the current account deficit (excluding investment) into balance by 2018-19, which would mean a public deficit of 1.4% of GDP. This goal is less ambitious than that of the Conservatives and would be met in part by higher taxes. The maximum marginal rate of income tax would rise from 45% to 50%. A tax would be introduced on “mansions” (properties worth more than 2 million pounds). Labour has pledged to maintain the most competitive corporate tax rates in the G7. This rate, which was cut to 20% in April, would nevertheless be raised by one point. The levy on banks would be increased (900 million expected). Labour also wish to reinstate a lower 10% starting rate of tax, to be financed by the abolition of the allowance for married couples. They want to eliminate the very unpopular tax on vacant rooms (the “bedroom tax”). Like the Conservatives, they would remove the tax advantages for “non-doms”.

Labour, however, want to cut government spending, except on health, education and international development. They propose an increase in NHS funding in order to reduce waiting times. They have pledged to raise the hourly minimum wage to GBP 8.00 in 2019 (from the current level of 6.50 pounds, which is set to rise to 6.70 in October 2015). They propose to regulate zero-hour contracts (at least for employees who have worked regularly for more than 12 weeks). On the other hand, they do not question a cap on income assistance. Labour also say that they will control immigration and limit the right of immigrants to social benefits (by requiring at least two years' residence in the country). They want to implement an industrial strategy to develop a green economy. They propose reducing the role of shareholders in corporate management and creating a British Investment Bank to help finance small businesses.

The Liberal Democrats call is for a "stronger economy, fairer society". They want to make the UK a world leader in terms of future technologies. They want to increase spending on health and education. They also want to increase the availability of childcare and parental leave. Above all, they want to develop green taxation and make the transition to a low-carbon economy. They aim to balance the current budget, like Labour, but this would occur a year earlier (2017-2018). This would be achieved by limited spending cuts, but also by increasing taxes on the wealthy, on banks, on big business and pollution and by fighting tax avoidance. They too propose a mansion tax.

... and a number of unknowns

The Institute for Fiscal Studies (IFS) has published two notes: "Post-election austerity: Parties' plans compared ", *IFS Briefing Note BN 170*, 22 April, and "Taxes and benefits: The parties' plans", *IFS Briefing notes BN 172*, 28 April. In these notes the IFS attempts to estimate the proposed measures, but underlines the lack of detail in the different programmes. The Conservatives are planning more spending cuts,

while Labour and the Liberal Democrats are planning a less rapid reduction in deficits and consequently in public debt. Under the Tories, the public deficit would fall from 5% of GDP in 2014-15 to 0.6% in 2017-18, to 1.1% for the Liberal Democrats, to 2% for Labour, and to 2.5% for the SNP. The public debt would decline from 80% of GDP in 2014-15 to 72% in 2019-20 under the Conservative plan, compared with 75% for the Liberal Democrats, 77% for Labour and 78% for the SNP. The three parties have announced that they will pursue the goal of deficit reduction but without specifically detailing how they would do this. The Conservatives, for instance, would not increase taxes; they would have to make an 18% cut in spending on non-protected sectors, that is to say, defence, transportation, social assistance and justice. They do not spell out how they would make large savings on social welfare spending while excluding pensions and the NHS. At the end of April, the Liberal Democrats injected into the debate the idea that the Conservatives would consider reducing family allowances, which David Cameron has denied he will do, but suspicion remains just a few days before the election. All the parties have committed not to increase the main VAT rate, income tax or health insurance contributions, but all of them are also counting on a great deal of revenue from the fight against tax avoidance.

Scotland-Europe: two key issues in the elections

Two issues make this vote unique and have given rise to a very specific political configuration. First, the Scottish National Party (SNP) is continuing to call for Scotland's independence, despite the outcome of the referendum in September 2014 (55% no). As a centre-left party that is currently in power in Edinburgh, it could win 55 of the 59 Scottish seats, at the expense of the Labour party, and thus be in a pivotal position for securing a future majority. It is calling for a new referendum on Scottish independence, but also for an end to austerity policies on public and social welfare spending.

UKIP is calling for the UK to leave the EU. David Cameron has promised to hold a referendum on this before the end of 2017 if the Conservatives prevail. In any case, Cameron is opposing any extension of Europe's economic or political powers; Europe must above all be a single market that needs for free market policies to be maximized; he rejects any European regulations on financial services as well as any solidarity between countries, any increase in the EU budget, and any increase in the British contribution ("I am not paying that bill"). He wants the UK to have the possibility of limiting the social rights of EU immigrants, which would be the main point in any Conservative negotiations over keeping the United Kingdom in the EU. David Cameron will not come out for keeping the UK in the EU until these demands are taken into account. Labour has denounced the UK's loss of influence in Europe caused by its isolationism, but it is also demanding less Europe: the UK should remain free to set its own immigration policy and social policy. According to Gordon Brown, leaving the EU would transform the UK into a "new North Korea", without allies and without influence. Labour would hold a referendum if Europe wanted to impose unacceptable measures on the UK. The Liberal Democrats are very attached to Europe. They want to defend business in Europe, along with the Transatlantic Trade and Investment Partnership (TTIP), eliminate unnecessary institutions such as the European Economic and Social Council and the sessions of the EU Parliament in Strasbourg. They want to maintain freedom of movement in Europe but reduce immigrants' rights to benefits. They will vote no on a referendum for leaving the EU. Currently, 35% of the British people would vote for leaving the EU and 57% against (but 38% want to stay while reducing the EU's powers). The large corporations and even more so the City want to remain in a big market. As was the case during the Scottish referendum, some corporations (e.g. HSBC[\[1\]](#)) are threatening to move their headquarters if the UK leaves the EU. The richest and best-educated part of the population also wants to stay in the EU.

The UK's economic and political development is thus now subject to three uncertainties: the risk that there will be no clear majority in Westminster; the return of the Scottish debate; and the debate on leaving the European Union.

[\[1\]](#) But HSBC is also challenging the increase in taxes on banks as well as the regulations inspired by the Vickers report, which would require ring-fencing the activities of the commercial banks.

The United Kingdom on the eve of elections: The economy, David Cameron's trump card (1/2)

By [Catherine Mathieu](#)

In the countdown to the general elections on 7 May 2015, there is so much suspense that the bookmakers are putting the Conservative Party as winners and Ed Miliband, the Labour leader, as the next Prime Minister! Not only are the Labour Party and the Conservative Party running neck-and-neck in the

polls, but with voting intentions fluctuating between 30 and 35% for many months now, neither party seems poised to secure a sufficient majority to govern alone. David Cameron, current PM and leader of the Tories, has placed the British economy at the heart of the election campaign. And the figures do seem rather flattering for the outgoing government with regard to growth, employment, unemployment, public deficit reduction, etc., though there are some less visible weaknesses in the UK economy.

A flattering macroeconomic result

With growth of 2.8% in 2014, the UK topped the charts for growth among the G7 countries (just ahead of Canada at 2.5% and the United States at 2.4%). The British economy has been on the road to recovery for two years, as growth picked up from 0.4% yoy in the fourth quarter of 2012 to 3% in the fourth quarter of 2014. This recovery stands in contrast to the situation of the large euro zone economies, where there was a weak recovery in Germany (respectively, 1.5% after 0.4%) and weak growth in France (only 0.4%, against 0.3% in 2012), with Italy still in recession (-0.5% after -2.3%).

At the end of 2014, Britain's GDP was 5% above its pre-crisis level (*i.e.* first quarter 2008), due to a strong recovery in services, which was particularly spectacular in business services (where value added (VA) was 20% above its pre-crisis level, representing 12% of VA), with a good performance in the fields of health care (VA 20% above the level of early 2008; 7% of VA) and in real estate (VA 17% above the pre-crisis level; 11% of added value).

According to the initial estimates released on April 28 by the Office of National Statistics (ONS), GDP nevertheless increased by only 0.3% in the first quarter of 2015, instead of 0.6% as in the previous quarters. While this initial estimate is likely to be revised (upwards or downwards, only half of the data on the quarter is known for this first

estimate), this slowdown in growth just a few days before the elections comes at a bad time for the outgoing government...

A strong decline in the unemployment rate ...

Another highlight of the macro-economic record as the elections approach: the unemployment rate has been falling steadily since late 2011, and was only 5.6% (ILO definition) in February 2015, against 8.4% in late 2011. This rate is one of the lowest in the EU, better than in France (10.6%) and Italy (12.6%), though still behind Germany (only 4.8%). While the unemployment rate has not yet reached its pre-crisis level (5.2%), it is now close. The number of jobs has increased by 1.5 million in the UK since 2011, and David Cameron unhesitatingly boasts of the UK's success as "the jobs factory of Europe", creating more jobs on its own than the rest of Europe combined! [\[1\]](#)

Behind this strong increase in employment, however, there are many grey areas.... First, the nature of the jobs created: 1/3 of the jobs created during this recovery are individual entrepreneurs, who now represent 15% of total employment. In times of crisis, a rise in the number of the self-employed generally reflects hidden unemployment, although according to a recent study by the Bank of England [\[2\]](#) this increase is part of a trend. The issue of the growth in what are called "zero hour" contracts, which are contracts for jobs with no guaranteed number of hours, has also burst into the discussion. Until 2013, this type of contract was not subject to statistical monitoring, but according to surveys recently released by the ONS, 697,000 households were affected by this type of contract (representing 2.3% of employment) in the fourth quarter of 2014, against 586,000 (1.9% of employment) a year earlier, *i.e.* an increase of 111,000 persons, while total employment increased by 600,000 over the period: zero-hours contracts therefore concern only a relatively small portion of the jobs created.

One corollary of the job creation that has taken place since 2011 is low gains in productivity. The British economy began to create jobs from the beginning of the recovery, while productivity fell sharply during the crisis. Companies have kept more employees on the payroll than they usually do in times of crisis, but in return wage increases have been curtailed. UK productivity today remains well below its pre-crisis level. Will the British economy keep a growth model based on low productivity and low wages for a long time to come? It is too early to tell, but this is a subject lying in the background of the election campaign.

Very low inflation

Inflation, as measured by the harmonized index of consumer prices (HICP), fell in February 2015 to only 0% yoy against 1.9% at the end of 2012. This slowdown was due to lower energy prices, but since the end of 2012, also to a slowing in core inflation: from 1.9% at end 2012 to 1.2% in February 2015. The question of inflationary risks has been debated within the UK Monetary Policy Committee for many months now: growth and low unemployment are potentially harbingers of short-term inflationary pressure, if one accepts that the economy is once again approaching full employment. In fact, the continuous decline in inflation since 2012, coming amid low wage increases, a more expensive pound and falling energy prices, has put off the prospect of an acceleration in short-term inflation. For the moment, the members of the Bank of England's Monetary Policy Committee are voting unanimously for the status quo.

Long-term interest rates on government debt remain at low levels, which was one of the goals hammered at by the Conservatives during the 2010 electoral campaign. In fact, UK rates are moving in much the same way as US rates, in line with similar growth prospects.

Despite this relatively good record, the British economy is

still fragile.

The vulnerabilities of the British economy over the medium term

Household debt continues to be high

Household debt had reached record levels before the 2007 crisis, and at that time represented 160% of household annual income. Since then, households have begun to deleverage, with indebtedness falling to 136% at end 2014, which is still well above the 100% level of the 1990s. This deleveraging is lessening households' vulnerability to a further economic slowdown or to a fall in the price of assets (especially property), but this also has the effect of reining in private domestic demand, while the household savings rate remains low (about 6%) and growth in nominal and real wages moderate. The rebalancing of domestic demand should continue, especially in terms of business investment.

Business investment is catching up

Business investment was structurally weak in the 2000s in the UK. But the recovery has been underway for 5 years, and the rate of investment volume is now close to its level of the early 2000s. The recovery of investment is obviously good news for the UK's productive capacity. But there is still an external deficit, a sign that the UK is struggling to regain competitiveness, at least with regard to the trade in goods. The stabilization of the trade deficit at around 7 GDP points in 2014, however, was due to the goods deficit being partially offset by a growing surplus in services (5 GDP points at end 2014), a sign that the UK economy still has a high level of specialization in services. Nevertheless, taking into account the balance in income [\[3\]](#), the current account deficit came to 5.5 GDP points, which is high.

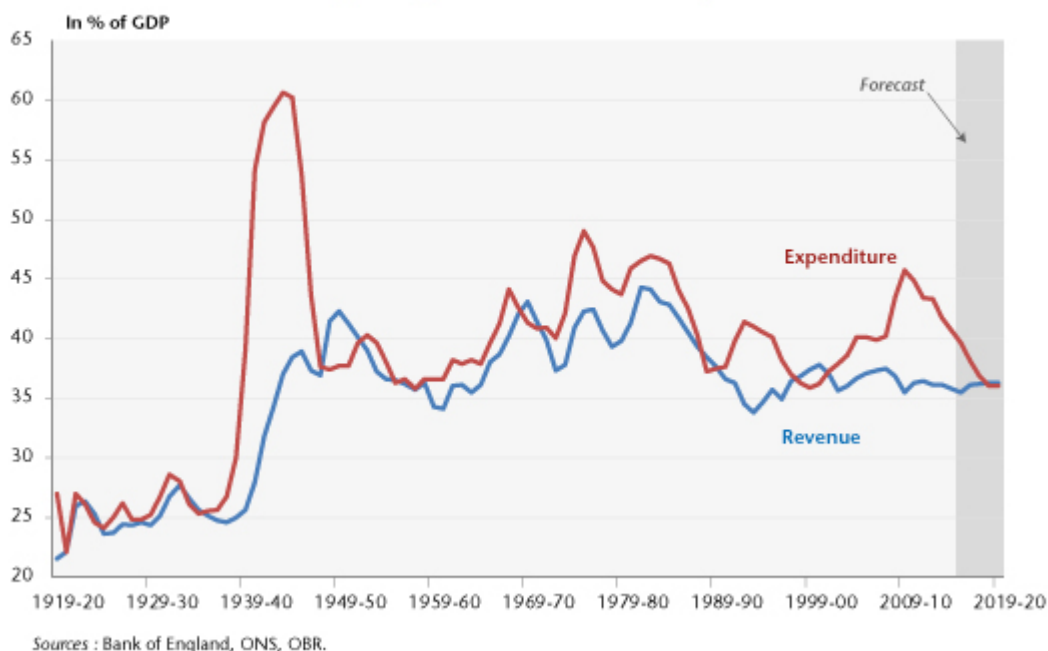
The deceptive appearance of the public finances

In 2010, the Tory campaign blamed the previous government for letting the deficits mount during the crisis. Their electoral programme included a large-scale fiscal austerity plan, which corresponded to the archetypical IMF plans: 80% spending cuts and 20% revenue increases over a 5-year horizon. In fact, as soon as they came to power, the government increased the VAT rate, which in 2010-2011 interrupted the recovery; it cut spending, while preserving the public health system (NHS) that the British hold so dear, as well as public pensions, which are low in the UK, but which the government decided to peg to inflation or wages (using whichever is the higher of the two variations, with a guaranteed minimum of 2.5%).

Five years later, David Cameron is highlighting the “success” of his government, which has cut the public deficit in half, from a level of 10% in 2010 to 5.2% in 2014. But with respect to the government’s initial ambitions, this is in fact only a partial success: its first budget in June 2010 set out a public deficit of only 2.2% of GDP in 2014. The originally planned decrease in public expenditure relative to GDP was in fact realized, but revenue rose much less than expected (due in part to sluggish household income).

While the austerity programme was generally weaker than what had been announced, in the March 2015 budget the government set out sharp cuts in public spending by 2019, which would bring it down from the current level of 40% of GDP to only 36% of GDP, one of the lowest levels of public spending since World War 2 (graphic). This reduction in public spending would be sufficient in itself to balance the public deficit, without any significant tax hikes: this would represent large-scale budget cuts, whose components are not specified and which it is hard to imagine would not sooner or later affect spending on health care and pensions, which the government has so carefully avoided doing up to now...

Public spending and revenue over the long term



[1] “We are the jobs factory of Europe; we’re creating more jobs here than the rest of Europe put together” (Speech on 19 January 2015).

[2] “Self-employment: what can we learn from recent developments?”, *Quarterly Bulletin*, 2015Q1.

[3] But the deficit of the balance of direct investment income (2 percentage points of GDP) is probably inflated by the relatively good performance of foreign companies operating in the UK in comparison to British companies operating abroad.

The coming recovery

By the Analysis and Forecasting Department, under the direction of [Eric Heyer](#) and [Xavier Timbeau](#)

This text summarises the [OFCE 2015-2016 economic outlook for the euro zone and the rest of the world](#)

While up to now the euro zone had not been part of the global recovery, the conjunction of a number of favourable factors (the fall in oil prices and depreciation of the euro) will unleash a more sustained process of growth that is shared by all the EU countries. These developments are occurring at a time when the massive and synchronised fiscal austerity that had pushed the euro zone back into recession in 2011 is easing. The brakes on growth are gradually being lifted, with the result that in 2015 and 2016 GDP should rise by 1.6% and 2%, respectively, which will reduce unemployment by half a point per year. This time the euro zone will be on the road to recovery. However, with an unemployment rate of 10.5% at the end of 2016, the social situation will remain precarious and the threat of deflation is not going away.

The expected demand shock

After a period during the Great Recession of 2008-2009 when growth was boosted by expansionary fiscal policy, the euro zone countries quickly reversed their policy orientation and adopted a more restrictive one. While the United States also chose to reduce its budget deficit, austerity has had less effect there. First, the negative demand shock at the euro zone level was amplified by the synchronisation of the consolidation. Second, in a context of rising public debt, the lack of fiscal solidarity between the countries opened up a breach for speculative attacks, which pushed up first sovereign rates and then bank rates or the non-financial agents market. The euro zone plunged into a new recession in 2011, while globally the momentum for growth gathered pace in the other developed countries (chart). This episode of consolidation and financial pressure gradually came to an end. In July 2012, the ECB made a commitment to support the euro; fiscal austerity was eased in 2014; and the Member States agreed on a draft banking union, which was officially

initiated in November 2014, with new powers on banking supervision entrusted to the ECB. All that was lacking in the euro zone then was a spark to ignite the engine of growth. The transfer of purchasing power to households that resulted from the fall in oil prices – about one percentage point of GDP if oil prices stay down until October 2015 – represents this positive demand shock, which in addition has no budget implications. The only cost resulting from the shock comes from the decline in income in the oil-producing countries, which will lead them to import less in the coming quarters.

An external demand shock will combine with this internal demand shock in the euro zone. The announcement of a quantitative easing programme in the euro zone represents a second factor accelerating growth. This programme, under which the ECB is to purchase more than 1,000 billion euros of securities at a pace of 60 billion per month until September 2016, not only will amplify the fall in sovereign yields but more importantly will also lead to a reallocation of portfolio assets and drive the euro (further) down. Investors looking for higher returns will turn to dollar-denominated securities, especially as the prospect of a gradual monetary tightening in the US improves the outlook for earnings on this side of the pond. The rising dollar will lift the currencies of the Asian countries with it, which will increase the competitive advantage of the euro zone at the expense this time of the United States and some emerging countries. It is unlikely that the fragility induced in these countries and in the oil-producing countries by the oil shock and by the decline in the euro will offset the positive effects expected in the euro zone. On the contrary, they will also be vectors for the rebalancing of growth needed by the euro zone.

Investment is the factor that will complete this growth scenario. The anticipation of higher demand will remove any remaining reluctance to launch investment projects in a situation where financing conditions are, overall, very

positive, representing a real improvement in countries where credit constraints had weighed heavily on growth.

All this will lead to a virtuous circle of growth. All the signals should turn green: an improvement in household purchasing power due to the oil impact, increased competitiveness due to the lower euro, an acceleration in investment and, ultimately, growth and employment.

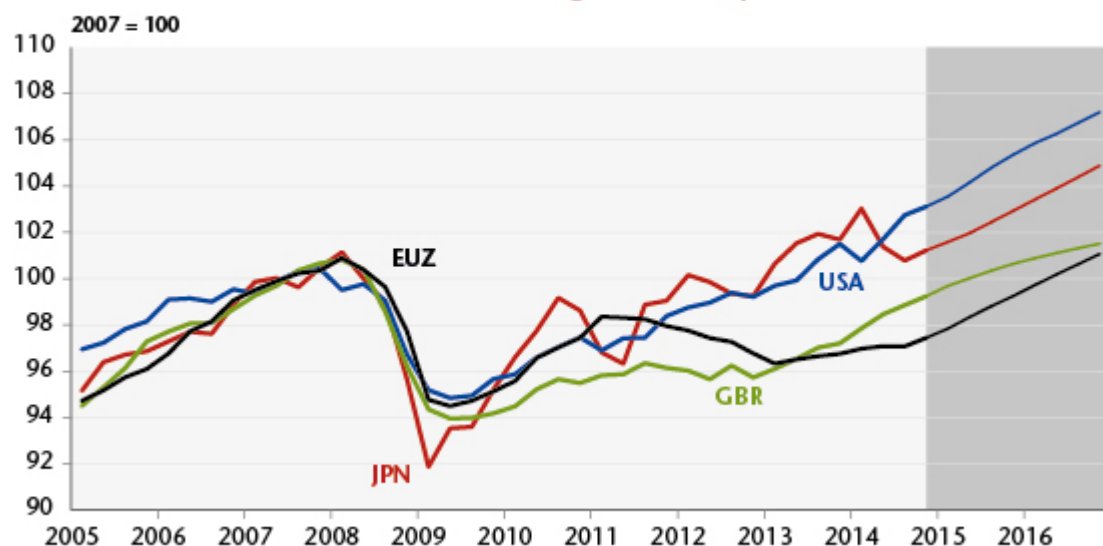
A fragile recovery?

While the elements promoting the euro zone's growth are not mere hypotheticals about the future but represent a number of tangible factors whose effects will gradually make themselves felt, the fact remains that they are somewhat fragile. The falling price of oil, for instance, is probably not sustainable. The equilibrium price of oil is closer to USD 100 than USD 50 and, ultimately, a rise in energy prices is in the cards: what has a positive effect today could undermine the resumption of a recovery tomorrow. The decline of the euro seems more long-term; it should last at least until the end of the ECB's quantitative easing programme, which officially is at least September 2016. The euro should not, however, fall below a level of 0.95 dollar per euro. The time it takes for changes in exchange rates to translate into trade volumes, however, should allow [the euro zone to benefit in 2016 from a gain in competitiveness.](#)

It is worth noting that a Greek exit from the euro zone could also put a halt to the nascent recovery. The firewalls set up at the European level to reduce that risk should limit any contagion, at least so long as the political risk has not been concretised. It will be difficult for the ECB to support a country where a party explicitly calling for leaving the euro zone is at the gates of power. The contagion that is now considered extinguished could then catch fire again and reignite the sovereign debt crisis in the euro zone.

Finally, the constraints of the Stability Pact have been shifted so as to leave more time to the Member States, particularly France, to get back to the 3% target. They have therefore not really been lifted and should soon be reinforced once it comes to assessing the budgetary efforts being made by the countries to reduce their debt.

Figure. The GDP of the euro zone, the United States, the United Kingdom and Japan



Source : National accounts, OFCE forecasts April 2015.

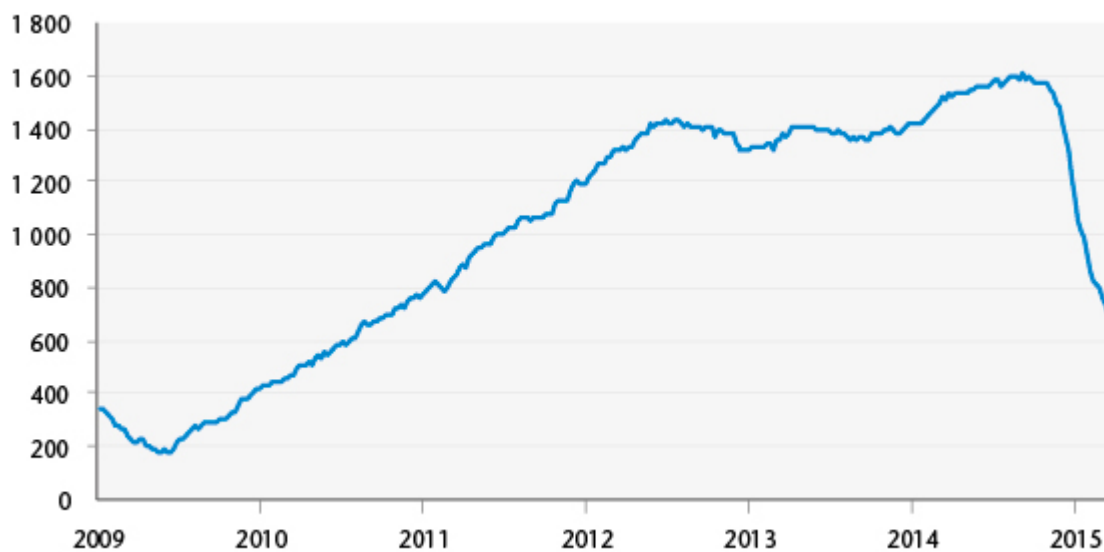
The US economy at a standstill in Q1 2015: the impact of shale oil

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The US Bureau of Economic Analysis has just released its estimate of US growth in the first quarter of 2015: at an annual pace of 0.2%, the figure is well below the consensus of the leading American institutes, who had agreed on a forecast of just above 1% – well below the 3% hoped for in early March.

While it is still too early to know the exact reasons for this setback, one factor seems to be emerging: in the United States, the shale oil “revolution” seems to be on the verge of imploding. The sharp fall in crude prices in the second half of 2014 caused a collapse in mining activity: the number of oil rigs operating in the US fell by 56% from November 2014 to April 2015, returning to the level of October 2010 (see chart). The speed of this downturn underscores the fragility of the shale oil boom and its dependence on high oil prices.

Figure. Oil drilling rig count in the continental US



Source : Baker Hughes.

Given the very short lifetime of shale oil wells, *i.e.* less than 2 years, the sharp decline in the pace of drilling should result in an equally rapid decline in production in the coming months: in fact, for the month of May the US Energy Information Agency (US EIA) has forecast that shale oil production will fall for the first time since the start-up of operations in 2010.

This rapid contraction of the shale oil industry could have significant consequences for the US economy. There are two main components to the macroeconomic impact this will have: the business of drilling and completing wells, and the gains in the trade balance from substituting domestic production for imported oil.

In 2013, the hydrocarbons mining industry and mining-related services accounted for 2.1% of the US economy, up from 1.6% four years earlier. At a first order, a decline in the drilling rate could therefore cut US growth by 0.3 GDP point. The Fed's manufacturing indicator already shows just such a decline: American industrial output is down by 1% on an annual basis in first quarter 2015, a first since the second quarter of 2009. The mining sector seems to be the leading contributor to this decline, with activity falling off by 4% during the quarter.

However, this figure neglects the ripple effect from the sector onto the rest of the economy – which goes beyond the impact simply on upstream industries: for example, in the regions affected, shale oil operations were accompanied by a real estate boom generated by the influx of workers into the shale fields. Texas and North Dakota, for example, which concentrate 90% of the total production of shale oil, contributed over 23% of US growth from 2010 to 2013, whereas they accounted for only 8% of the economy in 2010. The negative impact of the collapse of the oil industry could thus be more important than the size of the oil sector alone might suggest.

The rise in US production of over 4 million barrels per day in 2014 also led to an improvement in the trade balance, contributing an additional 0.7 GDP point to growth. If the reduction in the number of wells is followed by an equivalent decrease in production starting in the second half-year, and oil prices stay at around USD 60, US domestic production would now contribute only about 0.2 GDP point, half a percentage point less than in 2014.

Finally, the rapid exploitation of shale oil deposits was mainly due to the so-called independent producers who specialized in this activity, and who are therefore particularly vulnerable to the volatility in international prices. This is a very capital-intensive activity: the

independents made use of bonded debt to finance their operations – for a total of USD 285 billion as of 1 March 2015, including USD 119 billion in high-yield bonds[1]. The impact of the fall in oil prices has been particularly important for this last segment: the share of “[junk bonds](#)” rose from 1.6% in March 2014 to 42% in March 2015[2], i.e. 50 billion dollars. It should be noted that this increase has resulted mainly from the deterioration of existing bonds, even though new bond issues have also contributed. If this trend continues, it could lead to a crisis in the high-yield segment of the US bond market, which would hurt US corporate financing conditions this year at a time when the Fed wishes to begin to tighten monetary policy.

The implosion of the shale oil industry will test the strength of the recovery in the US: if it turns out to be weaker than expected, the shock of the sharp slowdown in the production of shale oil could be enough to bring the American economy to near stagnation in 2015.

[1] Yozzo & Carroll, 2015, “The New Energy Crisis: Too Much of a Good Thing (Debt, That Is)”, *American Bankruptcy Institute Journal*.

[2] Source: Standard & Poor’s.