So far so good …

By Christophe Blot

The euro zone is still in recession. According to Eurostat, GDP fell again in the fourth quarter of 2012 (-0.6%). This figure, which was below expectations, is the worst quarterly performance in the euro zone since the first quarter of 2009, and it is also the fifth consecutive quarter of a decline in activity. For 2012 as a whole, GDP decreased by 0.5%. This annual figure masks substantial heterogeneity in the zone (Figures 1 and 2), since Germany posted annual growth of 0.9% while for the second consecutive year Greece is likely to suffer a recession of more than 6%. Moreover, taking all the countries together, the growth rate will be lower in 2012 than in 2011, and some countries (Spain and Italy to name but two) will sink deeper into depression. This performance is all the more worrying as several months of renewed optimism had aroused hopes that the euro zone was recovering from the crisis. Were there grounds for such hope?

Although it is very cautious about growth for 2012, the European Commission, in its annual report on growth, noted the return of some good news. In particular, the fall in long-term sovereign rates in Spain and Italy and the success on the financial markets of the public debt issues by Ireland and Portugal reflected renewed confidence. It is clear now however that confidence is not enough. Domestic demand has stalled in France and is in freefall in Spain. All this is hurting trade within the zone, since a decline in imports by one country means a decline in exports from others, which is amplifying the recessive dynamics afflicting the countries in the zone as a whole. As we noted in our previous forecasting exercise and on the occasion of the publication of the iAGS (independent Annual Growth Survey), a recovery cannot in any case rely solely on a return of confidence so long as highly restrictive fiscal policies are being carried out synchronously throughout

Europe.

Since the third quarter of 2011, the signals have all confirmed our scenario and showed that the euro zone has gradually sunk into a new recession. Unemployment has continued to rise, setting new records every month. In December 2012, according to Eurostat 11.7% of the euro zone working population were jobless. However, neither the European Commission nor the European governments have adjusted their fiscal strategy, arguing that fiscal efforts were needed to restore credibility and confidence, which would in turn lower interest rates and create a healthy environment for future growth. In doing this, the Commission has systematically underestimated the recessionary impact of the fiscal consolidation measures and has ignored the increasingly abundant literature showing that the multipliers rise in times of crisis and may be substantially higher than one (see the post by Eric Heyer on this subject). Advocates of fiscal austerity also believe that the costs of such a strategy are inevitable and temporary. They view fiscal consolidation as a prerequisite for a return to growth and downplay the long-term costs of such a strategy.

This dogmatic blindness recalls the final comment in the film *La Haine* (directed by Mathieu Kassovitz): "This is the story of a society that is falling, and to reassure itself as it falls constantly repeats, so far so good, so far so good, so far so good … what's important is not the fall, it's the landing." It is time to recognize that the economic policy in force since 2011 has been a mistake. It is not creating the conditions for a recovery. Worse, it is directly responsible for the return of recession and for the social catastrophe that is continuing to deepen in Europe. As we have shown, other strategies are possible. They do not neglect the importance of eventually making the public finances sustainable once again. By postponing and reducing the scale of austerity (see the note by Marion Cochard, Bruno Ducoudré and Danielle Schweisguth), it would be possible to make more rapid progress in restoring growth and cutting unemployment.

Is the euro crisis over?

By Catherine Mathieu and Henri Sterdyniak

As of early 2013, it is possible to make two contrasting assessments of the crisis. On the one hand, the euro has survived. Europe's institutions and Member states have of course been slow and hesitant to react, and their reluctance has often fueled speculation. But its institutions have gradually managed to develop solidarity mechanisms, such as the European Financial Stability Facility and then the European Stability Mechanism, and they were able to impose strong fiscal discipline on Member states (strengthening the Stability and Growth Pact, adjustment programs, fiscal treaty).

The Member states have agreed to implement austerity policies and structural reforms. From the beginning of the crisis, the European Central Bank was willing to put in place unconventional policies, and it has supported the public debt of countries in difficulty by intervening in the secondary markets. It then undertook to commit unlimited resources to support countries in trouble that implemented satisfactory policies, which helped to reassure the financial markets and to lower risk premiums.

On the other hand, the euro zone has been unable to regain a satisfactory level of growth or to recover the 9 points of activity lost to the crisis. The Member states have been forced to implement austerity policies during a recession. According to the outlook of the Commission itself, the unemployment rate is expected to stay at about 11.8% in 2013. Imbalances between countries persist, even if they are somewhat mitigated by the deep depression that has engulfed the countries of southern Europe. The rigid standards that have been imposed on the Member states, with no real economic foundation, cannot replace the genuine coordination of economic policies. The solidarity mechanisms implemented are conditional on the loss of any autonomy and the introduction of drastic austerity policies. In the future, national policies will be paralyzed by European constraints and by the threats of the financial markets. Social Europe is not making progress, and, even worse, Europe is requiring countries in difficulty to call into question universal health care and to cut pension, unemployment and family benefits. Tax competition is continuing, and the crisis has not been seen as a time to challenge tax havens and tax evasion. While Europe is at the forefront of the fight against climate change, it is hesitating to make a robust commitment to the ecological transition. Although many countries in the area are suffering from continuing deindustrialization, no industrial policy has been implemented. A banking union will be established, but its content is not being democratically decided. The European authorities are persisting in a strategy – paralyzing national policies and imposing free market structural reforms – which has so far failed to boost growth and has made Europe unpopular. Europe is sorely lacking a socially unifying project, an economic strategy and a means of functioning democratically.

* Issue 127 of the “Debates et Politics” collection of the

Revue de l'OFCE, which appeared in January, contains analyses that provide contrasting insights into the origins of the euro zone crisis and into strategies for resolving the crisis. This issue brings together twelve papers following the 9th EUROFRAME conference [1] in June 2012 on issues concerning the European Union's economic policy.

---

[1] EUROFRAME is a network of European economic institutes, which includes: the DIW and IFW (Germany), WIFO (Austria), ETLA (Finland), OFCE (France), ESRI (Ireland), PROMETEIA (Italy), CPB (Netherlands), CASE (Poland) and NIESR (United Kingdom).

Spain: a lose-lose strategy

by Danielle Schweisguth

At a time when the IMF has publicly recognized that it underestimated the negative impact of fiscal adjustment on Europe's economic growth, Spain is preparing to publish its public deficit figure for 2012. The initial estimate should be around 8% of GDP, but this could be revised upwards, as was the case in 2011 – while the target negotiated with the European Commission is 6.3%. With social distress at a peak, only a sustainable return to growth would allow Spain to solve its budget problems through higher tax revenue. But the austerity being imposed by Europe is delaying the return of economic growth. And the level of Spain's fiscal multiplier, which by our estimates is between 1.3 and 1.8, is rendering the policy of fiscal restraint ineffective, since it is not *significantly reducing the deficit and is keeping the country in recession.*

At a time when the IMF has publicly recognized that it underestimated the negative impact of fiscal adjustment on Europe’s economic growth – the famous fiscal multiplier – Spain is preparing to publish its public deficit for 2012. The initial estimate should be around 8% of GDP, but this could be revised upwards as was the case in 2011. If we exclude the financial support for the banking sector, which is not taken into account in the excessive deficit procedure, the deficit then falls to 7% of GDP. This figure is still higher than the official target of 6.3% that was the subject of bitter negotiations with the European Commission. Recall that until September 2011, the initial target deficit for 2012 was 4.4% of GDP. It was only after the unpleasant surprise of the publication of the 8.5% deficit for 2011 (which was later revised to 9.4%) – which was well above the official 2011 target of 6% of GDP – that the newly elected government of Mariano Rajoy asked the European Commission for an initial relaxation of conditions. The target deficit was then set by Brussels at 5.3% of GDP for 2012. In July 2012, pressure on Spain’s sovereign rate – which approached 7% – then led the government to negotiate with the Commission to put off the 3% target to 2014 and to set a deficit target of 6.3% of GDP in 2012.

Tableau. Growth, fiscal impulse and the public deficit in Spain

	2007	2008	2009	2010	2011	2012
GDP growth (%)	3,5	0,9	-3,7	-0,3	0,4	-1,4
Fiscal impulse (% of GDP)	0,6	1,0	1,3	-2,2	-0,9	-3,3
Public deficit* (% of GDP)	1,9	-4,5	-11,2	-9,7	-9,4	-8,0

* The public deficit includes the financial support given to the banking sector.
Sources : Ministerio de Hacienda y Administraciones Publicas, OFCE forecast for 2012.

But the strategy of trying to reduce the deficit by 2.6 GDP points while in a cyclical downturn proved to be ineffective and even counter-productive. Furthermore, the result has not been worth the effort involved, even though the European authorities have praised it repeatedly. A succession of three consecutive years of austerity plans of historic proportions (2010, 2011 and 2012) has led to only a very small improvement in the budget balance (Table). The deficit was reduced by 3.2 percentage points in three years, while two years of crisis were enough to expand it by 13.3 points (from 2007 to 2009). The fiscal impulse was -2.2 percentage points of GDP in 2010, -0.9 point in 2011 and -3.3 points in 2012, or a total of 6.4 GDP points of fiscal effort (68 billion euros). Yet the crisis has precipitated the collapse of the real estate market and greatly weakened the banking system. Since then, the country has plunged into a deep recession: GDP has fallen by 5.7% since the first quarter of 2008, which puts it 12% below its potential level (assuming potential growth of 1.5% per year), with 26% of the workforce currently unemployed, in particular 56% of the young people.

The deterioration of Spain’s economic situation has hit tax revenue very hard. Between 2007 and 2011, the country’s tax revenues have fallen further than in any other country in the euro zone. Revenue declined from 38% of GDP in 2007 to 32.4% in 2011, despite a hike in VAT (2 points in 2010 and 3 points in 2012) and an increase in income tax rates and property taxes in 2011. The successive tax increases only slightly alleviated the depressive effect of the collapse of the tax base. VAT revenues recorded a sharp drop of 41% in nominal terms between 2007 and 2012, as did the tax on income and wealth (45%). In comparison, the decrease in tax revenue in the euro zone was much more modest: from 41.2% of GDP in 2007 to 40.8% in 2011. Finally, rising unemployment has undermined the accounts of the social security system, which will experience a deficit of 1 percentage point of GDP in 2012 for the first time in its history.

To compensate for the fall in tax revenue, the Spanish government had to take drastic measures to restrict spending to try to meet its commitments, including a 5% reduction in the salaries of civil servants and the elimination of their Christmas bonus; a hiring freeze in the public sector and increasing the work week from 35 to 37.5 hours (without extra pay); raising the retirement age from 65 to 67, along with a pension freeze (2010); a reduction of unemployment benefits for those who are unemployed more than seven months; and lowering severance pay from 45 days per year worked to 33 days (20 if the company is in the red). Even though household income has stagnated or declined, Spanish families have experienced a significant increase in the cost of living: a 5-point increase in VAT, higher electricity rates (28% in two years), higher taxes on tobacco and lower reimbursement rates for medicines (retirees pay 10% of the price and the employed 40% to 60%, depending on their income).

The social situation in Spain is very worrying. Poverty has increased (from 23% of the population in 2007 to 27% in 2011, according to Eurostat); households failing to pay their bills are being evicted from their homes; long-term unemployment has exploded (9% of the labour force); unemployed youth are a lost generation, and the best educated are emigrating. The VAT increase in September has forced households to tighten their budgets: spending on food declined in September and October 2012, respectively, by 2.3% and 1.8% yoy. Moreover, the Spanish health system is suffering from budget cuts (10% in 2012), which led to the closure of night-time emergency services in dozens of municipalities and to longer waiting lists for surgery (from 50,000 people in 2009 to 80,000 in 2012), with an average waiting time of nearly five months.

Social distress is thus at a peak. The movement of the *indignados* led millions of Spaniards to take to the streets in 2012, in protests that were often violently suppressed by riot police. The region of Catalonia, the richest in Spain but also the most indebted, is threatening to secede, to the consternation of the Spanish government. On 24 January, the Catalan government passed a motion on the region's sovereignty, the first step in a process of self-determination that could lead to a referendum in 2014.

Only a lasting return to growth would enable Spain to solve its budget problems through higher tax revenue. But the tightening of financing conditions on Spain's sovereign debt since the summer of 2012 has forced the government to strengthen its austerity policy, which is delaying the return to economic growth. Furthermore, the European Commission has agreed to provide financial assistance to Spain only if it renounces its sovereignty in budget matters, at least partially, which the government of Mariano Rajoy is still reluctant to accept. The initiative of the European Commission on the exclusion of capital expenditures from calculations of the public deficit for countries close to a balanced budget, the details of which will be published in the spring, is a step in the right direction (El Pais). But this rule would apply only to the seven countries where the fiscal deficit is below 3% of GDP (Germany, Luxembourg, Sweden, Finland, Estonia, Bulgaria and Malta), which leaves out the countries facing the most difficult economic situations. Greater awareness of the social dramas that underlie these poor economic performances should lead to greater respect for the fundamental rights of Europe's citizens. Moreover, in the 2013 iAGS report the OFCE showed that a restrained austerity policy (budget restrictions limited to 0.5 percent of GDP each year) is more effective from the viewpoint of both growth and deficit reduction in countries like Spain where the fiscal multipliers are very high (between 1.3 and 1.8, according to our estimates).

Repeat

By Jérôme Creel

In a beautiful book for children, every two pages Claude Ponti drew two chicks, one of which says to the other: “Pete and Repeat are in a boat. Pete falls overboard. Who is left?” Then the other chick says, “Repeat”, and off we go again. At the end of the book, the second chick, its eyes bulging, screams: “Repeat!” And it never stops. It’s a bit like these analyses of economic growth and fiscal contractions where almost every month it is rediscovered that the ongoing fiscal contractions are reducing economic growth or that underestimating the real impact of fiscal policy is leading to forecast errors.

Recently, and after having authored a box in the *2013 World Economic Outlook* in October 2012, Daniel Leigh and Olivier Blanchard of the IMF published a working document that confirms that the IMF’s recent forecasting errors are due to erroneous assumptions about the multiplier effect. Because this effect was underestimated, especially at the bottom of the economic cycle, the IMF forecasters, though they are not alone (see in particular the note by Bruno Ducoudré), underestimated growth forecasts: they had not anticipated that what was required by the austerity measures and their implementation would have such a negative impact on consumer spending and business investment. The attempt to reduce state debt was taking place during a period when households and businesses were also deleveraging, meaning that it would be difficult to avoid falling into the trap of recession.

Since it must be repeated, let’s repeat! “Expansionary-fiscal-contractions and Repeat are in a boat. Expansionary-fiscal-contractions falls overboard. Who is left in the boat? Repeat!” In support of this short story, it is worth referring to a literature review conducted by Eric Heyer: he shows the extent of the consensus that actually exists on the value of the fiscal multipliers, a consensus that has emerged since 2009, *i.e.* in the midst of a recession and at the very time that recommendations for austerity measures began to emerge. A note by Xavier Timbeau shows that the analysis of current fiscal cutbacks supports an assessment that the value of the fiscal multiplier is much higher in a crisis than in normal times … What paradoxes!

What is to be done now? Repeat, yet again, that recession may not be inevitable: as Marion Cochard, Bruno Ducoudré and Danielle Schweisguth pointed out in a supplement to the 2013 iAGS report, it is urgent to temper existing fiscal austerity measures in the euro zone: European growth but also actual fiscal consolidation would improve at last.

---

iAGS, independent Annual Growth Survey 2013

by OFCE (Paris), ECLM (Copenhagen) and IMK (Düsseldorf)

The independent Annual Growth Survey (iAGS) brings together a group of internationally competitive economists from three European economic institutes to provide an independent alternative to the Annual Growth Survey (AGS) published by the European Commission. iAGS 2013 focuses on the Eurozone economic outlook and on the sustainability of public finances until 2032. This first report advocates delaying and spreading fiscal consolidation in due respect of current EU fiscal rules.

Four years after the start of the Great Recession, the euro area remains in crisis. GDP and GDP per head are below their pre-crisis level. The unemployment rate has reached a historical record level of 11.6 % of the labour force in September 2012, the most dramatic reflection of the long lasting social despair that the Great Recession produced. The sustainability of public debt is a major concern for national governments, the European Commission and financial markets, but successive and large consolidation programmes have proven unsuccessful in tackling this issue. Up to now, asserting that austerity was the only possible strategy to get out of this dead end has been the cornerstone of policymakers' message to European citizens. But this assertion is based on a fallacious diagnosis according to which the crisis stems from the fiscal profligacy of members states. For the Euro area as a whole, fiscal policy is not the origin of the problem. Higher deficits and debts were a necessary reaction by governments facing the worst recession since WWII. The fiscal response was successful in two respects: it stopped the recession process and dampened the financial crisis. As a consequence, it led to a sharp rise in the public debt of all Euro area countries.

During normal times, sustainability of public debt is a long-term issue whereas unemployment and growth are short-term ones. Yet, fearing an alleged imminent surge in interest rates and constrained by the Stability and Growth Pact, though transition towards more normal times had not been completed, member states and the European Commission reversed priorities. This choice partly reflects well-known pitfalls in the institutional framework of EMU. But it is equally reflecting a dogmatic view in which fiscal policy is incapable of demand management and the scope of public administrations has to be fettered and limited. This ideology has led member states to implement massive fiscal austerity during bad times.

As it is clear now, this strategy is deeply flawed. Eurozone countries and especially Southern European countries have undertaken ill-designed and precipitous consolidation. The austerity measures have reached a dimension that was never observed in the history of fiscal policy. The cumulative change in the fiscal stance for Greece from 2010 to 2012 amounts to 18 points of GDP. For Portugal, Spain and Italy, it has reached respectively 7.5, 6.5 and 4.8 points of GDP. The consolidation has rapidly become synchronized leading to negative spillovers over the whole euro area, amplifying its first-round effects. The reduction in economic growth in turn makes sustainability of public debt ever less likely. Thus austerity has been clearly self-defeating as the path of reduction of public deficits has been by far disappointing regarding the initial targets defined by member states and the Commission.

Since spring 2011 unemployment within the EU-27 and the Euro zone has begun to increase rapidly and in the past year alone unemployment has increased by 2 million people. Youth unemployment has also increased dramatically during the crisis. In the second quarter of 2012 9.2 million young people in the age of 15-29 years were unemployed, which corresponds to 17.7 percent of the 15-29 years old in the workforce and accounts for 36.7 percent of all unemployed in the EU-27. Youth unemployment has increased more dramatically than the overall unemployment rate within the EU. The same tendencies are seen for the low skilled workers. From past experience it is well known that once unemployment has risen to a high level it has a tendency to remain high the years after. This is known as persistence. Along with the rise in unemployment the first symptoms that unemployment will remain high in the coming years are already visible. In the second quarter of 2012 almost 11 million people in EU had been unemployed for a year or longer. Within the last year long term unemployment has increased with 1.4 million people in the EU-27 and with 1.2 million people within the Euro area.

As a result of long term unemployment the effective size of the workforce is diminished which in the end can lead to a higher structural level in unemployment. This will make more difficult to generate growth and healthy public finances within the EU in the medium term. Besides the effect of long term unemployment on potential growth and public finances one should also add that long term unemployment may cause increased poverty because sooner than expected unemployment benefits will stop. Thus long term unemployment may also become a deep social issue for the European society. Given our forecast for unemployment in EU and the Euro area, we estimate that long term unemployment can reach 12 million in EU and 9 million in the Euro area at the end of 2013.

What is striking is that consequences of ill-designed consolidation could and should have been expected. Instead, they have been largely underestimated. Growing theoretical and empirical evidence according to which the size of multipliers is magnified in a fragile situation has been overlooked. Concretely, whereas in normal times, that is when the output gap is close to zero, a reduction of one point of GDP of the structural deficit reduces activity by a range of 0.5 to 1% (this is the fiscal multiplier), this effect exceeds 1.5% in bad times and may even reach 2% when the economic climate is strongly deteriorated. All the features (recession, monetary policy at the zero bound, no offsetting devaluation, austerity amongst key trading partners) known to generate higher-than-normal multipliers were in place in the euro area.

The recovery that had been observed from the end of 2009 was brought to a halt. The Euro area entered a new recession in the third quarter of 2011 and the situation is not expected to improve: GDP is forecast to decrease by 0.4 % in 2012 and again by 0.3 % in 2013. Italy, Spain, Portugal and Greece seem to sink in an endless depression. The unemployment soared to a record level in the Eurozone and especially in Spain, Greece, Portugal and Ireland. Confidence of households, non financial companies and financial markets has collapsed again. Interest rates have not receded and governments of Southern countries still face unsustainable risk premium on their interest rate, despite some policy initiatives, while Germany, Austria or France benefit from historically low interest rates.

Rather than focus on public deficits the underlying cause of the crisis needs to be addressed. The euro area suffered primarily from a balance of payments crisis due to the build-up of current account imbalances between its members. When the financial flows needed to finance these imbalances dried up the crisis took hold in the form of a liquidity crisis. Attempts should have been made to adjust nominal wages and prices in a balanced way, with minimal harm to demand, output and employment. Instead salvation was sought in across-the-board austerity, forcing down demand, wages and prices by driving up unemployment.

Even if some fiscal consolidation was almost certainly a necessary part of a rebalancing strategy to curb past excesses in some countries, it was vital that those countries with large surpluses, especially Germany, took symmetrical action to stimulate demand and ensure faster growth of nominal wages and prices. Instead the adjustment burden was thrust on the deficit countries. Some progress has been made in addressing competitive imbalances, but the cost has been huge. Failure to ensure a balanced response from surplus countries is also increasing the overall trade surplus of the euro area. This is unlikely to be a sustainable solution as it shifts the adjustment on to non-euro countries and will provoke counteractions.

There is a pressing need for a public debate on such vital issues. Policymakers have largely ignored dissenting voices, even as they have grown louder. The decisions on the present macroeconomic strategy for the Euro area should not be seized exclusively by the European Commission at this very moment, for the new EU fiscal framework leaves Euro area countries some leeway. Firstly, countries may invoke exceptional circumstances as they face “*an unusual event outside the control of the (MS) which has a major impact on the financial position of the general government or periods of severe economic downturn as set out in the revised SGP (…)”.* Secondly, the path of consolidation may be eased for countries with excessive deficits, since it is stated that “*in its recommendation, the Council shall request that the MS achieves annual budgetary targets which, on the basis of the forecast underpinning the recommendation, are consistent with a minimum annual improvement of at least 0.5 % of GDP as a benchmark, in its cyclically adjusted balance net of one-off and temporary measures, in order to ensure the correction of the excessive deficit within the deadline set in the recommendation*”. This is of course a minimum, but it would also be seen as a sufficient condition to bring back the deficit to Gdp ratio towards 3 % and the debt ratio towards 60 %.

A four-fold alternative strategy is thus necessary:

First, delaying and spreading the fiscal consolidation in due respect of current EU fiscal rules. Instead of austerity measures of nearly 100 billion euros for the whole euro area, a more balanced fiscal consolidation of 0.5 point of GDP, in accordance with treaties and fiscal compact, would give for the sole 2013 year a concrete margin for manoeuvre of more than 60 billion euros. This amount would substantially contrast with the vows of the June and October 2012 European Councils to devote (still unbudgeted) 120 billion euros until 2020 within the Employment and Growth Pact. By delaying and capping the path of consolidation, the average growth for the Eurozone between 2013 and 2017 may be improved by 0.7 point per year.

Second, it involves that the ECB fully acts as a lender of last resort for the Euro area countries in order to relieve MS from the panic pressure stemming from financial markets. For panic to cease, EU must have a credible plan made clear to its creditors.

Third, significantly increasing lending by the European Investment Bank as well as other measures (notably the use of structural funds and project bonds), so as to meaningfully advance the European Union growth agenda. Vows reported above have to be transformed into concrete investments.

Fourth, a close coordination of economic policies should aim at reducing current accounts imbalances. The adjustment should not only rely on deficit countries. Germany and the Netherlands should also take measures to reduce their surpluses.

Social action, but no end of the crisis

Evaluation of the five-year economic programme (2012-2017)

By Eric Heyer, Mathieu Plane, Xavier Timbeau

The initial decisions of the five-year programme are coming amidst an extremely difficult and very uncertain economic situation. In a recent *OFCE Note* (No. 23 of 26 July 2012), we first analyze the macroeconomic context for François Hollande's five-year programme and the XIVth legislature. This analysis details the likely consequences for the next five years of the strategy currently being implemented in Europe. We evaluate both the cost to the public finances as well as the impact on economic activity, employment and the distribution of income. In part two, we analyze the public policy choices being given priority by the new government, including both those aimed at the young (generation contracts, jobs of the future), at some seniors (revision of the pension reform), and at the middle and lower classes (allowance for the start of school, boost to the minimum wage, Livret A bank accounts, rent control, revised taxation of overtime), as well as those intended to revive certain public expenditures that are deemed essential (public jobs in education, the justice system and the police in the "public finance" section, and public early childhood services).

François Hollande was elected President of the French Republic at a time when France and Europe are going through an unprecedented crisis. Unemployment in metropolitan France has increased by over 2 percentage points since the crisis began and is now (in ILO terms, 9.6% of the workforce in first quarter 2012) approaching the record levels of 1997 (10.5%). Gross domestic product per capita in terms of purchasing power has fallen since 2008 by 3%. If the growth trend for the five years preceding the crisis had continued at that same rate from 2008 until early 2012, GDP per capita would now be 8% higher than it is. The current account has deteriorated during the crisis by 1.5 GDP points (25.7 billion euros, 10 billion of which is for the oil bill), thus worsening France's net balance of trade by 7.8 GDP points. The public debt increased by 577 billion (nearly 30 GDP points), and at the beginning of 2012 represented almost 90% of GDP. Industry has paid a heavy price for the crisis (almost 300,000 jobs lost), with all signs indicating that the job losses and closures of industrial sites might be irreversible.

Yet this dire situation, which can be chalked up to the crisis that began in 2008, is not over. Due to the impact of austerity policies implemented at a time of panic at seeing financing of the public debt dry up, the sovereign debt crisis is threatening the euro zone with a prolonged recession in 2012 and 2013. And the even worse scenario looming on the horizon – the disintegration of the euro zone – would transform the threats of recession into the risk of a major depression.

Assessments of the situation differ depending on the elements available. Some measures have been implemented by decree, while others are being discussed by the legislature, but the proposed bills do permit a quantitative analysis. Others are in the planning stage, with the main trade-offs still to be made, so our assessment tries to explore the main points.

Our assessment of the economic strategy for the five-year programme does not stop there. The outlines of the premises for a strategy to end the crisis can now be seen. The deficit reduction commitments and the initial steps taken in this direction in the budget packages in July 2012, such as those announced during the budget orientation debate of June 2012, point to a strategy whose first step is the achievement of a reduction in the public deficit to 3% of GDP by the end of 2013, regardless of the cost. Based on this fiscal virtue, this amounts to a strategy to end the crisis by stabilizing the state of the public accounts, thereby reassuring the financial markets and other economic agents and establishing the conditions for a strong future recovery. This strategy is based on cutting public expenditures and raising taxes (see the "public finance" section, government tax proposals and the taxation of the oil companies).

This strategy for ending the crisis is risky, to say the least, because it does not take full account of the crisis facing Europe today. It might be justified if we were already on course to end the crisis and if the point were simply to set priorities. But Europe remains in a situation of extreme uncertainty, living in the expectation of a massive failure of one or another Member State in the euro zone, fearing the collapse of this or that financial institution, and suffering the consequences of a spiral of austerity that is being fueled by rising sovereign interest rates. In this situation, everything is coming together to strengthen the existence of a liquidity trap and to generate high fiscal multipliers. Given this, *ex ante* reductions in the deficit through tax hikes and spending cuts is weighing heavily on activity, and thus limiting or even cancelling out any actual deficit reductions. The factors pushing up the public debt are not being reversed, and the reduction in activity is heightening the risk that the unsustainable private debt will be socialized. The increase in sovereign interest rates is being fueled by an inability to meet deficit reduction targets and by rising public debt, and is thus pushing public deficits higher, forcing even more austerity.

One response to this dynamic that is bringing about the collapse of the euro would be one form or another of pooling public debts in Europe. This would require relatively complete control of the budgets of member countries by a federal body with strong democratic legitimacy. A response like this would therefore mean “more Europe”, and would make it possible to define “more moderate” austerity policies for France as well as its major trading partners. It would make putting an end to involuntary mass unemployment and the liquidity trap prerequisites to an improvement in the public finances. It would also make it possible to ensure the sustainability of public finances without leading to the lost decades that are now gestating.

In the first part of the Note, we analyze the macroeconomic context for François Hollande’s five-year programme and the XIVth legislature. This analysis details the likely consequences for the next five years of the strategy currently being implemented in Europe. The value of the fiscal multiplier is a critical parameter, and we show that the current strategy is valid only if the multipliers are low (*i.e.* on the order of 0.5). However, a slew of empirical evidence indicates that, in the exceptional situation we are experiencing today, the budget and fiscal multipliers may be larger than 0.5 (between 1 and 1.5, see the Note). We detail in a second part the measures taken in the Supplementary Budget Act of July 2012 (for 2012) and the elements outlined in the budget orientation debate in preparation for the Budget

Act for 2013 and for the period 2012-2017. To succeed in reducing the public deficit to 3%, it seems that there must be over 10 billion euros in additional tax revenue or in savings on expenditure, *ex ante*.

We then present an evaluation of eleven measures. Guillaume Allègre, Marion Cochard and Mathieu Plane have estimated that the implementation of the *contrat de génération* [“generation contract”] could create between 50,000 and 100,000 jobs, at the cost of a strong deadweight effect. Eric Heyer and Mathieu Plane point out that in the short term, subsidized *emplois avenir* [“jobs for the future”]-type contracts can help to reduce unemployment. Eric Heyer shows that the revision of taxation on overtime will help to cut the public deficit by 4 billion euros, without hurting the labour market. Guillaume Allègre discusses the consequences of increasing the *Allocation de rentrée scolaire* [allowance for the start of school] and shows that it mainly benefits the lowest five deciles in terms of standard of living. Henri Sterdyniak analyzes the possibilities for fiscal reform. The point is not to evaluate the government’s proposals for fiscal reform, but to provide a comprehensive overview of the current system’s margin for change and its inconsistencies. Henri Sterdyniak and Gérard Cornilleau evaluate the increased opportunities for retiring at age 60 and analyze the possible paths to a more large-scale reform of the pension system. Hélène Périvier evaluates the possibilities for an early childhood public service, the eventual cost of which could be covered in part by an increase in activity that would generate more than 4 billion euros. Eric Heyer and Mathieu Plane analyze the impact of a boost in the minimum wage (SMIC) and conclude that, given the small spillover of increases in the SMIC onto the rest of the wage structure, the impact on the cost of labour is limited by the greater reduction in social charges on low wages. While the effect on employment is small, it would cost the public purse 240 million euros. Sabine Le Bayon, Pierre Madec and Christine Rifflart evaluate rent control. Hervé

Péléraux discusses the compensation of Livret A bank accounts and the impact of doubling their ceiling. Céline Antonin and Evens Salies evaluate the new taxes on the oil companies, which could provide 550 million euros in tax revenue in 2012, at the risk that this tax might ultimately be passed on to the end consumer.