

# Does financial instability really undermine economic performance?

By [Jérôme Creel](#), [Paul Hubert](#) and Fabien Labondance

What relationship can be established between the degree to which an economy is financialized (understood as the ratio of credit to the private sector over GDP), financial instability and economic performance (usually GDP per capita) in the European Union (EU)? [A recent working paper \[1\]](#) attempts to provide a few answers to this question.

Two major competing approaches can be found in the economic literature. On the one hand, an approach inherited from Schumpeter emphasizes the need for entrepreneurs to access sources of credit to finance their innovations. The financial sector is thus seen as a prerequisite to innovative activity and a facilitator of economic performance. On the other hand, financial development can be viewed instead as the result or consequence of economic development. Development implies increased demand for financial services on the part of households and businesses. There is therefore a source of endogeneity in the relationship between financial development and economic growth, as one is likely to lead to the other, and vice versa.

Until recently, analytical studies that attempted to disentangle and quantify these causalities showed a positive significant link between an economy's financial depth and its economic performance ([Ang, 2008](#)). However, the onset of the international financial crisis led to nuancing these conclusions. In particular, [Arcand et al. \(2012\)](#) showed that beyond a certain level the impact of increased financialization becomes negative [\[2\]](#). The relationship

between financialization and economic performance can be represented by a bell curve: positive at the beginning and then, from a level of 80%-100% for the private credit to GDP ratio, fading to zero or turning negative.

Unlike other works that include both developed and emerging or developing countries, our study focuses on the EU Member States from 1998 to 2011. The advantage of this sample is that we include only economies whose financial systems are developed or at least in advanced stages of development [3]. Moreover, it is a relatively homogeneous political space that permits the establishment of common financial regulations. We adopt the methodology of [Beck & Levine \(2004\)](#) who, using a panel and instrumental variables, are able to resolve the endogeneity issues discussed above. Economic performance is explained by the usual variables in endogenous growth theory, namely initial GDP per capita, the accumulation of human capital over the average years of education, government expenditure, trade openness and inflation. In addition, we include the aforementioned financialization variables. We show that, contrary to the usual results in the literature, an economy's financial depth does not have a positive impact on economic performance as measured by GDP per capita, household consumption, business investment or disposable income. In most cases, the effect of financialization is not different from zero, and when it is, the coefficient is negative. It is therefore difficult to argue that financial and economic development go hand in hand in these economies!

In addition, we included in these estimates different variables quantifying financial instability so as to check whether the results set out above might be due simply to the effects of the crisis. These financial instability variables (Z-score [4], CISS[5], bad debt rate, the volatility of stock market indices and an index reflecting the microeconomic characteristics of Europe's banks) usually seem to have a significant *negative* impact on economic performance. At the

same time, the variables measuring the *degree* of an economy's financialization show no obvious effects on performance.

These various findings suggest that it is certainly unrealistic to expect a positive impact of any further increase in the degree of financialization of Europe's economies. It is likely that the European banking and financial systems have reached a critical size beyond which no improvement in economic performance can be expected. Instead, there are likely to be negative effects due to the financial instability arising out of a financial sector that has grown overly large and whose innovations are insufficiently or poorly regulated.

The findings of this study suggest several policy recommendations. The argument of the banking lobbies that regulating bank size would have a negative impact on growth finds absolutely no support in our results—quite the contrary. Furthermore, we show that financial instability is costly. It is important to prevent it. This undoubtedly requires developing a better definition of micro- and macro-prudential standards, together with effective supervision of Europe's banks. Will the forthcoming banking union help in this regard? There are many sceptics, including the economists of [Bruegel](#), the [Financial Times](#) and the [OFCE](#).

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[1] Creel, Jérôme, Paul Hubert and Fabien Labondance, “Financial stability and economic performance”, *Document de travail de l'OFCE*, 2013-24. This study was supported by funding from the European Union Seventh Framework Program (FP7/2007-2013) under grant agreement no. 266800 (FESSUD).

[2] We consider this work in an earlier [post](#).

[3] In addition to the ratio of private sector credit to GDP, the depth of financialization is also indicated by the turnover ratio, which measures the degree of liquidity of financial markets, measured as the ratio of the total value of shares traded to total capitalization.

[4] Index measuring the stability of banks based on their profitability, their capital ratio and the volatility of their net income.

[5] Index of systemic risk calculated by the ECB and including five components of the financial system: the banking sector, non-bank financial institutions, money markets, securities markets (stocks and bonds) and foreign exchange markets.

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# What's masked by the fall in US unemployment rates

By Christine Riffart

Despite the further decline in the US unemployment rate in December, data from the Bureau of Labor Statistics released last week confirms paradoxically that the American labour market is in poor health. The US unemployment rate fell by 0.3 percentage point from November (-1.2 points from December 2012) to end the year at 6.7%. The rate has fallen 3.3 percentage points from a record high in October 2009, and is coming closer and closer to the [non-accelerating inflation rate of unemployment](#) (NAIRU), which since 2010 has been set by the OECD at 6.1%. However, these results do not at all reflect a rebound in employment, but instead mask a further

deterioration in the economic situation.

While the unemployment rate is the standard indicator for summarizing how tight a labour market is, this can also be considered using two other indicators, *i.e.* the employment rate and the labour force participation rate – in the US case, these give a different view of the state of the labour market (see chart).



After falling nearly 5 percentage points in 2008 and 2009, the employment rate has been constant for 4 years, at the level of the early 1980s (58.6%, following a peak of 63.4% at end 2006). Since then, the decline in the unemployment rate has reflected the decline in the participation rate, a trend that is confirmed by the figures for December. Over the period 2010-2013, the participation rate lost a little more than 2 percentage points, to wind up at end December at its lowest level since 1978 (62.8%, following a peak of 66.4% at end 2006).

This poor performance is due to insufficient job creation, which has a threefold impact. Despite positive GDP growth – which contrasts with the recession in the euro zone – demand is far from sufficient to reassure business and revitalize the labour market. After four years of recovery, at end 2013

employment has still not returned to its pre-crisis level. Net creation of salaried jobs in the private sector has not even been sufficient to absorb the demographic increase in the working age population. As a result, the employment rate is not improving from where it bottomed out.

Moreover, the difficulty in finding employment is encouraging the exit or delaying the entry or return of people who are old enough to participate in the labour market. This effect, familiar to economists, is called *effet de flexion* ("bending effect") in French: young people are encouraged to study longer, women stay at home after raising their children, and unemployed people become discouraged and stop looking for work. Despite the resumption of economic growth and job creation, this effect continued to be felt in full in 2013. While the reduction in the participation rate slowed in 2011 and 2012 – the growth of the labour force was once more positive but remained lower than that of the working-age population – it accelerated in 2013 with the decline in the labour force. During the second half of 2013, 885,000 people were in effect diverted away from the labour market, due in particular to the more difficult economic and social conditions.

Companies seem reluctant to rehire in the particularly difficult economic context. The fiscal shock in early 2013 depressed activity: GDP growth fell from 2.8% in 2012 to an expected level of about 1.8% in 2013. There will be additional fiscal adjustments in 2014. Beyond drastic cuts (related to sequestration [\[1\]](#)) in state spending, some exceptional measures that have been in force since 2008-2009 for the poorest households and the long-term unemployed (3.9 million out of the 10.4 million unemployed) are coming to an end and have not been renewed. According to estimates by the [Centre on Budget and Policy Priorities \(CBPP\)](#), 1.3 million unemployed who have exhausted their entitlement to basic benefits (26 weeks) and who have enjoyed an exceptional extension will find

themselves without support as of 1 January 2014 due to the non-renewal of the measure, and nearly 5 million unemployed will be affected by the end of the year.

There is a risk of growing numbers of people falling into poverty in this situation. According to the Census Bureau, since 2010 the poverty rate has been about 15%. However, again according to the [CBPP](#), unemployment benefits would have prevented 1.7 million people from falling below the poverty line. The greater difficulties facing the long-term unemployed and the withdrawal of part of the population from the labour market are the direct result of a morose labour market, which is not indicative of a continuous decline in the unemployment rate.

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[1] See [America's fiscal headache](#) written 9 December 2013.

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## **Important change of course at the Elysée Palace. Austerity is no longer the priority**

By [Xavier Timbeau](#), Twitter: @XTimbeau

(published in [Le Monde on Thursday 16 January 2014](#), p. 17)

When he was elected François Hollande made fiscal discipline his main goal. The 2008 crisis was continuing to have an

impact on the developed economies; in the face of a sovereign debt crisis, Europe's governments had been implementing austerity measures that were to cause a second recession, a "double dip", to use the language of economists. For example, when François Hollande came to power, the situation in France seemed disastrous: the public deficit was 5.2%, with a rise in the public debt of more than 600 billion euros since 2008 along with a 2-point rise in unemployment (to 9.6% of the workforce). The pressure was intense, and, the euro zone states were falling like dominos, with Spain and Italy in danger of following Greece, Portugal and Ireland. In this context, it seemed that only budgetary discipline could help Germany to support a faltering euro zone.

Yet the worst was still to come. By underestimating the magnitude of the fiscal multipliers (the impact of fiscal policy on activity), as was eventually recognized by the International Monetary Fund (IMF) and the European Commission, and as we had pointed out in July 2012, the consequences of generalizing this unprecedented fiscal effort throughout the European Union were dismissed.

What François Hollande had presumed would be a painful recovery preceding a rebound that would open up new possibilities proved instead to be a period of economic stagnation, where rising unemployment went in hand with bad fiscal news. When the fiscal multiplier is high, nothing works. The budget efforts were weighing down economic activity, and there was no real re-absorption of the government deficits. If this infamous multiplier had been low, François Hollande's strategy – and that of the euro zone as a whole – would have worked. But the multiplier is not at our beck and call; it was the result of an economic situation in which the balance sheets of agents were degraded, with the banks suffocating and expectations dire.

The second part of François Hollande's five-year term, which the press conference of 14 January 2014 was to launch, is now



much more complicated than expected. Instead of a recovery in public finances, the debt has barely been stabilized despite an incredible effort. Instead of a strong recovery, what we have is, in the understated language of the INSEE, a “sluggish recovery”, which really amounts to continuing recession, with unemployment rising relentlessly. Our businesses are anaemic, and to try to restore their margins, the tax credit for competitiveness and employment (the “CICE”), inspired by the Gallois report, has not really injected new blood.

To lower the cost of labour without increasing the deficit, households, though exhausted, have to be hit again. The fiscal multiplier is still high, and growth, along with a reversal in the trend in unemployment, is being postponed. Worse, the commitment to Brussels to reduce the public deficit (a structural effort of 0.8 GDP point by the end of the five-years, *i.e.* 50 billion euros in total) will postpone a reduction in unemployment until after 2017. The patient may well die from the cure, and at best it will be Hollande’s successor in the 2017 elections, which he’s lost in advance, who might hope to reap the benefits of a policy that prioritized deficit reduction at the worst possible time.

The responsibility pact now proposed by François Hollande is setting out a different path, a different choice. Instead of austerity, a reduction in the cost of labour is to be financed not by taxes but by fiscal spending (amounting to 1 GDP point). The bet is that the growth stimulated will bring in additional revenue to meet the commitments on the public deficit. A reduction in social charges of thirty billion euros was announced, replacing the current CICE (20 billion). This means an additional 10 billion euros that can be obtained by companies that are to engage in collective bargaining under the watchful eye of a bipartisan watchdog. While this does not simplify the complex CICE, it will promote social dialogue.

On the other hand, François Hollande confirmed that the target for cutting public expenditure remains, *i.e.* 16 billion euros

in 2015 and 18 billion in 2016 and 2017, for a total of 50 billion, with no increase on previous announcements. The CICE was partially funded by an increase in VAT (6 billion euros from 2014) and environmental taxes (4 billion). Replacing the CICE with cuts in social charges gives room for finesse: if companies benefit from the lower labour costs to boost their profits, then taxes on these profits will reduce the bill for the state by 10 billion euros (one-third of 30 billion). If, however, they increase employment and wages or lower their prices or invest, then there will be an increase in activity and the financing will come through growth.

Compared with France's budget commitments to Brussels (an 0.8 point reduction in the structural deficit every year), there will be a 20 billion euro fiscal stimulus based on lowering labour costs by 2017. This GDP point could lead to the creation of 250,000 jobs by 2017 and allow a one-point drop in unemployment. This is a substantial change of course from the priority given up to now to deficit reduction. A choice has been made to focus on business and push companies to create new activity or jobs through a pact. This is a significant step, but there is still more to be done to put an end to austerity, to repair the social damage done and to take radical action to reduce unemployment.

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**The war between taxis and  
chauffeur-driven private  
cars: everyone has their**

# reasons

By [Guillaume Allègre](#)

*Editor's note:* This post was first published on the OFCE blog on 21 October 2013, when the issue of car with driver services was a subject of intense debate. Given the recent events in France, it seemed appropriate to republish this text by Guillaume Allègre.

*"What's worse is that everyone has their reasons"*

Jean Renoir, *La Règle du jeu*

In the war between taxis and chauffeur-driven private cars (*voitures de tourisme avec chauffeur* – VTCs), everyone has their reasons. We noted in [a previous post](#) that the discourse on innovation masked a classic conflict over distribution between producers, who want to defend their incomes, and consumers, who want an inexpensive quick-response taxi service including at peak times. This conflict is coupled with another no less classic one between holders of licenses with a scarcity value and new entrants, who support opening up the market.

In this conflict the current regulatory system is absurd. Limiting the number of taxi licenses was intended to support the income of independent taxis and prevent them from working too many hours per day to achieve a decent income. However, the authorities have committed two errors. First, by allowing the transfer of licenses, they transferred the benefit of quotas on taxi drivers to the license owners: a taxi driver now must either rent their license or buy it at a price reflecting its scarcity value (230,000 euros in Paris in 2012!). The current situation is even more absurd given that new licenses are [allocated free of charge](#) (to a waiting list): if the *préfet* allocates 1000 new licenses for free, then a value of 230 million euros at market prices will be

transferred to the fortunate winners (who may subsequently rent out the licenses)!

The second error is that the government has allowed the taxi license bubble to expand. The high price of licenses clearly reflects that supply is too low relative to demand. But it would now be unfair to penalize those who have just spent a fortune acquiring a license by, for example, massively increasing their number: why should recent purchasers pay for the shilly-shallying of the regulatory authorities?

### **What's the solution?**

It would be preferable to put an end to a system that generates constant worry about the value of licenses issued for free. But redeeming all the licenses at their market price would be costly and would result in the unjust enrichment of those who received a license for free.

One solution, which was proposed in the [previous post](#), is to buy the current licenses over time (as taxi drivers retire), not at their market value but at their acquisition value plus interest, and to assign new licenses that are free but not transferable. This system would compensate recent purchasers, without contributing to the unjust enrichment of those who have obtained a license for free or at a very low price. It would allow a transition from a system of transferable licenses to a system of non-transferable licenses in which the number of licenses in circulation and the division of the market between chauffeured cars and taxis would depend on the demand for services and not on the nuisance power of one or the other party. This system is of course complex, but it would help to overcome past mistakes in the fairest way possible.

For further information: [Chauffeur-driven private cars: Victory of the anti-innovation lobby?](#)

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# Latvia: goodbye lats, hello euro!

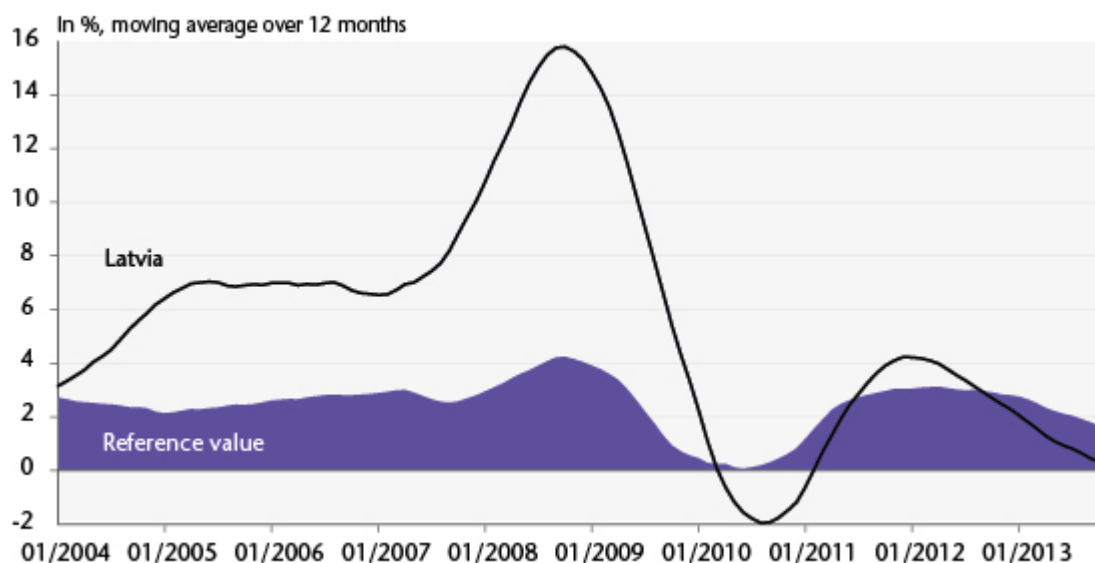
By [Céline Antonin](#)

On 1 January 2014, Latvia will become the 18th member of the euro zone, two years after its Estonian neighbour. From a European perspective, Latvia's entry into the "euro club" may seem of merely incidental importance. The country accounts for only 0.2% of euro zone GDP, and its integration is above all politically symbolic – it represents the culmination of the fiscal and monetary efforts undertaken by the country, which was hit hard by the crisis in 2008-2009 that slashed its GDP by almost a fifth.

At the end of 2008, facing an emergency situation, the country requested international assistance from the IMF and the European Union, which granted this in return for a drastic austerity plan. The aid came to some 7.5 billion euros, about one-third of the country's GDP. The national debt thus rose sharply between 2007 and 2012, from 9% of GDP to 40%. Latvia undertook a fiscal purge in order to boost its competitiveness and reduce its public deficit by drastically lowering public spending, wages and pension payments. This internal devaluation strategy led to sharp disinflation, which allowed Latvia to meet the ERM II goal for price stability (see chart). In accordance with IMF advice, the country has stuck to its goal of joining the euro zone quickly while categorically refusing to use the weapon of an external devaluation to get out of the crisis. It has for instance

adhered to its policy of maintaining a fixed exchange rate against the euro without interruption since 1 January 2005.

Figure : Price stability in Latvia with respect to inflation criteria



Sources : Eurostat, author's calculations.

2011 saw the country's return to growth, which was driven mainly by external demand from the Nordic countries and Russia. As for the public deficit, it rose from 9.8% of GDP in 2009 to 1.3% in 2012. Sovereign bond rates have fallen, which enabled the country to borrow only 4.4 billion euros (instead of the 7.5 billion planned) and to repay its debt to the IMF (three years in advance). Public debt has stabilized at around 40%. In addition, Latvia has met its inflation target over the reference period used to decide the issue of its euro zone membership. These various factors led the European Union to give it the green light in June 2013.

So is the entry of Latvia of merely incidental importance? Not entirely. First, Latvia has still not erased the scars of the crisis; in 2012, GDP was below its 2007 level in real terms. Furthermore, while the unemployment rate has been cut almost in half since 2009, it still represents 11.9% of the workforce, and most importantly, this reduction has been due in part to high emigration. But above all, as was pointed out by the European Central Bank in its Convergence Report, nearly one-third of bank deposits (a total of 7 billion euros) are

held by non-residents, particularly from Russia. As with Cyprus, this poses a high risk to banking stability in a crisis situation, with the potential for capital flight. At a time when the proposed banking union is stumbling up against the heterogeneity of the euro zone's banking systems, this illustrates yet again that it is very difficult to reconcile the logic of economic integration with the political choice of enlargement. Whether at the level of the euro zone or at the level of the European Union, it is time for Europe to make a clear choice between these two opposing logics.

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## Part-time work

By [Françoise Milewski](#)

Part-time work as a share of total employment has increased significantly. This increase was limited in the 1970s and then accelerated in the 1980s and especially in the 1990s. During the 2000s and early 2010s, changes in the long-term trend were less pronounced. Overall, the share of part-time work more than doubled in the last forty years and now accounts for nearly one-fifth of employment.

This development is the result of a number of social and economic trends. It reflects both changes in the labour market – growth in the tertiary sector to the detriment of industry and the proliferation of categories of employment – and inequalities between women and men. It is also the fruit of public policy.

Part-time jobs are occupied mostly by women. They are also predominantly held by employees aged 25 to 49, although a

trend towards part-time work has emerged among seniors. Part-time jobs are usually low-skilled. Although these jobs often involve working 15 to 29 hours a week, working times can vary greatly, with a trend towards a greater portion of shorter work weeks. Part-time employees generally are not on fixed-term contracts, so it is a stable form of employment. Whether monthly or hourly, wages are low, and part-time employees are overrepresented among minimum wage and low-wage workers. Work schedules that are atypical and which can involve multiple shifts, with fluctuating unpredictable schedules, generally mean poorer working conditions.

Part-time work is heterogeneous in terms of both the reasons given by employees who may request it as well as the ways businesses are organized in different economic sectors. There are thus multiple logics involved in part-time work (which in French leads to use of the term "des temps partiels" to account for this multiplicity).

The development of the service sector has spurred the increase in part-time work. Part-time jobs in sectors such as retailing and distribution, hotels and catering, cleaning, personal services and some public services are predominantly occupied by women. This reflects the type of training women have acquired, stereotypes about the natural aptitude they supposedly have to care for others, and their overrepresentation in low or unskilled work. The tradeoffs women make between work and family tasks reinforce these trends, either because full-time work seems incompatible, or because after parental leave they prolong the reduction in work that they have experienced. After an extended leave, it can sometimes be very difficult to reintegrate the world of work.

Increasing labour flexibility in recent decades has reinforced these trends. The multiplication of forms of employment has affected women in particular, both because they work mainly in the sectors that have been at the origin of this trend and



because women are at a disadvantage in the labour market and more readily accept poorly paid jobs.

During certain periods public policy has favoured part-time employment while at others it has sought to limit its impact. At the junction between employment-related goals and family-related goals, policy has sometimes suffered from being inconsistent.

There are sometimes significant differences between countries within the European Union, as a result of specific historical developments, different social consensuses, and specific regulations on the labour market.

Analyzing the current situation and identifying the changes underway provides a glimpse of the potential changes to come and thus fuels debate about these developments and their implications for policy makers. Do part-time work and full-time work develop according to the same dynamics? Is there a trend within part-time work towards greater flexibility, or less? To what extent is women's autonomy being challenged by the development of part-time work as a stable form of employment? Is part-time work a form of underemployment or a way of getting into the labour market and full-time work? All of these are questions that influence the development of public policy<sup>[1]</sup>.

For further information, read the [OFCE Note, no. 38 of 13 December 2013](#).

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<sup>[1]</sup> This article summarizes a study by the Labor and Employment section of the Conseil économique, social et environnemental [Economic, Social and Environmental Council], "Part-time work ," Françoise Milewski , Les Editions des Journaux officiels, December 2013, forthcoming.

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# How can a basic income be defended?

By [Guillaume Allègre](#)

Following the submission of 125,000 signatures collected by organizations supporting the introduction of a basic income, Swiss citizens will vote in a referendum on a popular initiative on the inclusion of the principle of an unconditional basic income in the Swiss Federal Constitution.

An [OFCE Note \(no. 39 of 19 December 2013\)](#) analyses the grounds for supporting the institution of a basic income.

While a basic income can take many forms, its principle is that it is paid (1) on a universal basis, in an equal amount to all, without testing for means or needs, (2) on an individual basis and not to households, and (3) unconditionally, without requirement of any counterpart. A progressive version would add a fourth characteristic: it must be (4) in an amount sufficient to cover basic needs and enable participation in social life.

While this looks attractive, it is not easy to find grounds in terms of distributive justice that are consistent with these four characteristics of a guaranteed basic income. So long as there exist economies of scale and a political trade-off between conditionality and the level of minimum income, then in a Rawlsian perspective a system of guaranteed minimum income like the French RMI / RSA programme (family-based with weak conditionality) seems preferable to a pure basic income.

In addition, the generalized reduction of working time seems more sustainable than a guaranteed basic income for achieving the ecological and emancipatory goals that are often attributed to a guaranteed basic income.

It seems that the main advantage of a guaranteed basic income is that its universality means that it does not cause any undue use or non-use and so does not stigmatize the net beneficiaries of the system. From this perspective, minimum income support could be turned into a universal benefit, which would be less stigmatizing. This allocation needs to take into account family composition and set conditions on social participation. It would involve checks on black market work and include incentives to work. It would be supplemented by specific policies to provide support for children, the elderly and disabled people, *i.e.* people who do not respond to incentives, and it would complement the insurance system (unemployment, retirement, illness). The social protection system would thus not really be simplified but transformed in such a way as to avoid stigmatization and the lack of take-up.

While a guaranteed basic income is not a stupid idea, nor is it the miracle reform pictured by its advocates, *i.e.* a veritable Swiss Army knife for reforming social welfare, a social and environmental emancipator.

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## Europe's banks: sustaining

# the renewal of confidence

By [Céline Antonin](#) and [Vincent Touzé](#)

Since August 2012, bank shares in the stock markets have risen and their volatility has reduced, attesting to a return of confidence. Is this newfound confidence sustainable? [OFCE Note no. 36 of 11 December 2013](#) attempts to answer this question by taking stock of the state of the banks in late 2013.

The financial crisis saw the valuation of banks suffer due to both a decline in the profitability of activities related to the financial markets and a general crisis of confidence in stock market investments. Since August 2012, however, bank results have improved, as has their performance on the stock markets.

That said, this newfound confidence is emerging in a context of profound change: the crisis has altered the way the European banking system functions, with the European Central Bank playing a greater role in lending to banks and with a sharp reduction in national exposures in the riskier countries (Portugal, Ireland, Italy, Spain and Greece).

Whether this confidence is sustainable will depend on the ability of the banks to face up to two challenges: first, to reduce the risk of insolvency of public and private debt in certain Member States; and second, to adapt to the institutional changes taking place at the European level (implementation of Basel 3, the banking union project and the gradual shift from a bail-out logic to a bail-in logic).

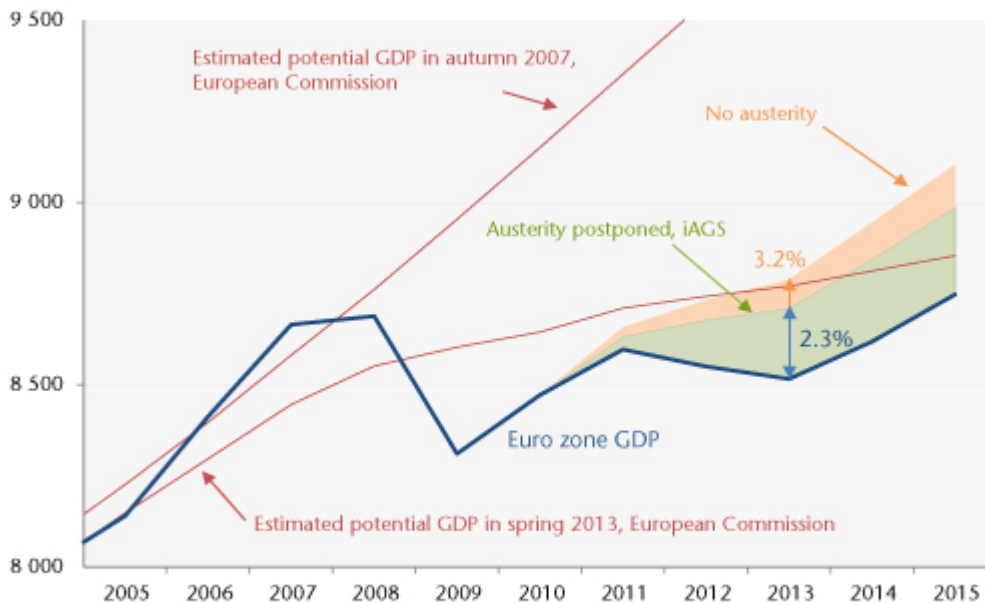
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# From austerity to stagnation

By [Xavier Timbeau](#)

Since 2010, the European Commission has published the Annual Growth Survey to stimulate discussion on the occasion of the European semester, during which the governments and parliaments of the Member States, the Commission, and civil society discuss and develop the economic strategies of the various European countries. We considered it important to participate in this debate by publishing simultaneously with the Commission an independent Annual Growth Survey (iAGS), in collaboration with the IMK, a German institute, and the ECLM, a Danish institute. In the 2014 iAGS, for instance, we estimate the cost of the austerity measures enacted since 2011. This austerity policy, which was implemented while the fiscal multipliers were very high and on a scale unprecedented since the Second World War, was followed simultaneously by most euro zone countries. This resulted in lopping 3.2% off euro zone GDP for 2013. An alternative strategy, resulting after 20 years in the same GDP-to-debt ratios (*i.e.* 60% in most countries), would have been possible by not seeking to reduce public deficits in the short term when the multipliers are high. In order to lower the fiscal multipliers again, it's necessary to reduce unemployment, build up agents' balance sheets and get out of the liquidity trap. A more limited but ongoing adjustment strategy, just as fiscally rigorous but more suited to the economic situation, would have led to 2.3 additional points of GDP in 2013, which would have been much better than under the brutal austerity we find ourselves in today. This means there would not have been a recession in 2012 or 2013 for the euro zone as a whole (see the figure below: GDP in million euros).

### Impact of austerity on economic activity, 2011-2015



Source: iAGS 2014, Eurostat and European Commission.

It is often argued that the state of euro zone public finances left no choice. In particular, market pressure was so great that certain countries, like Greece for example, were concerned that they would lose access to private financing of their public debt. The amounts involved and the state of the primary deficit are advanced to justify this brutal strategy and convince both the markets and the European partners. However, the sovereign debt crisis, and hence market pressure, ended when the European Central Bank announced that no country would leave the euro and set up an instrument, Outright Monetary Transactions, which makes it possible under certain conditions to buy back public debt securities of euro zone countries and therefore to intervene to counter the distrust of the markets ([see an analysis here](#)). From that point on, what matters is the sustainability of the public debt in the medium term rather than demonstrating that in an emergency the populace can be compelled to accept just any old policy. Sustainability does however require an adjustment policy that is ongoing (because the deficits are high) and moderate (because fiscal policy has a major impact on activity). By choosing the difficult path of austerity, we paid a high price for the institutional incoherence of the euro zone, which was

exposed by the crisis. In the 2014 iAGS, we point out costs due to austerity that go beyond the loss of activity. On the one hand, inequality is increasing, and “anchored poverty”, *i.e.* as measured from the median incomes of 2008, is increasing dramatically in most countries affected by the recession. The high level of unemployment is leading to wage deflation in some countries (Spain, Portugal and Greece). This wage deflation will result in gains in cost competitiveness but, in return, will lead the countries’ partners to also take the path of wage deflation or fiscal devaluation. Ultimately, the adjustment of effective exchange rates either will not take place or will occur at such a slow pace that the effects of deflation will wind up dominant, especially as the appreciation of the euro will ruin the hopes of boosting competitiveness relative to the rest of the world. The main effect of wage deflation will be a greater real burden (*i.e.* relative to income) of private and public debt. This will mean a return to centre stage of massive public and private defaults, as well as the risk of the euro zone’s collapse. It is possible nevertheless to escape the trap of deflation. Possible methods are explored and calculated in the 2014 iAGS. By reducing sovereign spreads, the countries in crisis can be given significant maneuvering room. The levers for this include the continuation of the ECB’s efforts, but also a credible commitment by the Member states to stabilizing their public finances. Public investment has been cut by more than 2 points of potential GDP since 2007. Re-investing in the future is a necessity, especially as infrastructure that is not maintained and is allowed to collapse will be extremely expensive to rebuild. But it is also a way to stimulate activity without compromising fiscal discipline, since the latter must be assessed by trends not in the gross debt but in the net debt. Finally, the minimum wage should be used as an instrument of coordination. Our simulations show that there is a way to curb deflationary trends and reduce current account imbalances if surplus countries would increase their minimum wage faster in real terms than their productivity while

deficit countries would increase their minimum wage slower than their productivity. Such a rule, which would respect both national practices in wage bargaining as well as productivity levels and the specific features of labour markets, would lead to gradually reducing macroeconomic imbalances in the euro zone.

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## America's fiscal headache

By Christine Riffart

Before next December 13<sup>th</sup>, the Budget Conference Committee must present the results of the discussions begun following the shutdown and debt crisis in October 2013. The objective of the negotiations is to enable Congress to approve the 2014 Budget, for which the fiscal year began on October 1 [\[1\]](#), and find an alternative to the automatic cuts in federal spending that are to take effect on 1 January 2014. An agreement does not seem out of reach. Even if sharp opposition between Republicans and Democrats remains, reason should prevail and the risk of a new budget crisis seems excluded. At worst a new Continuing Resolution [\[2\]](#) will be passed that allows institutions to continue to function and the arbitrary nature of automatic budget cuts in structural expenditure to guide government policy. At best, the negotiations will lead to reasoned cuts in expenditure, and even to increases in some revenues that will then curb the violence of the adjustment, a violence that is amplified by the ending of the exceptional measures to support income and activity that were enacted at the heart of the crisis.



There is little room for negotiation. In fiscal year 2013, the deficit for the entire public sector reached 7% of GDP (after 12.8% in fiscal year 2009), and the federal deficit came to 4.1% of GDP (after 9.8%). The federal debt currently comes to 72.7% of GDP, and is rising. Moreover, growth remains weak: 2.2% at an annual average since the 2010 recovery, with 1.8% expected in 2013, which in particular is insufficient to revitalize the job market. How then is it possible to come up with a budget policy to support growth in a context of fiscal austerity and deficit reduction while complying with the commitments previously made by Congress[\[3\]](#), in particular the Budget Control Act of 2011? Following the crisis concerning the federal debt ceiling in July 2011, on 2 August 2011 President Obama signed the Budget Control Act of 2011, which conditioned any increase in the federal debt ceiling on a massive reduction in government spending over 10 years. In addition to the introduction of caps on discretionary spending [\[4\]](#), 1200 billion dollars in automatic cuts (sequestrations) in expenditures were planned for the period 2013 to 2021 based on a principle of parity between defense and non-defense budgets. A number of social programs (pension insurance, Medicaid, income guarantees, etc.) were exempted, while cuts to the Medicare program for the elderly were limited to 2%. In total, the cuts will apply to a little less than half of federal spending and will represent 109 billion per year in savings on the deficit, *i.e.* 0.6% of GDP.

For the 2014 fiscal year, according to the CBO the combination of these two measures (capped discretionary spending and automatic cuts in unprotected budgets) as well as the renewal of the amount of credits from 2013 to 2014 (*i.e.* a constant nominal budget) will lead to cuts in discretionary spending of 20 billion dollars that will have to be borne entirely by the Pentagon. On this basis, if the cuts are maintained, discretionary spending in the defense and non-defense budgets will have declined by 17% and 17.8%, respectively, in real terms between 2010 and 2014.

But in addition to these brutal cuts, other programs, in particular those primarily intended for low-income households, will experience a reduction in their budget in 2014 because of the expiration of the exceptional measures they previously enjoyed. Thus, the program to extend unemployment benefits created on 30 June 2008 for unemployed people who had exhausted their rights (Emergency Unemployment Compensation) ends on 1 January 2014. In the absence of other plans, this will hit 4 million people.

This is also the case of the Supplemental Nutrition Assistance Program (SNAP), which had benefited under the American Recovery and Reinvestment Act of 2009 from additional funding that elapsed on 1 November. Yet 47.7 million beneficiaries (15% of the population) received food stamps this year. According to the CBPP, the 7% cut in the program's funds should result in a decrease of 4 million in the number of beneficiaries.

Another example: the housing benefits for the 2.1 million families who cannot find decent housing will also be affected by the termination of the budget extensions introduced in 2009 and the automatic cuts. If the budget is not renewed, from 125,000 to 185,000 of the families receiving benefits at end 2012 will no longer receive aid at end 2014.

According to the information currently available, a minimum agreement on the Budget Conference Committee seems to be emerging. The cuts in the defense budget could be approved [\[51\]](#), while eventual increases in public utility charges would be used to fund budget extensions for some social programs and lighten the impact of the automatic cuts. Last April, President Obama presented his Draft 2014 Budget to Congress. At that time he proposed to remove the procedures for automatic cuts, to reduce the debt in the long term through an extensive fiscal reform, and in the shorter term to defer a portion of the 2014 budget cuts to fiscal years 2015 and 2016 in order to boost growth. The agreement, which is likely to be

presented to Congress by 13 December, will undoubtedly not be this ambitious. Faced with Republican (the majority in the House of Representatives) partisans of additional savings, the Democrats (the majority in the Senate) will find it difficult to defend an increase in public spending in 2014 and to adopt a fiscal policy that is less harmful to growth this year than it was in 2013.

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[\[1\]](#) After not having been adopted by Congress, the 2014 budget has been financed since 16 October by a Continuing Resolution (see note 2) on the basis of the 2013 budget amounts. The Resolution is retroactive from the 1st day of the 2014 fiscal year, *i.e.* 1 October 2013, until 15 January 2014.

[\[2\]](#) A Continuing Resolution is a temporary resolution passed by Congress that is used to extend the appropriations made the previous fiscal year to the current fiscal year, while waiting for new measures to be approved.

[\[3\]](#) According to the [CBPP](#), if all the deficit reduction measures adopted since 2010 in the 2011 Budget, the Budget Control Act of 2011 and the American Taxpayer Relief Act of 2012 are taken into account, the cumulative impact on the deficit would be 4000 billion over the period 2014-2023, *i.e.* the equivalent of 24% of 2013 GDP.

[\[4\]](#) Discretionary spending (33% of federal spending) is spending for which the budgets are voted on an annual basis, unlike mandatory spending (61%), which is based on programs covered by prior law. The spending side of the government's fiscal policy rests mainly on changes in discretionary spending, which are structural expenditure.

[\[5\]](#) Expenditure related to defense had already fallen by 13.1% in real terms between Q3 2010 and Q3 2013.

