Spain: a 2018 budget on target, if the Commission likes it or not

By Christine Rifflart

With a deficit of 3.1% of GDP in 2017, Spain has cut its deficit by 1.4 points from 2016 and has been meeting its commitments to the European Commission. It should cross the 3% threshold in 2018 without difficulty, making it the latest country to leave the excessive deficit procedure (EDP), after France in 2017. The 2018 budget was first presented to the European Commission on April 30 and then approved by Spain's Congress of Deputies on May 23 amidst a highly tense political situation, which on June 1 led to the dismissal of Spain's President Mariano Rajoy (supported by the Basque nationalist representatives of the PNV Party who had approved the 2018 budget a few days earlier). It should be passed in the Senate soon by another majority vote. The expansionary orientation of the 2018 budget, backed by the government of the new Socialist President Pedro Sanchez, does not satisfy the Commission, which considers the adjustment of public finances insufficient to meet the target of 2.2% of GDP included in the 2018-2021 Stability and Growth Pact (SGP). According to the hypotheses of the previous government, not only would the deficit fall below 3% but the nominal target would be respected.

Admittedly, while, given the strong growth expected in Spain in 2018, the public deficit will easily be below 3% in 2018 and therefore meet the requirements set in the EDP, the new budget act is not in line with the fiscal orthodoxy expected by Brussels. The lack of a People's Party majority in Congress led ex-President Mariano Rajoy into strategic alliances with Ciudadanos and the PNV to get the 2018 budget adopted (with the hope, in particular, of avoiding early parliamentary elections), at the price of significant concessions:

– An increase in civil servants’ salaries of 1.75%[1] in 2018 and at least 2.5% in 2019, with a larger increase if GDP grows by more than 2.5% (estimated cost of 2.7 billion euros in 2018 and 3.5 billion in 2019 according to the outgoing government);

– Lower taxes for low-income households (via the increase in the minimum tax threshold from 12,000 to 14,000 euros income per year, tax credits for childcare expenses, assistance for disabled people and large families, and a reduction in tax on gross wages between 14,000 and 18,000 euros) (cost 835 million in 2018 and 1.4 billion in 2019);

– The revaluation of pensions by 1.6% in 2018 and by 1.5% in 2019 (cost of 1.5 and 2.2 billion), in addition to a rise of up to 3% in the old age and non-taxpayer minimum, and between 1% and 1.5% for the lowest pensions (cost 1.1 billion in 2018).

According to the former government, these measures will cost a little more than 6 billion euros in 2018 (0.5% of GDP) and nearly 7 billion in 2019 (0.6% of GDP). The revaluation of pensions should be partly covered by the introduction of a tax on digital activities (Google tax) in 2018 and 2019, with revenues of 2.1 billion euros expected. In the end, spending, which was expected to fall by 0.9 GDP point in 2018 based on the undertakings made in the previous 2017-2020 SGP, would fall by only 0.5 GDP point in the 2018-2021 SGP (to 40.5% of GDP) (Table). But above all, despite the tax cuts just introduced, the extra revenue expected from the additional growth should represent 0.1 GDP point (to 38.3% of GDP). In fact, the budget’s redistributive character, combined with the downward revision of the impact of the Catalan crisis on the economy (0.1% of GDP according to the AIReF [2]) led all the institutes (Bank of Spain, the Government, the European Commission) to raise their 2018 growth forecasts from last winter by 0.2 or 0.3 GDP point to bring it slightly below 3%

(2.6% for the OFCE according to our April forecasts [3]).

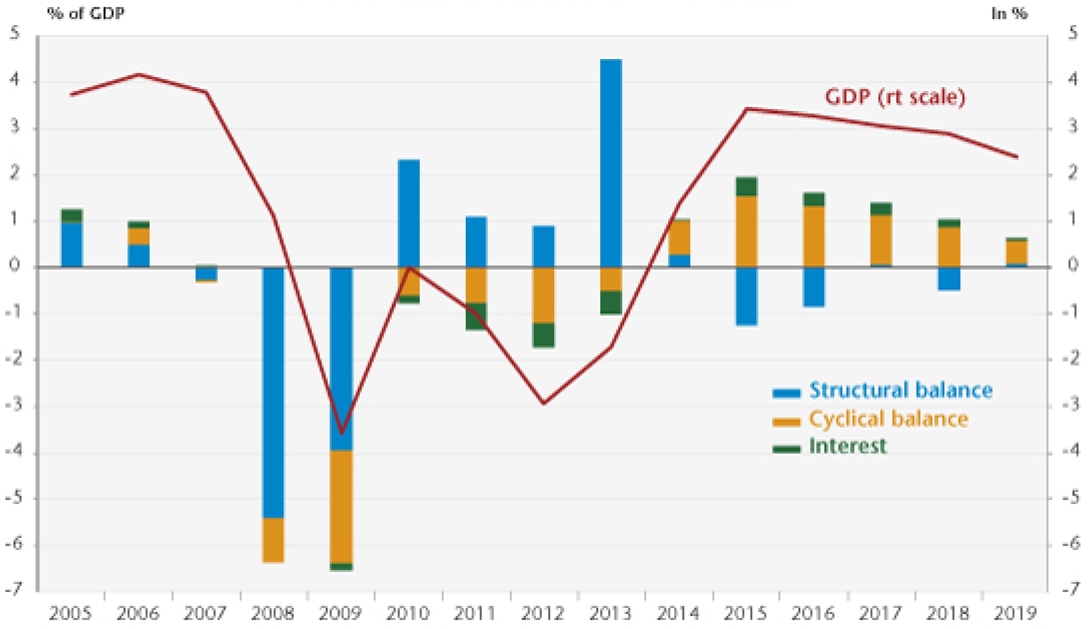
Table. Breakdown of Spanish public finances

% of GDP	2017			2018			2019*		
	Gvt	EC	OFCE	Gvt	EC	OFCE	Gvt	EC	OFCE
GDP	3.1	3.1	3.1	2.7	2.9	2.6	2.4	2.4	1.9
Potential GDP	1.0	1.0	0.9	1.0	1.2	1.1	1.3	1.4	1.1
Output gap	-1.6	-0.2	-2.9	0.1	1.4	-1.4	1.2	2.3	-0.6
Budget balance	-3.1	-3.1	-3.1	-2.2	-2.6	-2.3	-1.3	-1.9	-1.5
Revenue	37.9	37.9		38.3	38.1		38.5	38.1	
Spending	41.0	41.0		40.5	40.7		39.8	40.0	
Cyclical balance	-0.8	-0.1	-1.5	0.0	0.8	-0.7	0.6	1.3	-0.3
Interest	2.6	2.6	2.6	2.4	2.4	2.4	2.3	2.4	2.3
Primary balance adjusted for cycle	0.3	-0.4	1.0	0.2	-1.0	0.8	0.4	-0.8	1.1

* In 2019, the cyclically-adjusted primary balance should improve by 0.2 GDP point due to the elimination of exceptional measures, estimated by the government at 0.2 GDP point.
Sources: European Commission; OFCE – April 2018 forecasts.

Nevertheless, beyond the shared optimism about Spanish growth, the calculations of the cost of the new measures differ between the Spanish authorities and the Commission. According to the government, the increase in growth should, as we have said, boost tax revenues and neutralize the expected cost of new spending. In 2018, the 0.9 percentage point reduction in the deficit (from 3.1% to 2.2%) would therefore be achieved by the 0.8 GDP point growth in the cyclical balance, combined with the 0.2 point fall in debt charges, with the structural balance remaining stable (fiscal policy would become neutral rather than restrictive as set out in the earlier version of the Pact). But this scenario is not shared by Brussels[4], for whom the cost of the measures, and in particular of the increase in civil servants' salaries, is underestimated. Expenditures are expected to be 0.2 GDP point higher and revenue 0.2 GDP point higher than the government has announced. According to the Commission, the cyclical balance is expected to improve by 0.9 GDP point, but the fiscal impulse would worsen the structural balance by 0.6 GDP point. In these conditions, the deficit would bypass the 3% mark, but fiscal policy would clearly become expansionary and the 2.2% target would not be hit. The public deficit stood at 2.6% in 2018 (Figure 1).

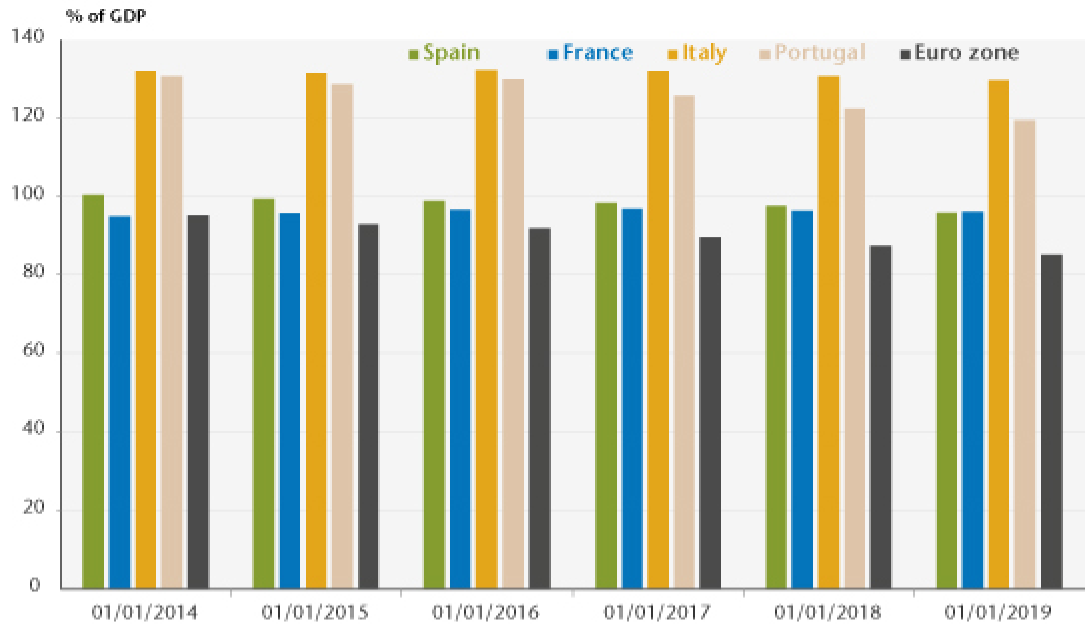
Figure 1. Breakdown of the public balance, as % of GDP, according to the European Commission



Source: European Commission.

This more expansionary orientation of the 2018 budget results above all from the political considerations of the former Rajoy government and its effort to deal with the impossibility of governing (facts have demonstrated the fragility of this position). Nevertheless, the timing is ideal – because the only budget commitment required in 2018 is to cross the 3% deficit threshold in order to get out of the corrective arm of the SGP. The year 2018 therefore makes it possible to implement a generous fiscal policy, while crossing the 3% mark, without exposing the country to sanctions. The situation will be more delicate in 2019, when EU rules aimed at reducing a debt that is still well above 60% of GDP will be applied, notably by adjusting the structural balance (Figure 2).

Figure 2. The public debt in the euro zone



Source: European Commission.

[1] https://www.boe.es/boe/dias/2018/03/26/pdfs/BOE-A-2018-4222.pdf

[2] https://elpais.com/economia/2018/04/17/actualidad/1523949570_477094.html?rel=str_articulo#1526464987471

[3] See the Spain part of the dossier: https://www.ofce.sciences-po.fr/pdf/revue/11-155OFCE.pdf , pp 137-141.

[4] Nor by the AIReF.

An end to growth?

Analysis and Forecasting Department (international team)

This text relies on the 2016-2018 forecast for the global *economy and the euro zone, the full version of which is available here, in French.*

After avoiding a Grexit in the summer of 2015, Europeans will now have to face a Brexit. In addition to what should be a significant impact on the UK economy lies the question of the effect this shock will have on other countries. Given that all the indicators seemed to be green for finally allowing the euro zone to recover from the double-dip recession following the 2007-2008 financial crisis and then the sovereign debt crisis, will a Brexit risk interrupting the trend towards a recovery? This fear is all the more credible as the delayed recovery was not sufficient to absorb all the imbalances that built up over the years of crisis. The unemployment rate for the euro zone was still over 10% in the second quarter of 2016. A halt to growth would only exacerbate the social crisis and in turn fuel doubt – and therefore mistrust – about Europe's ability to live up to the ambitions set out in the preamble to the Treaty on the Functioning of the European Union and reiterated in Lisbon in 2000.

Nevertheless, despite fears of a new financial shock, it is clear that it hasn't happened. Brexit will of course be the fruit of a long process that has not yet started, but it seems that the worst has been avoided for now. The British economy will see growth halved in 2017. But the short-term negative effects on other euro zone countries should be fairly limited, except perhaps Ireland which is more interdependent on the United Kingdom. In any case the global recovery should continue, but growth will be down in the euro zone from 1.9% in 2015 to 1.3% in 2018.

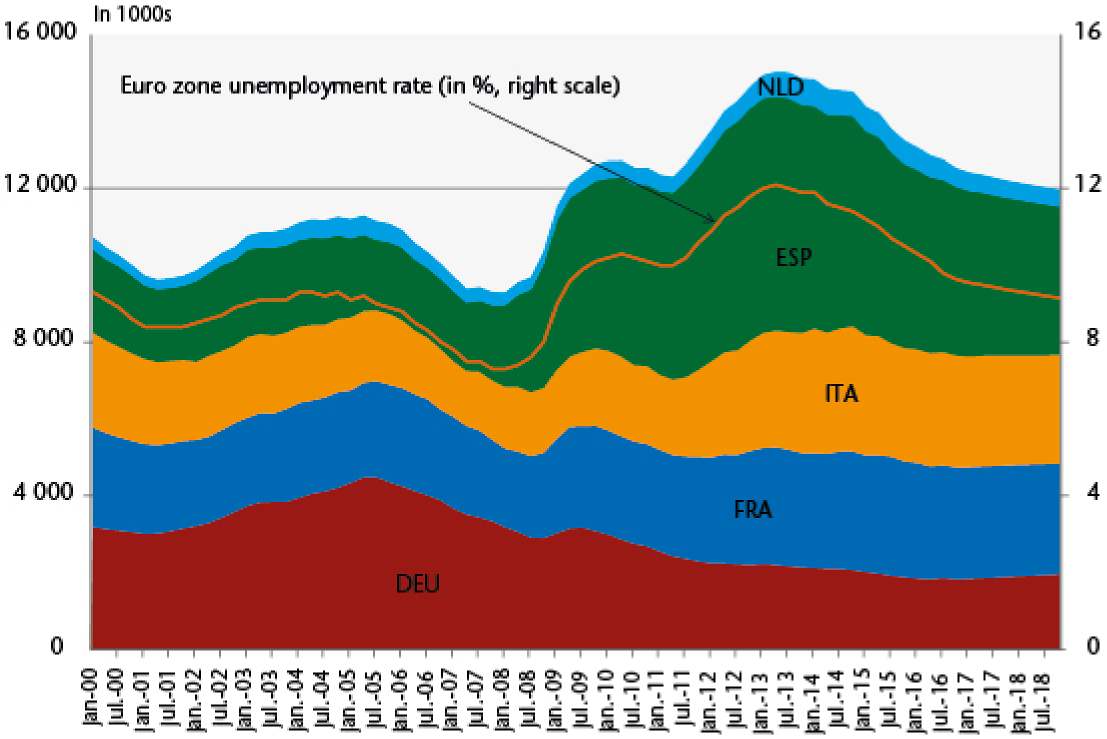
The many factors that helped initiate the recovery[1] will to some extent lose steam. The price of oil has already begun to rise after hitting a low of under USD 30 in January 2016. It is now once again over 50 dollars a barrel. As for the euro, it has fluctuated since the beginning of the year at around 1.10 dollar, while in 2014 and 2015 it depreciated by 12.5%

and 11.3%, respectively. In contrast, the European Central Bank has stuck to its expansionary monetary policy, and fiscal policy is much less restrictive than from 2011 to 2014. In 2015 and 2016, the aggregate fiscal impulse was even slightly positive.

Finally, world trade is slowing significantly, well beyond what would be expected simply from the change in China’s economic model, which is resulting in a deceleration of imports. There were hopes that after the recovery kicked off, a virtuous cycle of growth would be triggered in the euro zone. Higher growth partly driven by exogenous factors would lead to job creation, higher incomes and better prospects for households and businesses. These elements would be conducive to a return of confidence and in turn stimulate investment and consumption. The dynamics of productive investment in France and Spain in the last quarter have given credence to this scenario.

The recovery will certainly not be aborted, but this rate of growth seems insufficient to reduce the imbalances brought about by long years of recession and low growth. At the end of 2018, the unemployment rate in the euro zone will still be nearly 2 percentage points higher than at end 2007 (graphic). For the five largest countries in the euro zone, this represents nearly 2.7 million additional people without jobs. In these conditions, it is undoubtedly the social situation of the euro zone which, even more than Brexit, is putting the European project in jeopardy. Europe certainly cannot be held solely responsible for low growth and high unemployment in the various countries, but the current forecast indicates that we have undoubtedly not achieved the goals that were set in Lisbon in 2000, i.e. making the European Union “the most competitive and dynamic knowledge-based economy in the world capable of sustainable economic growth with more and better jobs and greater social cohesion”.

Figure: Unemployment in the euro zone



Source: Eurostat, OFCE forecasts – October 2016.

[1] View See the OFCE's earlier synthesis (in French) of the international outlook (summarized here in English).

François Hollande's five years in office: Stagnation or recovery?

By OFCE

The five-year term of French President Francois Hollande has been marked by serious economic difficulties, but also by some signs of improvement in the last year of his mandate. Overall, France experienced low growth from 2012 to 2014, mainly due to the fiscal consolidation policy, with moderate growth after that (see: OFCE, Policy Brief, no2, September 5th, 2016).

The scale of the fiscal shock at the start of Hollande's mandate, when the government underestimated the negative impact on growth, proved to be incompatible with a fall in unemployment during the first half of the mandate.

The effort to improve France's public finances involved a major fiscal adjustment, even though the target of a 3% public deficit was put off till the end of Hollande's term in office. According to the calculations of the European Commission, France's structural balance (i.e. the balance adjusted for cyclical effects) will have improved by 2.5 points over the 2012-2016 period. This effort did not however prevent the public debt from reaching a historic peak and from diverging significantly from the level in Germany.

Fiscal consolidation in France and in Europe had a marked negative impact, amounting to 0.8 point per year on average between 2012 and 2017. The simultaneity of the austerity policies enacted in Europe amplified their recessionary impact by depressing domestic demand, but also external demand.

The economic policy of the governments led by Ayrault and Valls was initially marked by a significant period of rising taxation, on both companies and households, followed by a shift towards a supply policy in 2014. This policy, embodied in the Responsibility Pact and the CICE tax credit, is bearing fruit late in Hollande's term, as business margins improve, although household purchasing power and short-term growth have been hurt.

After a period marked by a significant downturn in business margins, they picked up over the first four years of the five-year term by the equivalent of 1 point in added value thanks to tax measures, and one additional point due to lower oil prices. The profit margin in industry even reached a level comparable to the historical records of the early 2000s.

Based on our forecasts for the five-year mandate as a whole, ILO-measured unemployment will have increased by about 100,000 people, despite the creation of 720,000 jobs, due to the lack of growth, combined with an increase in the labour force.

Small recovery after a big crisis

By the Analysis and Forecasting Department

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

Global growth is once again passing through a zone of turbulence. While growth will take place, it is nevertheless being revised downwards for 2016 and 2017 to 2.9% and 3.1%, respectively. The slowdown is first of all hitting the emerging countries, with the decline in Chinese growth continuing and even worsening (6.1% anticipated for 2017, down from 7.6% on average in 2012-2014). The slowdown in Chinese demand is hitting world trade and fuelling lower oil prices, which in turn is exacerbating the difficulties facing oil and commodity producers. Finally, the prospect for the normalization of US monetary policy is resulting in a reflux of capital. The dollar is appreciating even as the currencies of the emerging countries of Asia and Latin America are depreciating. While the industrialized countries are also suffering from the Chinese slowdown through the demand channel, growth is resilient there thanks to falling oil prices. The support provided by monetary policy is being cut back in the US, but is strengthening in the euro zone, keeping the euro at a low level. Countries are no longer systematically adopting austerity policies. In these conditions, growth will slow in the US, from 2.4% in 2015 to 1.9% in 2016 and then 1.6% in 2017. The recovery will pick up pace slightly in the euro zone, driven mainly by the dynamism of Germany and Spain and the improved outlook in France and Italy. For the euro zone as a whole, growth should come to 1.8% in 2016 and 1.7% in 2017. This will push down the unemployment rate, although by year-end 2017 it will still be 2 points above its pre-crisis level (9.3%, against 7.3% at year-end 2007).

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

At the level of the euro zone as a whole, overall fiscal policy is neutral (expansionary in Germany and Italy in 2016 but restrictive in France and even more so in Greece), whereas it needs to be more expansionary in order to bring unemployment down more rapidly and help to avert deflationary risks. Furthermore, the continuing moderate growth is leading to the accumulation of current account surpluses in the euro zone (3.2% in 2015). While imbalances within the euro zone have been corrected to some extent, this mainly took place through adjustments by countries in deficit prior to the crisis. Consequently, the surplus in the euro zone’s current account will eventually pose risks to the level of the euro, which could appreciate once the monetary stimulus ends, thereby slowing growth.

Table. Outlook for world growth

Annual growth rate (%)

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

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

2015-2017 forecasts for the French economy

By [Mathieu Plane](), [Bruno Ducoudré](), [Pierre Madec](), Hervé Péléraux and Raul Sampognaro

This text summarizes the **[OFCE's economic forecast for the French economy for 2015-2017]()**

After a hesitant upturn in the first half of 2015 (with growth rates of 0.7% and 0% respectively in the first and second quarter), the French economy grew slowly in the second half year, with GDP rising by an average of 1.1% for the year as a whole. With a GDP growth rate of 0.3% in the third quarter of 2015 and 0.4% in the fourth quarter, which was equal to the pace of potential growth, the unemployment rate stabilized at 10% at year end. Household consumption (+1.7% in 2015) was boosted by the recovery in purchasing power due in particular to lower oil prices, which will prop up growth in 2015, but the situation of investment by households (-3.6%) and the public administration (-2.6%) will continue to hold back activity. In a context of sluggish growth and moderate fiscal consolidation, the government deficit will continue to fall slowly, to 3.7% of GDP in 2015.

With GDP growth in 2016 of 1.8%, the year will be marked by a recovery, in particular by rising corporate investment rates. Indeed, all the factors for a renewal of investment are coming together: first, a spectacular turnaround in margin rates since mid-2014 due to a fall in the cost of energy supplies and the impact of the CICE tax credit and France's Responsibility Pact; next, the historically low cost of capital, which has been helped by the ECB's unconventional monetary policy; and finally, an improvement in the economic outlook. These factors will lead to an acceleration of business investment in 2016, which will increase by 4% on average over the year. Household consumption should remain strong in 2016 (+1.6%), driven by job creation in the market sector and by a slight fall in the savings rate. Fuelled by the rise in housing starts and building permits, housing investment will pick up (+3%), after shrinking for four years in a row. Foreign trade will be boosted by the impact of the euro's depreciation and the government's competitiveness policies, and will make a positive contribution to growth (+0.2 GDP point in 2016, the same as in 2015). Once the impact of the downturn in oil prices has fed through, inflation should be positive in 2016, but still low (1% on an annual average, after two years of virtual stagnation), a rate that is close to underlying inflation. The pace of quarterly GDP growth in 2016 will be between 0.5% and 0.6%: this will trigger a gradual closing of the output gap and a slow fall in the unemployment rate, which will end the year at 9.8%. The public deficit will be cut by 0.5 GDP point, due to savings in public spending, notably through the contraction of public investment (-2.6%), low growth in government spending (+0.9%), and the impact of the rise in tax revenues as the economy recovers.

Assuming that the macroeconomic environment remains favourable, the output gap is expected to continue to close in 2017. With GDP growth of 2%, the government deficit will fall further to 2.7% of GDP, passing below the 3% bar for the first time in 10 years. Under the impact of the government's employment policies and the absorption of the overstaffing by companies, the unemployment rate will continue to fall, to 9.4% of the active population by the end of 2017.

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.

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[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

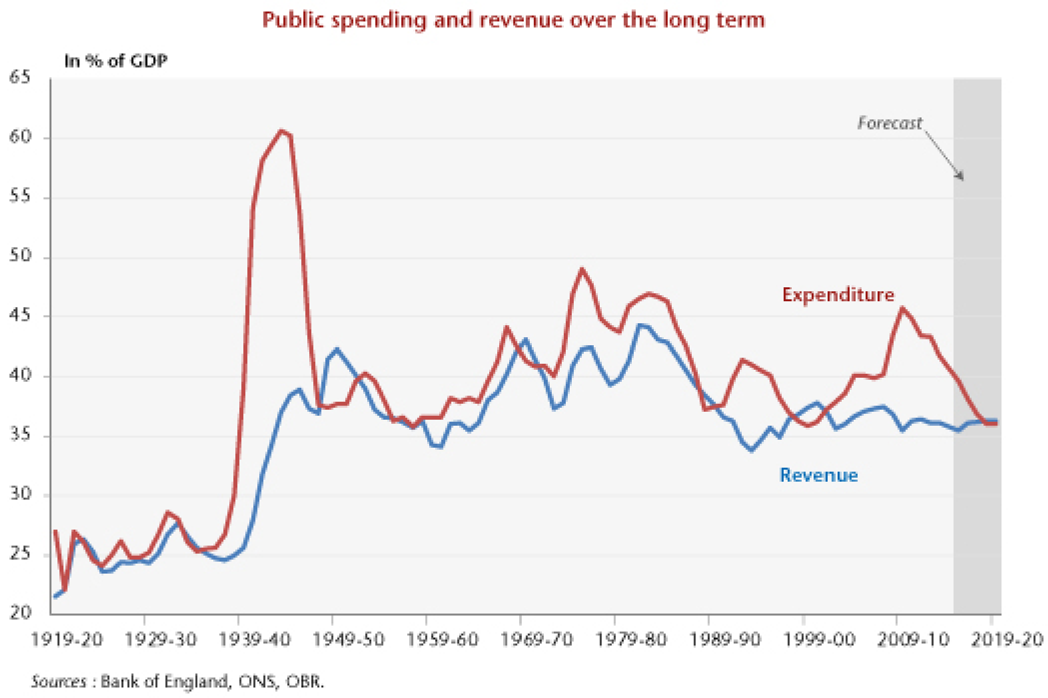
Business investment was structurally weak in the 2000s in the UK. But the recovery has been underway for 5 years, and the rate of investment volume is now close to its level of the early 2000s. The recovery of investment is obviously good news for the UK's productive capacity. But there is still an external 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…



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[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.

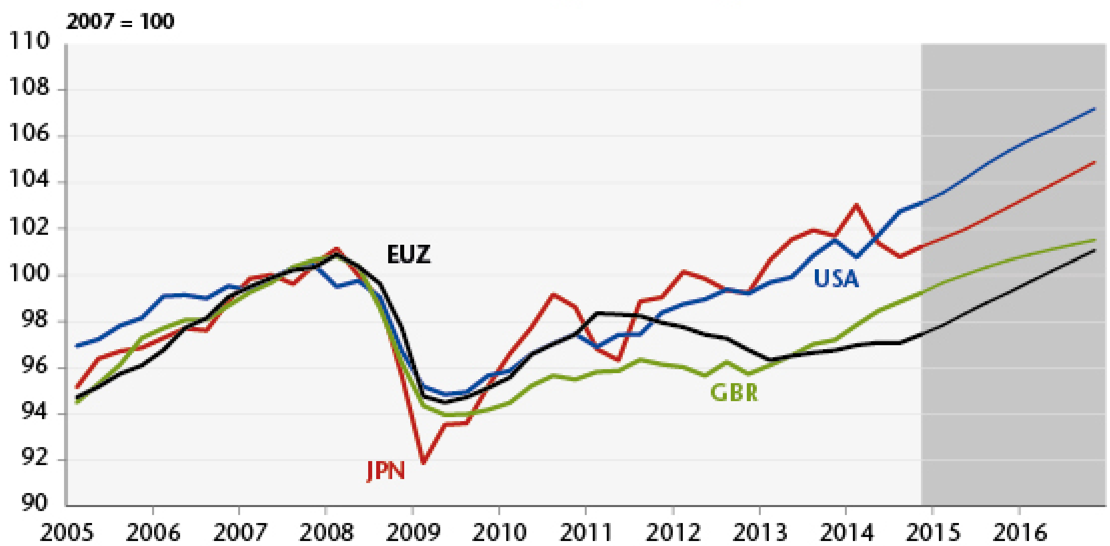
A fragile recovery?

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.

Recovery aborted

By Christophe Blot

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

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

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

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

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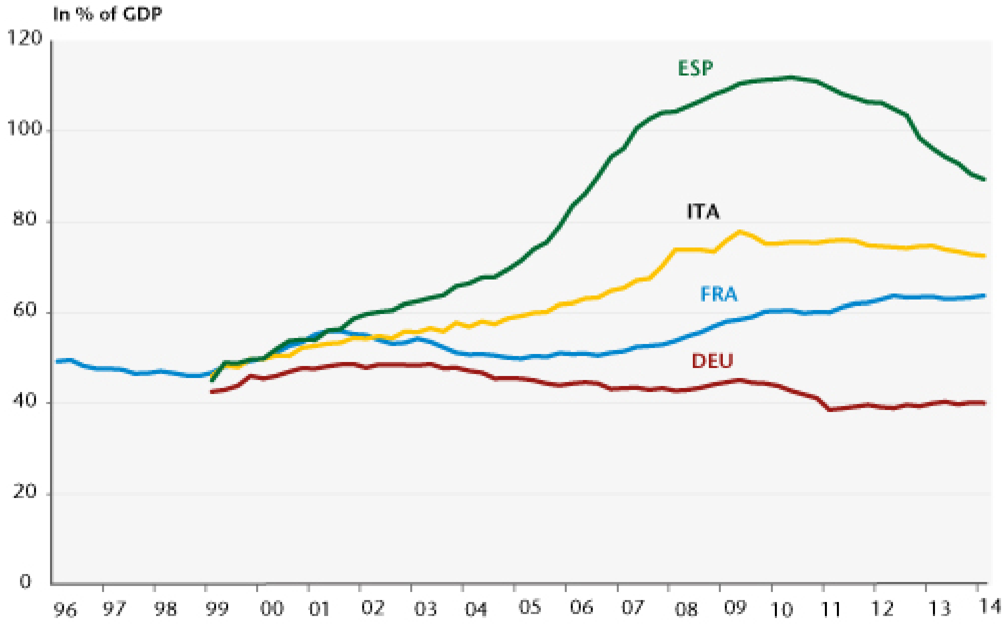
(TSCG) requiring Member countries to make fiscal adjustments to bring public debt down to the 60% threshold within 20 years[3].

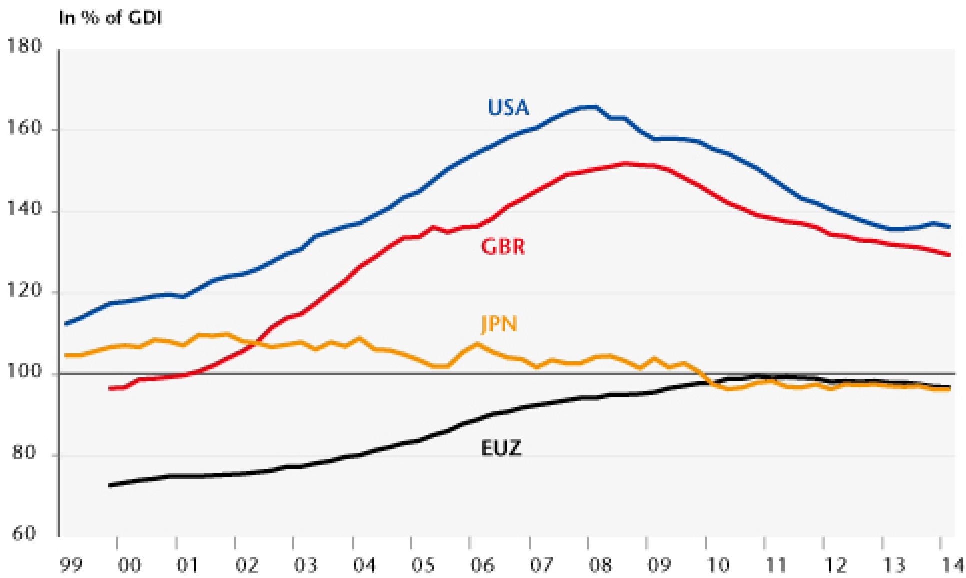
These conditions could push a recovery further down the road, and the euro zone could wind up locked in the trap of deflation. A lack of growth and high unemployment are creating downward pressure on prices and wages, pressure that is being exacerbated by internal devaluations, which are the only solutions being adopted to improve competitiveness and regain market share. This reduction in inflation is making the deleveraging process even more protracted and difficult, thus undercutting demand and strengthening the deflationary process. The Japanese experience of the 1990s shows that it is not easy to pull out of this kind of situation.

Figure 1. Debt of non-financial corporations



Source: Banque de France.

Figure 2. Household debt



Source: Banque de France.

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

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

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

Euro zone: Recovery or deflation?

By Céline Antonin, Christophe Blot, Sabine Le Bayon and Danielle Schweisguth

This text summarizes the OFCE's forecast for 2014-2015 for the euro zone economy

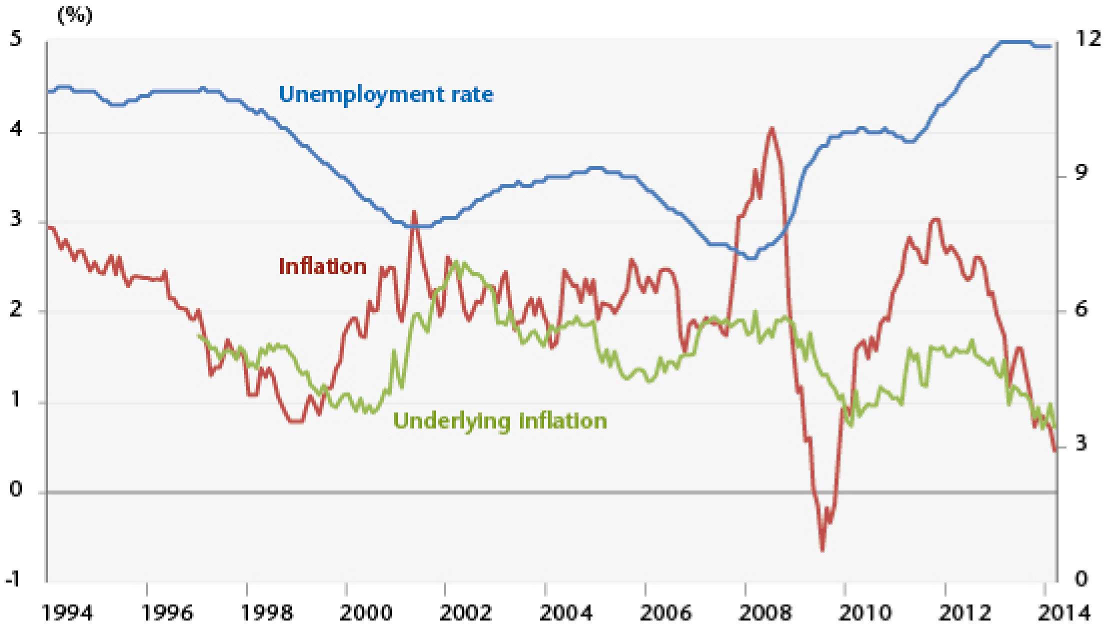
Will the euro zone embark on the road to recovery, or will it sink into a deflationary spiral? The latest macroeconomic indicators are sending out conflicting signals. A return to growth is being confirmed, with three consecutive quarters of rising GDP. However, the level of unemployment in the euro zone remains at a historically high level (11.9% for the month of February 2014), which is fuelling deflationary pressures, as is confirmed by the latest figures on inflation (0.5% yoy for March 2014). While this reduction in inflation is partly due to changes in energy prices, the fact remains that underlying inflation has fallen under 1% (Figure 1). In these conditions, a turnaround in inflationary expectations cannot be excluded, which would undoubtedly push the euro zone into deflation. The ECB has been concerned about this situation for several weeks and says it is ready to act (see here). However, no concrete proposal for a way to ease monetary policy and ensure that expectations are not anchored on a deflationary trajectory has been set out.

After a fall in GDP of 0.4% in 2013, the euro zone will return to positive growth: 1.3% in 2014 and 1.6% in 2015. Even so, at this rate of growth, there will still be an open output gap in most of the euro zone countries, reflecting the idea that the euro zone is only slowly pulling out of the crisis. Indeed, although efforts to reduce deficits will be curtailed, fiscal policies will still be pro-cyclical. Furthermore, financing conditions will continue to improve. The end of the sovereign debt crisis, thanks in particular to the announcements by the ECB in July and September 2012 [1], has reduced the risk premiums on the market for government bonds. The impact of lower long-term market rates has been partly reflected in bank interest rates, and credit supply conditions are generally less restrictive than they were between early 2012 and mid-2013. But there will still not be sufficient growth to trigger a recovery strong enough to lead to a rapid and significant reduction in unemployment. Indeed, the level will fall only very moderately, from 11.9% in the first quarter of 2014 to 11.3% at year end 2015. While Germany will enjoy almost full employment, mass joblessness in Spain and the other countries of southern Europe will persist (Figure 2). Unemployment should stabilize in Italy and continue to grow in France.

However, this continuing underemployment is giving rise to the risk of deflation. It is holding back growth in wages and contributing to the weakness of underlying inflation, which was in fact zero in Spain in March 2013 and negative in Greece and Portugal. For the euro zone as a whole, we do not expect deflation in the short term, but the weakness of growth is increasing the likelihood that private agents' expectations are not anchored in a deflationary scenario.

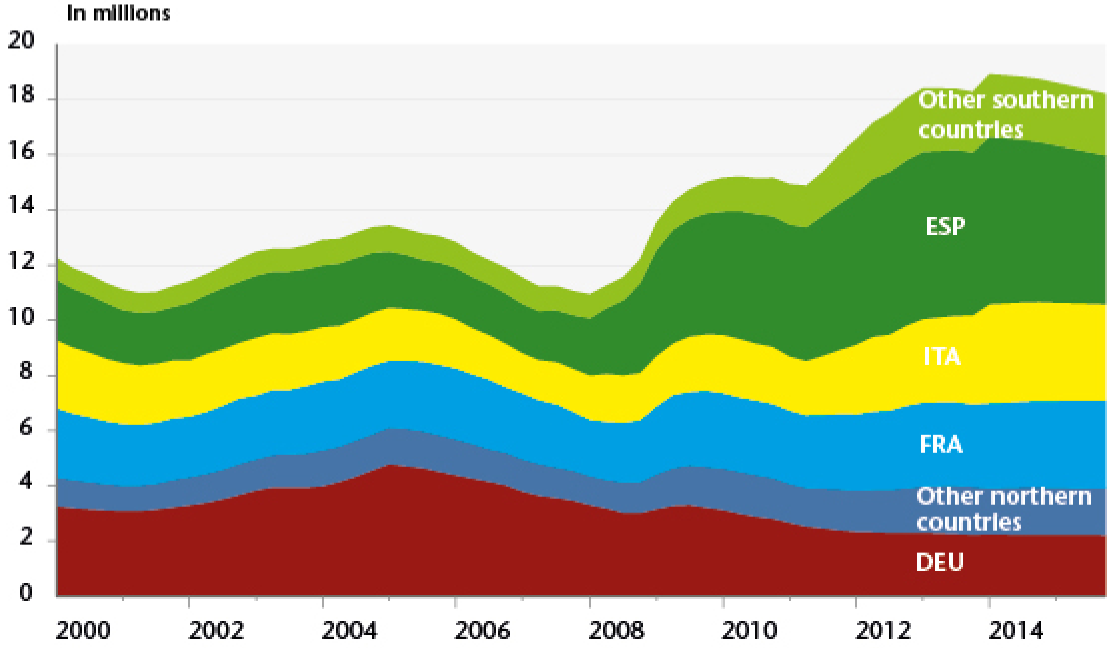
The situation in the euro zone is reminiscent of Japan in the 2000s. The country began to experience deflation in 1999 [2] following the recession associated with the Asian crisis. At that point, despite average growth of 1.4% between 2000 and 2006, prices failed to pick up, and the country's central bank did not find a way out of this trap, despite trying expansionary monetary policies. This is precisely the dynamic threatening the euro zone today, making it crucial to use all possible means to avoid this (monetary policy, fiscal policy and the coordination of wage policy [3]).

Figure 1. Unemployment rate and inflation rate in the euro zone



Source : Eurostat.

Figure 2. Unemployment in the euro zone countries



Note : The other southern countries are Portugal and Greece. The other northern countries are the Netherlands, Belgium, Ireland, Austria and Finland.

Sources : Eurostat, OFCE forecast April 2014.

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[1] In July, ECB President Mario Draghi declared that the central bank would save the euro "whatever it takes". In September, the ECB announced the creation of a new mechanism called Outright Monetary Transactions (see the post by Jérôme Creel and Xavier Timbeau), which enables it to engage in unlimited purchases of sovereign debt.

[2] It should be pointed out that there was an initial period of deflation in 1995 following three years of economic stagnation.

[3] All these elements are discussed in detail in the previous iAGS report (2014).