Will Germany be caught up in the recession of its European partners?

Christophe Blot and Sabine Le Bayon

Can Germany avoid the recession that is hitting a growing number of countries in the euro zone? While Germany's economic situation is undoubtedly much more favourable than that of most of its partners, the fact remains that the weight of exports in its GDP (50%, vs 27% for France) is causing a great deal of uncertainty about the country's future growth.

Thus, in the last quarter of 2011, the downturn in the German economy (-0.2%) due to the state of consumption and exports has upset hopes that the country would be spared the crisis and that it could in turn spur growth in the euro zone based on the strength of its domestic demand and wage increases. Exports of goods fell 1.2% in value in late 2011 over the previous quarter, with a contribution of -1.5 points for the euro zone and -0.4 points for the rest of the European Union. Admittedly, the beginning of 2012 saw renewed growth, with GDP rising by 0.5% (versus 0% in the euro zone). Once again this was driven by exports, in particular to countries outside the euro zone. The prospects of a recession across the Rhine in 2012 thus appear to be receding, but there is still great uncertainty about how foreign trade will be affected in the coming months and about the extent of the slowdown "imported" into Germany. The question is whether the improvement in the first quarter of 2012 is temporary. The decline in manufacturing orders from euro zone firms to Germany (-7.5% in the first quarter of 2012, after -4.8% in the last quarter of 2011) could spell the end of German's persistent growth, especially if the recession in the euro zone continues or worsens.

With GDP per capita above the pre-crisis level, Germany has been an exception in a euro zone that is still profoundly marked by the crisis. The country’s public deficit is under control, and it already meets the 3% threshold set by the Stability and Growth Pact. Germany is still running a foreign trade [1] surplus, which came to 156 billion euros (6.1% of GDP) in 2011, whereas at this same time France ran a deficit of 70 billion euros (3.5% of GDP). Despite Germany’s favourable foreign trade performance, the crisis has left scars, which today are being aggravated by the energy bill. For instance, before the crisis the trade surplus was 197 billion euros, with over 58% from trade with partners in the euro zone. With the crisis, activity slowed sharply in the euro zone – the zone’s GDP in the first quarter of 2012 was still 1.4% lower than the level in the first quarter of 2008 – which is automatically reflected in demand addressed to Germany. Thus, exports of goods to the euro zone are still below their level of early 2008 (down 2.9% for Germany and 6.3% for France, see Table 1). Germany’s trade surpluses vis-à-vis Italy and Spain – two countries that were hit hard by the crisis – have fallen significantly, mainly due to lower demand from the two countries. German exports to these two countries have decreased by 27% and 4% respectively since 2007.

Nevertheless, although Germany is more exposed to foreign trade shocks than France, it is less exposed to the euro zone. The share of euro zone countries in German exports fell from 44.8% in 2003 to 39.7% in 2011 (Table 2a). In France, despite a fall on the same order of magnitude, 47.5% of exports are still directed towards the euro zone. When the European Union as a whole is considered, however, the gap disappears, as the EU represents 59.2% of German exports compared with 59.8% of French exports. The lower level of dependence on the euro zone has been offset by increasing exports to the new member states of the European Union (the NEM), with which German trade reached 11.4% in 2011. Moreover, Germany has maintained its lead over France on the emerging markets: in 2011 Asia represented 15.8% of German exports and China 6.1%, against 11.5% and 3.2% in the French case. By managing to diversify the geographical composition of its exports to areas experiencing vigorous growth, Germany has been able to dampen the shock of the slowdown in the euro zone. This can be seen in recent trade trends: while Germany's exports (like France's) have surpassed their pre-crisis level, this was due to exports to countries outside the euro zone, where Germany has benefited more than France (Table 1). Germany has in fact succeeded in significantly reducing its deficit with Asia, which has helped to offset the poor results with the euro zone and with Central and Eastern Europe. Finally, Germany has advantages in terms of non-price competitiveness [2], which reflects the dynamism of trade in automobiles and electrical, electronic and computer equipment. The surpluses in these two sectors regained their pre-crisis level in 2011 (respectively, 103 and 110 billion euros in 2011), whereas the balances in these two sectors have continued to deteriorate in France.

Even if orders from countries outside the euro zone remain buoyant (up 3.6% in early 2012), the weight of the euro zone is still too strong for exports to emerging markets to offset the decline in orders placed by the euro zone to Germany. This will inevitably affect the country's growth. GDP should therefore rise less rapidly in 2012 than in 2011 (0.9% according to the OFCE [3], following 3.1%). Germany might thus avoid a recession, unless the euro zone as a whole experiences even sharper fiscal contraction. Indeed, the slowdown in growth means that the euro zone member states will not be able to meet their budget commitments in 2012 and 2013, which could lead them to decide on further restrictive measures, which would in turn reduce growth throughout the zone, and therefore demand addressed to the zone's partners. In this case Germany would not avoid a recession.

Finally, the role of foreign trade is not limited to growth and employment. It could also have an impact on negotiations between France and Germany about the governance of the euro zone. The relative growth of the two countries will in practice affect the balance of power between them. The expected slowdown in growth in Germany clearly reflects its conflicting interests between, on the one hand, maintaining its market opportunities and, on the other, its fears vis-à-vis the functioning of the euro zone and the cost to public finances of broader support for the countries in greatest difficulty. While up to now the latter consideration has dominated the German position, this could change once its commercial interests come under threat, especially at a time when the German Chancellor is negotiating with the Parliamentary opposition about the ratification of the fiscal pact – an opposition that could demand measures to support growth in Europe, as has the new French president.

Table 1. German and French exports since the crisis, in value

2008 Q1 = 100

		2009 - Q2	2012 - Q1
Totale	Germany	76,5	108,4
	France	77,6	101,6
Euro zone	Germany	76,4	97,1
	France	75,4	93,7
Other EU countries	Germany	71,2	103,3
	France	71,4	89,4
Rest of the world	Germany	79,8	123,0
	France	83,1	117,5

Sources : Customs, Destatis.

Table 2a. The main partners of Germany and France

%

	2003		2011	
	Germany	France	Germany	France
European Union	65,0	67,0	59,2	59,8
Euro zone	44,8	52,2	39,7	47,5
- France/Germany	*10,4*	*15,8*	*9,6*	*16,3*
- Italy	*7,3*	*9,2*	*5,9*	*8,0*
- Spain	*4,9*	*10,0*	*3,3*	*7,2*
- Netherlands	*6,4*	*3,8*	*6,5*	*4,2*
- Belgium/Luxembourg	*5,8*	*8,2*	*5,0*	*7,5*
- Austria	*5,4*	*1,0*	*5,4*	*0,9*
United Kingdom	8,4	9,5	6,2	6,5
NEM*	9,2	3,7	11,4	4,8
United States	9,3	6,7	6,9	5,5
Asia	11,4	7,3	15,8	11,5
- China	*2,7*	*1,4*	*6,1*	*3,2*
- Japan	*1,8*	*1,6*	*1,4*	*1,5*

Note : The NEM include Bulgaria, the Czech Republic, Latvia, Lithuania, Hungary, Poland, Romania, Slovenia, Slovakia and Estonia.
Sources : Customs, Destatis.

Table 2b. The main suppliers of Germany and France

%

	2003		2011	
	Germany	France	Germany	France
European Union	61,4	65,2	55,7	58,9
Euro zone	42,4	53,6	37,7	48,2
- France/Germany	*9,3*	*18,9*	*7,6*	*17,3*
- Italy	*6,5*	*9,4*	*5,3*	*7,4*
- Spain	*3,0*	*7,6*	*2,8*	*6,1*
- Netherlands	*7,9*	*4,7*	*8,4*	*4,4*
- Belgium/Luxembourg	*5,1*	*7,4*	*4,5*	*8,2*
- Austria	*4,1*	*1,0*	*4,1*	*0,9*
United Kingdom	6,4	6,7	4,8	4,4
NEM*	9,3	3,2	10,7	4,0
United States	7,8	6,5	5,6	5,7
Asia	15,5	12,5	20,4	15,7
- China	*4,1*	*4,1*	*9,7*	*8,2*
- Japan	*3,8*	*3,2*	*2,8*	*1,9*

Note : The NEM include Bulgaria, the Czech Republic, Latvia, Lithuania, Hungary, Poland, Romania, Slovenia, Slovakia and Estonia.
Sources : Customs, Destatis.

[1] Measured by the gap between the export and import of goods.

[2] See also J.-C. Bricongne, L. Fontagné and G. Gaulier (2011): “Une analyse détaillée de la concurrence commerciale entre la France et l’Allemagne” [A detailed analysis of commercial competition between France and Germany], Presentation at the Fourgeaud seminar [in French].

[3] This figure corresponds to the update of our forecast of April 2012, which takes into account the publication of the growth figures for Q1 2012.

What risks face the Greeks if they return to the drachma?

By Anne-Laure Delatte (associate researcher of the Forecasting Department)

The debate about whether the Greeks will stay in the euro zone is intensifying. Christine Lagarde, head of the IMF, has lamblasted the Greek government. The German Finance Minister, Wolfgang Schäuble, believes that the euro zone can now deal with a Greek exit, and that the Greeks no longer have a choice. What would be the risks for the Greeks of a return to the drachma? Would this inevitably plunge the country into chaos? Argentina’s experience with returning to the peso in 2002 provides some insight.

In Argentina, the peso/dollar parity was set at one peso per dollar by law in 1991. The dollar could be used freely in domestic exchange. The result was that dollars began to be used for everyday transactions, including the denomination of financial assets. In practice, in the 1990s, on average more than 70% of bank deposits and two-thirds of private sector lending were denominated in dollars. These figures peaked in the last quarter of 2001, just before the system was abandoned, when 75% of private deposits and 80% of all loans were denominated in dollars.

The average Argentinean's strong commitment to the dollar was propped up during the 1990s by the promises of all the presidential candidates to continue the system. Moreover, the abandon of the dollar in January 2002 took place in an especially dramatic context, after five presidents in a row had resigned and amidst a period of popular revolt that was felt beyond the country's borders. The peso was devalued by more than 70% against the dollar, and a massive amount of domestic savings fled the country into foreign banks. While the barter economy remained marginal, the provinces and the central State began to issue their own currency to pay civil servants and government suppliers. According to the country's central bank, in 2002 these parallel currencies accounted for an average of 30% of all bills in circulation.

The context in which Argentina returned to its national currency in 2002 therefore bears some resemblance to the current situation in Greece: widespread political confusion, a serious recession, and above all a national currency with no credibility.

Against all expectations, despite the serious crisis, the social and political disorder and monetary disintegration, which led to predictions that it would take 10 years for Argentina's GDP to return to its pre-crisis level, an economic recovery began to take hold by the second half of 2002. With nominal annual growth of 9% and controlled inflation, Argentina ultimately restored its pre-crisis level by 2004.

How did the country manage to leave the dollar with such results?

The default on 90 billion dollars in public debt, followed by a fiscal pact between the provinces and the central State, along with budget controls, led to a recovery in public finances. But the unique feature of Argentina’s experience was the monetary reform carried out in January 2002.

The devaluation of the peso rocked the country’s financial equilibrium. With 80% of lending contracted in dollars, most consumers and businesses saw the value of their debt virtually quadrupled! After the devaluation, in 2002 the amount of private debt came to 120 billion dollars, whereas the country’s GDP was only 106 billion dollars. To avoid bankrupting the entire private sector, the national authorities came up with a rule for the reimbursement of debt.

The logic was that, to avoid bankruptcy, business revenue should be denominated in the same currency as the debt. Hence on 4 February 2002, the government issued decree 214/02, which imposed the “peso-fication” of the entire economy: all prices and all contracts in the real and financial sectors, all salaries and debts, were converted into pesos at a rate of one peso per dollar, whereas the market rate was almost four pesos per dollar. Contracts in the financial sector were also converted: deposits that did not exceed thirty-thousand dollars were converted at a rate of 1.4 pesos for 1 dollar [1]. How could such a rule be imposed in light of the disastrous wealth effects on creditors?

The conversion at a rate of one for one (or 1.4 for 1) imposed by the authorities resulted in a settlement of conflicts over debt in favour of debtors, and to the detriment of national and foreign creditors. However, the main debtor in the economy is the productive sector, that is, businesses. By offering them a protected way out of the crisis, the new monetary rules neutralized balance sheet effects and permitted the devaluation to have the expansionary impact one would conventionally expect. In effect, trade began to run a surplus and the country's economy was able to benefit from the booming global economy in the early 2000s. Exports rose from 10% to 25% of GDP, and by 2004 GDP was 2% higher than the average for the 1990s. In short, the government's monetary rule led to a return to growth and employment, which explains why it won the support of the majority of the population.

In actuality, the Argentines, like the Greeks today, were caught in a trap: with contracts denominated in dollars, the return to the peso, following the devaluation, was leading towards a generalized bankruptcy of the private sector. If the Greeks were to leave the euro right now, the entire country would go bankrupt. If the drachma were devalued by 50%, as certain forecasts currently predict, private debt would double. With revenue denominated in drachmas and debt in euros, businesses and consumers would be incapable of repaying their lenders. This was the same kind of trap that paralyzed Argentina's leaders before 2002.

Argentina's experience thus provides several lessons. First, the main risk for Greece of leaving the euro is that the entire private sector would go bankrupt. Given that the public sector has already restructured 50% of its debt, all else being equal, a return to the drachma would lead to financial conflicts between private creditors and debtors that would paralyze the entire system of payments. Secondly, the State has to play a key role as arbitrator in order to resolve the crisis. In conditions like these, the nature of the rules adopted is not neutral. A number of solutions exist, and these reflect different policy orientations and have different economic consequences. In Argentina, the decision to favour national debtors ran counter to the interests of the holders of capital and foreign investors. Furthermore, contrary to the assertions of Wolfgang Schäuble, the Greek government does have choices. This is the third lesson. The resolution of the

Greek crisis is not simply an economic matter, and the options being offered to the Greek people involve political choices. The choice made will have a more favourable result for some economic groups (such as European creditors, Greek employees, holders of capital, etc.).

Depending on the nature of the political order, the State could seek to maintain the existing balance of forces, or, on the contrary, disrupt them. A reform could lead to a rupture, and provide an opportunity to establish a new balance of forces. The option pursued up to now has consisted of spreading the cost of resolving the Greek crisis over creditors, on the one hand, by restructuring the public debt, and over debtors, on the other hand, by means of structural efforts (cuts in wages \and social transfers), along with an increase in the tax burden. In contrast, a withdrawal from the euro zone accompanied by an Argentina-style restructuring of private and public debt would place the burden of the crisis resolution more on the shoulders of creditors, mainly the rest of Europe. This explains the renewed pressure seen in the discourse of some European creditor countries with respect to Greece, as well as the confusion that typifies the debate in Europe today: in the absence of an optimal solution with a neutral impact, each party is defending its own interests – at the risk of destroying the euro.

[1] Deposits of greater amounts could be either converted under the same conditions or transformed into dollar-denominated Treasury bonds.

Less austerity = more growth and less unemployment

Eric Heyer and Xavier Timbeau

The European Commission has just released its spring forecast, which anticipates a recession in 2012 for the euro zone ("mild" in the words of the Commission, but still -0.3%), which is in line with the OFCE's economic analysis of March 2012.

The brutal fiscal austerity measures launched in 2010, which were intensified in 2011 and tightened even further in 2012 virtually throughout the euro zone (with the notable exception of Germany, Table 1 and 1a), are hitting activity in the zone hard. In 2012, the negative impact on the euro zone resulting from the combination of raising taxes and reducing the share of GDP that goes to expenditure will represent more than 1.5 GDP points. In a deteriorating fiscal situation (many euro zone countries had deficits of over 4% in 2011) and in order to continue to borrow at a reasonable cost, a strategy of forced deficit reduction has become the norm.

Table 1. The euro zone in 4 macroeconomic aggregates from 2009 to 2012

	2009	2010	2011	2012
GDP growth (%/yr)	-4,4	1,8	1,5	-0,4
Public deficit (% GDP)	-5,5	-5,5	-3,6	-2,9
Jobless rate (% active pop)	9,6	10,1	10,2	10,9
Fiscal impulse (% GDP)	1,7	-0,3	-1,1	-1,5

Sources : National accounts, OFCE calculations and forecasts.

This strategy is based on declarations that the 3% ceiling will be reached by 2013 or 2014, with balanced budgets to follow by 2016 or 2017 in most countries. However, these goals seem to be overly ambitious, as no country is going to meet its targets for 2013. The reason is that the economic slowdown is undermining the intake of the tax revenue needed to balance budgets. An overly optimistic view of the impact of fiscal restraint on activity (the so-called fiscal multiplier) has been leading to unrealistic goals, which means that GDP growth forecasts must ultimately be systematically revised downward. The European Commission is thus revising its spring forecast for the euro zone in 2012 downward by 0.7 point compared to its autumn 2011 forecast. Yet there is now a broad consensus on the fact that fiscal multipliers are high in the short term, and even more so that full employment is still out of reach (here too, many authors agree with the analyses made by the OFCE). By underestimating the difficulty of reaching inaccessible targets, the euro zone members are locked in a spiral where jitters in the financial markets are driving ever greater austerity.

Unemployment is still rising in the euro zone and has hardly stopped increasing since 2009. The cumulative impact on economic activity is now undermining the legitimacy of the European project itself, and the drastic remedy is threatening the euro zone with collapse.

What would happen if the euro zone were to change course in 2012?

Assume that the negative fiscal impulse in the euro zone is on the order of -0.5 percent of GDP (instead of the expected total of -1.8 GDP points). This reduced fiscal effort could be repeated until the public deficit or debt reaches a fixed target. Because the effort would be more measured than in current plans, the burden of the adjustment would be spread out more fairly over the taxpayers in each country, while avoiding the burden of drastic cuts in public budgets.

Table 2 summarizes the results of this simulation. Less austerity leads to more growth in all the countries (Table 2a), and all the more so as the fiscal consolidation announced for 2012 intensifies. Our simulation also takes into account the impact of the activity in one country on other countries through trade. Thus, Germany, which has an unchanged fiscal impulse in our scenario, would experience an 0.8 point increase in growth in 2012.

Table 2. Fiscal impulse of -0.5 GDP point in the euro zone in 2012

	GDP (%/yr)		Public deficit (% GDP)		Jobless rate (% active pop.)	
	2011	2012	2011	2012	2011	2012
2012, under current plans	1,5	-0,4	-3,6	-2,9	10,2	10,9
2012, if 0.5% GDP impulse		1,7		-3,1		9,7

Note: The impulse is the change in the structural deficit. The structural deficit is the public deficit excluding the impact of the economic cycle. A negative impulse reflects a restrictive fiscal policy. Here the public («administrations publiques», or "APU") deficit includes the central state, regional government and social security agencies.

Sources: National accounts, OFCE calculations and forecasts.

In the "less austerity" scenario, unemployment would decline instead of continuing to increase. In all the countries except Greece, the public deficit would be lower in 2012 than in 2011. Admittedly, this reduction would be less than in the initial scenario in certain countries, in particular those that have announced strong negative impulses (Spain, Italy, Ireland, Portugal and … Greece), which are the ones most mistrusted by the financial markets. In contrast, in some countries, such as Germany and the Netherlands, the government deficit would shrink more than in the initial scenario, with the indirect positive effect of stronger growth outweighing the direct effect of less fiscal consolidation. For the euro zone as a whole, the public deficit would be 3.1 percentage points of GDP, against 2.9 points in the initial scenario. It is a small difference compared to more favorable growth (2.1%), along with lower unemployment (-1.2 points, Table 2) instead of an increase as in the initial scenario.

The key to the "less austerity" scenario is to enable the countries in greatest difficulty, those most obliged to implement the austerity measures that are plunging their economies into the vicious spiral, to reduce their deficits more slowly. The euro zone is split into two camps. On the one hand, there are those who are demanding strong, even brutal austerity to give credibility to the sustainability of public finances, and which have ignored or deliberately underestimated the consequences for growth; on the other are those who, like us, are recommending less austerity to sustain more growth and a return to full employment. The first have failed: the sustainability of public finances has not been secured, and recession and the default of one or more countries are threatening. The second strategy is the only way to restore social and economic – and even fiscal – stability, as it combines a sustainable public purse with a better balance between fiscal restraint and employment and growth, as we proposed in a letter to the new President of the French Republic.

Table 1a. Details on the 4 macroeconomic aggregates for the euro zone from 2009 to 2012

	GDP growth (%/yr)				Public deficit (% GDP)				Jobless rate (% active pop.)				Fiscal impulse (% GDP)			
	2009	2010	2011	2012	2009	2010	2011	2012	2009	2010	2011	2012	2009	2010	2011	2012
DEU	-5,1	3,6	3,1	0,3	-3,2	-4,3	-1,0	-1,1	7,8	7,1	6,0	5,5	0,7	1,2	-0,9	-0,3
FRA	-2,6	1,4	1,7	0,2	-7,5	-7,1	-5,2	-4,4	9,2	9,4	9,3	9,8	2,5	-0,7	-1,7	-1,7
ITA	-5,5	1,8	0,5	-1,7	-5,4	-4,6	-3,8	-2,8	7,8	8,4	8,4	9,4	0,8	-0,4	-1,0	-2,9
ESP	-3,7	-0,1	0,7	-1,1	-11,2	-9,3	-8,5	-6,5	18,0	20,1	21,7	23,5	4,1	-1,9	-1,2	-3,4
NLD	-3,5	1,6	1,3	-1,1	-5,6	-5,1	-5,0	-4,5	3,7	4,5	4,5	5,4	3,8	-1,5	-0,2	-1,9
BEL	-2,7	2,3	1,9	0,1	-5,8	-4,1	-4,0	-3,4	7,9	8,3	7,2	7,6	1,8	-0,3	-0,1	-1,4
PRT	-2,9	1,4	-1,5	-2,9	-10,1	-9,8	-4,0	-4,5	10,7	12,1	12,9	13,4	4,9	-0,6	-5,5	-3,0
IRL	-7,0	-0,4	0,7	-0,3	-14,4	-32,0	-10,1	-8,7	11,9	13,7	14,5	14,9	3,7	-4,1	-2,5	-3,0
GRC	-2,3	-4,4	-6,2	-5,3	-15,8	-10,6	-9,3	-7,3	9,5	12,5	17,2	19,5	3,4	-7,9	-5,6	-5,3
FIN	-8,4	3,7	2,8	0,7	-2,5	-2,5	-1,2	-0,9	8,8	8,4	7,8	7,5	0,4	-1,5	-1,1	-1,1
AUT	-3,6	2,5	3,0	0,4	-4,1	-4,4	-3,4	-3,0	4,8	4,4	4,2	4,5	0,4	0,6	-0,5	-1,2

Note: DEU Germany; FRA France; ITA Italy; ESP Spain; NLD Netherlands; BEL Belgium; PRT Portugal; IRL Ireland; GRC Greece; FIN Finland; AUT Austria.
Sources: National accounts, OFCE calculations and forecasts.

Table 2b. Fiscal impulse of -0.5 GDP point in the euro zone countries in 2012

	DEU	FRA	ITA	ESP	NLD	BEL	PRT	IRL	GRC	FIN	AUT
GDP growth rate (%/yr)	1,1	2,2	1,4	2,6	2,1	1,8	0,7	2,8	0,2	1,9	1,8
Difference with Table 1a	0,8	2,0	3,1	3,7	3,2	1,7	3,6	3,1	5,5	1,2	1.4
Of which: - direct impact	0,0	1,2	2,4	2,9	2,5	0,9	2,5	2,5	4,8	0,6	0,7
- impact *via* trade	0,8	0,8	0,7	0,8	0,7	0,8	1,1	0,6	0,7	0,6	0.7
Public deficit (% GDP)	-0,7	-4,6	-3,7	-7,5	-4,3	-3,4	-5,2	-9,7	-9,4	-0,9	-3,0
Difference with Table 1a	0,4	-0,2	-0,9	-1,0	0,2	0,0	-0,7	-1,0	-2,1	0,0	0,0
Jobless rate (% active pop.)	5,1	8,8	7,9	21,6	3,8	6,7	11,6	13,3	16,8	6,9	3,8
Difference with Table 1a	-0,4	-1,0	-1,5	-1,9	-1,6	-0,9	-1,8	-1,5	-2,7	-0,6	-0,7

Sources: National accounts, OFCE calculations and forecasts.

The financial markets: Sword of Damocles of the presidential election

By Céline Antonin

Although some of the candidates may deny it, the financial risk linked to the fiscal crisis in the euro zone is the guest of honour at the presidential campaign. As proof that this is a sensitive issue, the launch in mid-April of a new financial product on French debt crystallized concerns. It must be said that this took place in a very particular context: the Greek default showed that the bankruptcy of a euro zone country had become possible. Despite the budgetary firewalls in place since May 2010 (including the European Financial Stability Fund), some of France's neighbours are facing a lack of confidence from the financial markets, which is undermining their ability to meet their commitments and ensure the fiscal sustainability of their government debt, the most worrying example to date being Spain. What tools are available to speculators to attack a country like France, and what should be feared in the aftermath of the presidential election?

The tool used most frequently for speculation on a country's public debt is the Credit Default Swap, or CDS. This contract provides insurance against a credit event, and in particular against a State's default (see the "Technical functioning of CDS" annex for more detail). Only institutional investors, mainly banks, insurance companies and hedge funds, have direct access to the CDS market on sovereign States [1].

Credit default swaps are used not only for coverage, but also as an excellent means of speculation. One criticism made of the CDS is that the buyer of the protection has no obligation to hold any credit exposure to the reference entity, i.e. one can buy CDS without holding the underlying asset ("naked" purchase/sale). In June 2011, the CDS market represented an outstanding notional amount of 32,400 billion dollars. Given the magnitude of this figure, the European Union finally adopted a Regulation establishing a framework for short-selling: it prohibits in particular the naked CDS on the sovereign debt of European States, but this will take effect only on 1 November 2012.

The FOAT: new instrument for speculation on French debt?

This new financial instrument, introduced by Eurex on April 16 [2], is a futures contract, that is to say an agreement between two parties to buy or sell a specific asset at a future date at a price fixed in advance. The specific asset in this case is the French Treasury OAT bond, with a long residual maturity (between 8.5 and 10.5 years) and a coupon of 6%, and it has a face value of 100,000 euros. Should we worry about the launch of this new contract on the eve of the presidential election? Not when you consider that the launch of the FOAT addresses the gap in yields between German and French bonds that has arisen since the recent deterioration of France's sovereign rating: previously, as German and French bond yields were closely correlated, the FOAT on German bonds allowed coverage of both German and French bond risks. After the gap in yields between the two countries widened, Eurex decided to create a specific futures contract for French bonds. Italy witnessed this same phenomenon: in September 2009, Eurex also launched three futures contracts on Italian government bonds [3]. In addition, Eurex is a private market under German law, and is much more transparent than the OTC market on which CDS are traded. Note that the FOAT launch was not very successful: on the day it was launched, only 2,581 futures contracts were traded on French bonds, against 1,242,000 on German bonds and 13,671 on Italian bonds [4].

Even if, as with the CDS, the primary function of the FOAT is to hedge against risk, it can also become an instrument for speculation, including via short selling. While speculation on French debt was previously limited to large investors, with an average notional amount of 15 billion euros per CDS [5], the notional amount of the new FOAT contract is 100,000 euros, which will attract more investors into the market for French debt. If speculators bet on a decline in the sustainability of France's public finances, then the price of futures contracts on the OAT bonds will fall, which will amplify market movements and result in higher interest rates on OAT contracts.

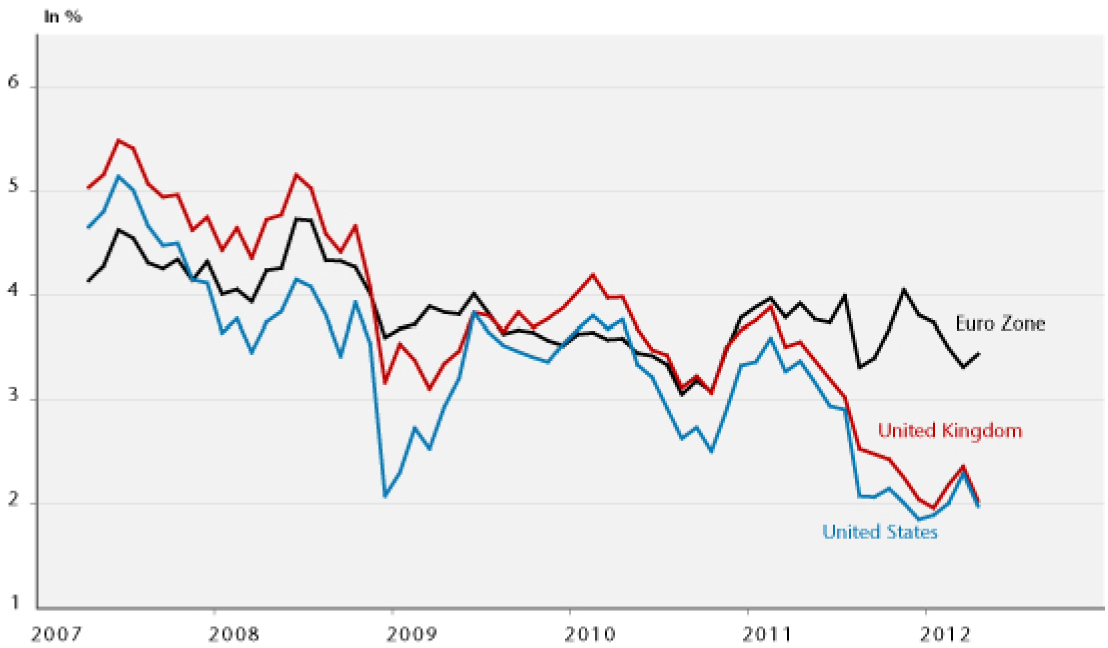
The not so rosy future?

It is difficult to predict how the financial markets will behave in the wake of the French presidential election. Studying what has happened in other euro zone countries is not very informative, due to each one's specific situation. The country most "comparable" to France would undoubtedly be Italy. However, the appointment of Mario Monti in November 2011 took place in an unusual context, where the formation of a technocratic government was specifically intended to restore market confidence through a strenuous effort to reduce the deficit, with Italy also benefitting from the ECB's accommodative policy.

The [French budgetary configuration is different](), as the financial imperative appears only in the background. The candidates of the two major parties both advocate the need to restore a balanced budget. Their timetables are different (2016 for Nicolas Sarkozy's UMP, 2017 for François Hollande's PS), as are the means for achieving this: for Sarkozy, the focus will be more on restraint in public spending (0.4% growth per year between 2013 and 2016, against 1.1% for the PS), while Hollande emphasizes growth in revenue, with an increase in the tax burden of 1.8% between 2012 and 2017 (against 1% for the UMP).

But this is not the heart of the matter. What is striking, beyond the need to reduce public deficits in the euro zone countries, is the fact that our destinies are inextricably linked. As is shown by the graph on changes in bond yields in the euro zone (Figure 2), when the euro zone is weakened, all the countries suffer an impact on their risk premium relative to the United States and the United Kingdom, although to varying degrees. It is therefore unrealistic to think about France's budget strategy and growth strategy outside of a European framework. What will prevent the financial markets from speculating on a country's debt is building a Europe that is fiscally strong, has strict rules, and is supported by active monetary policy. This construction is taking place, but it is far from complete: the EFSF does not have sufficient firepower to help countries in difficulty; the growth strategy at the European level agreed at the summit of 2 March 2012 needs to be more comprehensive; and the ECB needs to pursue an active policy, like the Fed, which specifically requires a revision of its statutes. As was pointed out by Standard and Poor's when it announced the downgrade of the French sovereign rating last December, [what will be watched closely by the financial markets is the fiscal consistency of the euro zone](). On 6 May 2012, what attitude will the next President then take vis-à-vis the construction of the budget and how able will he be to assert his position in the euro zone – this will determine the future attitude of the financial markets, not only vis-à-vis France, but also vis-à-vis every euro zone country.

Figure 1. Average yields on 10-year bonds in the euro zone, the United States and the United Kingdom



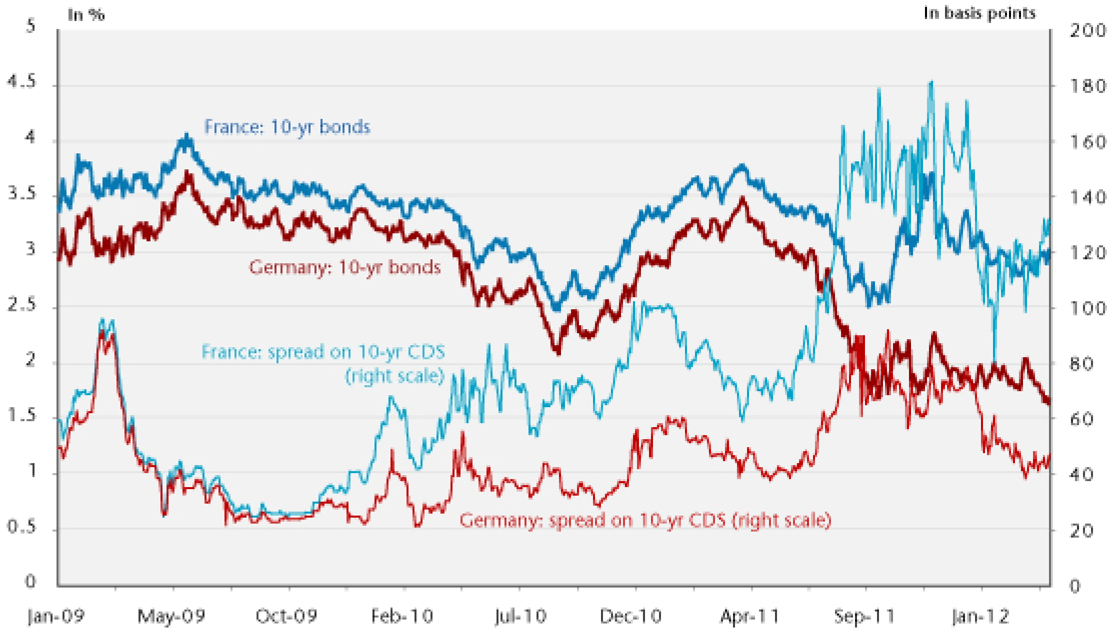
Source : Datastream.

Annex: Technical functioning of Credit Default Swaps

The contract buyer acquires the right to sell a benchmark bond at its face value (called the "principal") in case of a credit event. The buyer of the CDS pays the seller the agreed amounts at regular intervals, until maturity of the CDS or the occurrence of the credit event. The swap is then unwound, either by delivery of the underlying instrument, or in cash. If the contract terms provide for physical settlement, the buyer of the CDS delivers the bonds to the seller in exchange for their nominal value. If the CDS is settled in cash, the CDS seller pays the buyer the difference between the nominal amount of the buyer's bonds and the listed value of the bonds after the credit event (recovery value), in the knowledge that in this case the buyer of the CDS retains its defaulted bonds. In most cases, the recovery value is determined by a formal auction process organized by the ISDA (International Swaps and Derivatives Association). The annual premium that the bank will pay to the insurance company for the right to coverage is *called the CDS spread and constitutes the value listed on the market: the higher the risk of default, the more the CDS spread increases (Figure 1). In reality, as the banks are both the buyers and sellers of protection, the spread is usually presented as a range: a bank can offer a range from 90 to 100 basis points on the risk of a French default. It is thus ready to buy protection against the risk of default by paying 90 basis points on the principal but it demands 100 to provide that protection.*

To illustrate this, consider the following example. On 7 May 2012, a bank (buyer) signs a CDS on a principal of 10 million euros for five years with an insurance company (seller). The bank agrees to pay 90 basis points (spread) to protect against a default by the French State. If France does not default, the bank will receive nothing at maturity, but will pay 90,000 euros annually every 7 May for the years 2012-2017. Suppose that the credit event occurs on 1 October 2015. If the contract specifies delivery of the underlying asset, the buyer has the right to deliver its French bonds with a par value of 10 million euros and in exchange will receive 10 million euros in cash. If a cash settlement is expected, and if the French bonds are now listed only at 40 euros, then the insurance company will pay the bank 10 million minus 4 million = 6 million euros.

Annex Figure. France/Germany: premiums on 10-year CDS and 10-year bond yields



Source : Datastream.

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[1] Individuals can play on the markets for corporate CDS via trackers (collective investment in transferable securities that replicates the performance of a market index).

[2] The Eurex was created in 1997 by the merger of the German futures market, Deutsche Termin-Borse (DTB), and the futures market in Zurich, the Swiss Options and Financial Futures Exchange (SOFFEX), to compete with the LIFFE. It belongs to Deutsche Börse and dominates the market for long-term financial futures.

[3] In September 2009 for bonds with long residual maturities (8.5 to 11 years), October 2010 for bonds with short residual maturities (2 to 3.25 years) and July 2011 for bonds with average residual maturities (4.5 to 6 years).

[4] Note that this comparison is biased due to the fact that there are 4 types of futures contracts on German debt, 3 on Italian debt and only 1 on French debt.

[5] Weekly data provided by the DTCC for the week of 9 to 13 April 2012 on CDS on French sovereign debt: the outstanding

notional amount came to 1,435 billion dollars, with 6822 contracts traded.

Must balancing the public finances be the main goal of economic policy

By Henri Sterdyniak

The financial crisis of 2007-2012 caused a sharp rise in public deficits and debt as States had to intervene to save the financial system and support economic activity, and especially as they experienced a steep drop in tax revenues due to falling GDP. In early 2012, at a time when they are far from having recovered from the effects of the crisis (which cost them an average of 8 GDP points compared to the pre-crisis trend), they face a difficult choice: should they continue to support activity, or do whatever it takes to reduce public deficits and debt?

An in-depth note expands on nine analytical points:

– The growth of debt and deficits is not peculiar to France; it occurred in all the developed countries.

– France's public bodies are certainly indebted, but they also have physical assets. Overall the net wealth of government represented 26.7% of GDP in late 2010, or 8000 euros per capita. Moreover, when all the national wealth is taken into account (physical assets less foreign debt), then every French newborn has an average worth at birth of 202 000 euros (national wealth divided by the number of inhabitants).

– In 2010, the net debt burden came to 2.3% of GDP, reflecting an average interest rate on the debt of 3.0%, which is well below the nominal potential growth rate. At this level, the real cost of the debt, that is, the primary surplus needed to stabilize the debt, is zero or even slightly negative.

– The true "golden rule" of public finances stipulates that it is legitimate to finance public investment by public borrowing. The structural deficit must thus be equal to the net public investment. For France, this rule permits a deficit of around 2.4% of GDP. There is no reason to set a standard for balancing the public finances. The State is not a household. It is immortal, and can thus run a permanent debt: the State does not have to repay its debt, but only to guarantee that it will always service it.

– The public deficit is detrimental to future generations whenever it becomes destabilizing due to an excessive increase in public spending or an excessive decrease in taxation, at which point it causes a rise in inflation and interest rates and undermines investment and growth. This is not the situation of the current deficit, which is aimed at making adjustments to provide the necessary support for economic activity in a situation of low interest rates, due to the high level of household savings and the refusal of business to invest more.

– For some, the 8 GDP points lost during the crisis have been lost forever; we must resign ourselves to persistently high unemployment, as it is structural in nature. Since the goal must be to balance the structural public balance, France needs to make an additional major effort of around 4 percentage points of GDP of its deficit. For us, a sustainable deficit is about 2.4 GDP points. The structural deficit in 2011 is already below that figure. It is growth that should make it possible to reduce the current deficit. No additional fiscal effort is needed.

– On 9 December 2011, the euro zone countries agreed on a new fiscal pact: the Treaty on Stability, Coordination and Governance of the European Monetary Union. This Pact will place strong constraints on future fiscal policy. The structural deficit of each member country must be less than 0.5% of GDP. An automatic correction mechanism is to be triggered if this threshold is exceeded. This constraint and the overall mechanism must be integrated in a binding and permanent manner into the fiscal procedures of each country. Countries whose debt exceeds 60% of GDP will have to reduce their debt ratio by at least one-twentieth of the excess every year.

This project is economically dangerous. It imposes medium-term objectives (a balanced budget, a debt rolled back to below 60% of GDP) that are arbitrary and are not *a priori* compatible with the necessities of an economic equilibrium. Likewise, it imposes a fiscal policy that is incompatible with the necessities of short-term economic management. It prohibits any discretionary fiscal policy. It deprives governments of any fiscal policy instrument.

– As the rise in public debts and deficits in the developed countries came in response to mounting global imbalances, we cannot reduce the debts and deficits without addressing the causes of these imbalances. Otherwise, the simultaneous implementation of restrictive fiscal policies in the OECD countries as a whole will lead to stagnating production, falling tax revenues and deteriorating debt ratios, without managing to reassure the financial markets.

– A more balanced global economy would require that the countries in surplus base their growth on domestic demand and that their capital assumes the risks associated with direct investment. In the Anglo-American world, higher growth in wage and social income and a reduction in income inequalities would undercut the need for swelling financial bubbles, household debt and public debt. The euro zone needs to find the 8 GDP points lost to the crisis. Instead of focussing on government balances, the European authorities should come up with a strategy to end the crisis, based on a recovery in demand, and in particular on investment to prepare for the ecological transition. This strategy must include keeping interest rates low and public deficits at the levels needed to support activity.

The new European treaty, the euro and sovereignty

By Christophe Blot

On 2 March 2012, 25 countries in the Economic and Monetary Union (EMU) adopted a new treaty providing for greater fiscal discipline. The treaty became an object of dispute almost before the ink was dry [1], as Francois Hollande announced that, if elected, he would seek to renegotiate it in order to emphasize the need to address growth. There is no doubt that a turnabout like this on a treaty that was so fiercely negotiated would be frowned upon by a number of our European partners. The merit of strengthening fiscal discipline in a time of crisis is, nevertheless, an issue worth posing.

So how should we look at this new treaty? Jérôme Creel, Paul Hubert and Francesco Saraceno have already demonstrated the potential recessionary impact of the rules it introduces. In addition to these macroeconomic effects, the treaty also fails to deal with an essential question that should be at the heart of the European project: sovereignty.

In 1998, one year before the launch of the euro, Charles Goodhart [2] published an article in which he raised a peculiar feature of the Economic and Monetary Union (EMU) with respect to monetary theory and history. Goodhart recalled that a currency is almost always inextricably bound up with the expression of political and fiscal sovereignty. However, in the context of the EMU, this link is broken, as the euro and monetary policy are controlled by a supranational institution even though they are not part of any expression of European sovereignty, as fiscal policy decisions in particular remain decentralized and regulated by the Stability and Growth Pact. Goodhart concluded that the creation of the euro portends tensions that will need careful attention.

The current crisis in the euro zone shows that this warning was well founded. The warning makes it possible above all to consider the crisis from a different perspective – a political one. The issue of the sustainability of the debt and compliance with rules in effect masks the euro’s underlying problem, its “original sin”: the single currency is doomed if it is not based on fiscal and political sovereignty. If there are any exceptions to this, they consist of micro-states that have abandoned their monetary sovereignty to neighbours that are far more powerful economically and politically. The euro zone is not the Vatican.

The renegotiation of the treaty or the opening of new negotiations with a view to the ratification of a European

Constitution is not only urgent but vital to the survival of the European project. Beyond the overarching objectives of growth, employment, financial stability and sustainable development, which, it must be kept in mind, are at the heart of European construction, as is evidenced by their inclusion in Article 3 of the Treaty on the European Union, any new negotiations should now address the question of Europe's political and fiscal sovereignty, and therefore, by corollary, the issue of the transfer of national sovereignty.

It should be noted that this approach to the implementation of European sovereignty is not inconsistent with the existence of rules. In the United States, most states have had balanced budget rules since the mid-nineteenth century, prior to which a number of them had defaulted (see C.R. Henning and M. Kessler [3]). However, these rules were adopted at the initiative of the states and are not included in the US Constitution. There are, however, ongoing efforts to include a requirement in the Constitution for a balanced budget at the federal level. For the moment, these have not been successful, and they are being challenged on the grounds that this would risk undermining the stabilizing power of the federal budget. In the United States, before the crisis the resources of the federal state accounted for 19% of GDP, compared with an EU budget that does not exceed 1% of GDP and which must always be balanced, and therefore cannot be used for of macroeconomic adjustments. In the US, the stabilization of shocks is thus handled through an unrestricted federal budget, which offsets the poor responsiveness of local fiscal policies that are constrained by the requirement for balance. While the euro zone must surely find its own way, the fact remains that the euro should not be an instrument in the hands of the European Central Bank alone: it must become a symbol of the political and fiscal sovereignty of all the euro zone's citizens.

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[1] It will only take effect, however, after a ratification

process in the 25 countries. This could be a long and uncertain process, as Ireland has announced that it will hold a referendum.

[2] See "The two concepts of money: implications for the analysis of optimal currency areas", *Journal of European Political Economy* vol.14 (1998) pages 407-432.

[3] "Fiscal federalism: US history for architects of Europe's fiscal union", (2012) Peterson Institute for International Economics.

He who sows austerity reaps recession

By the Department of Analysis and Forecasting, headed by X. Timbeau

This article summarizes OFCE note no.16 that gives the outlook on the global economy for 2012-2013.

The sovereign debt crisis has passed its peak. Greece's public debt has been restructured and, at the cost of a default, will fall from 160% of GDP to 120%. This restructuring has permitted the release of financial support from the Troika to Greece, which for the time being solves the problem of financing the renewal of the country's public debt. The contagion that hit most euro zone countries, and which was reflected in higher sovereign rates, has been stopped. Tension has eased considerably since the beginning of 2012, and the risk that the euro zone will break up has been greatly reduced, at least in the short term. Nevertheless, the process of the Great Recession that began in 2008 being transformed into a very Great Recession has not been interrupted by the temporary relief of the Greek crisis.

First, the global economy, and especially the euro zone, remains a high-risk zone where a systemic crisis is looming once again. Second, the strategy adopted by Europe, namely the rapid reduction of public debt (which involves cutting public deficits and maintaining them below the level needed to stabilize debt), is jeopardizing the stated objective. However, since the credibility of this strategy is perceived, rightly or wrongly, as a necessary step in the euro zone to reassure the financial markets and make it possible to finance the public debt at acceptable rates (between 10% and 20% of this debt is refinanced each year), the difficulty of reaching the goal is demanding ever greater rigor. The euro zone seems to be pursuing a strategy for which it does not hold the reins, which can only fuel speculation and uncertainty.

Our forecast for the euro zone points to a recession of 0.4 percentage point in 2012 and growth of 0.3 point in 2013 (Table 1). GDP per capita in the euro zone should decline in 2012 and stabilize in 2013. The UK will escape recession in 2012, but in 2012 and 2013 annual GDP growth will remain below 1%. In the US, GDP growth will accelerate from 1.7% per year in 2011 to 2.3% in 2012. Although this growth rate is higher than in the euro zone, it is barely enough to trigger an increase in GDP per capita and will not lead to any significant fall in unemployment.

The epicenter of the crisis is thus shifting to the Old Continent and undermining the recovery in the developed countries. The United States and United Kingdom, which are faced even more than the euro zone with deteriorating fiscal positions, and thus mounting debt, are worried about the sustainability of their public debts. But because growth is just as important for the stability of the debt, the budget cuts in the euro zone that are weighing on their activity are only adding to difficulties of the US and UK.

By emphasizing the rapid reduction of deficits and public debt, euro zone policymakers are showing that they are anticipating a worst case scenario for the future. Relying on so-called market discipline to rein in countries whose public finances have deteriorated only aggravates the problem of sustainability by pushing interest rates up. Through the interplay of the fiscal multiplier, which is always underestimated in the development of strategies and forecasts, fiscal adjustment policies are leading to a reduction in activity, which validates the resignation to a worse “new normal”. Ultimately, this is simply a self-fulfilling process.

Outlook for global growth

Annual growth rate (%)

	Weight in the total (1)	GDP in volume 2011	2012	2013
DEU	4,2	3,1	0,1	0,8
FRA	3,1	1,7	0,2	0,7
ITA	2,6	0,8	-1,7	-0,9
ESP	2,0	0,7	-1,3	-0,6
NLD	1,0	1,5	-1,3	0,5
BEL	0,6	1,9	0,1	0,9
AUT	0,5	3,1	0,4	0,8
FIN	0,5	2,7	0,7	1,1
PRT	0,3	-1,3	-2,9	0,2
GRE	0,3	-6,3	-5,3	-0,5
IRL	0,2	0,8	-0,6	0,9
EEZ	15,5	1,5	-0,4	0,3
GBR	3,2	0,9	0,7	0,9
SWE	0,5	4,0	0,8	1,6
DNK	0,3	1,1	0,6	1,1
EU-15	19,4	1,5	-0,2	0,4
12 new member states	2,7	3,1	1,1	2,1
EU-27	22,0	1,7	-0,1	0,6
CHE	0,5	1,9	0,2	1,0
NOR	0,4	2,5	2,1	2,0
Europe	22,9	1,6	0,0	0,6
USA	20,0	1,7	2,1	2,4
JPN	6,3	-0,6	1,9	1,5
CAN	1,9	2,5	2,0	2,3
Industrialized countries	50,5	1,4	1,2	1,5
EU candidate countries (2)	1,6	7,6	1,7	4,3
RUS	3,3	4,3	3,3	3,8
Other CIS (3)	1,3	3,9	3,7	4,2
CHN	11,3	9,2	8,1	8,1
Other Asian countries	13,2	5,6	3,8	6,3
Latin America	8,7	4,3	3,1	3,5
Sub-Saharan Africa	2,3	4,9	5,3	5,3
Middle East and North Africa	4,8	3,1	3,2	3,6
World	100	3,5	3,1	3,4

(1) Weighted according to GDP and 2008 PPPs estimated by the IMF.
(2) Croatia, Republic of Macedonia and Turkey.
(3) Commonwealth of Independent States.
Sources: IMF, OECD, national sources, [illegible] OFCE calculations and forecasts.

Austerity is not enough

By André Grjebine and [Francesco Saraceno]

It is certainly possible to question whether the role acquired by the rating agencies in the international economy is legitimate. But if in the end their message must be taken into account, then this should be done based on what they are really saying and not on the economic orthodoxy attributed to them, sometimes wrongly. This orthodoxy is so prevalent that many commentators are continuing to talk about the decision by Standard & Poor's (S&P) to downgrade the rating of France and other European countries as if this could be attributed to an insufficiently strong austerity policy.

In reality, the rating agency justifies the downgrade that it has decided with arguments opposed to this orthodoxy. For instance, the agency criticises the agreement between European leaders that emerged from the EU summit on 9 December 2011 and the statements that followed it, making the reproach that the agreement takes into account only one aspect of the crisis, as if it "… stems primarily from fiscal profligacy at the periphery of the euro zone. In our view, however, the financial problems facing the euro zone are as much a consequence of rising external imbalances and divergences in competitiveness between the EMU's core and the so-called 'periphery'. As such, we believe that a reform process based on a pillar of fiscal austerity alone risks becoming self-defeating, as domestic demand falls in line with consumers' rising concerns about job security and disposable incomes, eroding national tax revenues."

Based on this, S&P believes that the main risk facing the European states could come from a deterioration in the fiscal positions of certain among them "in the wake of a more recessionary macroeconomic environment." As a result, S&P does not exclude a further deterioration in the coming year of the rating of euro zone countries.

So if the European countries do indeed take into account the explanations of the rating agency, they should implement economic policies that are capable of both supporting growth and thereby facilitating the repayment of public debts while at the same time rebalancing the current account balances between the euro zone countries. This dual objective could be achieved only by a stimulus in the countries running a surplus, primarily Germany.

Unsustainable debt

The budget adjustments being imposed on the countries of the periphery should also be spread over a period that is long enough for its recessionary effects to be minimised. Such a strategy would accord with the principle that in a group as heterogeneous as the euro zone, the national policies of member countries must be synchronised but certainly not convergent, as is being proposed in some quarters. Such a policy would boost the growth of the zone as a whole, it would make debt sustainable and it would reduce the current account surpluses of some countries and the deficits of others. The least we can say is that the German government is far from this approach.

Didn’t Angela Merkel respond to the S&P statement by calling once again for strengthening fiscal discipline in the countries that were downgraded, that is to say, adopting an analysis opposed to that of the rating agency? Given its argumentation, one begins to wonder whether the agency wouldn’t have been better advised to downgrade the country that wants to impose austerity throughout the euro zone rather than wrongly to give it a feeling of being a paragon of virtue by making it one of the few to retain its AAA rating.

Estonia: a new model for the euro zone?

By Sandrine Levasseur

In the wake of the Swedish and German models, should Europe now adopt the Estonian model? Despite Estonia's *success story*, the answer is no. Here's why.

Estonia has been a source of continuous surprise in recent years. First, it wrong-footed those who, in the autumn of 2008, thought the country had no alternative but to abandon its *currency board* and massively devalue its currency. However, Estonia chose a different path, as it strengthened its monetary anchor by adopting the euro on 1st January 2011. The winter of 2008 saw another surprise when the country decided on a significant reduction in civil servant salaries in the hope of creating a "demonstration effect" for the private sector, particularly for businesses exposed to international competition. The government's objective was clearly to help the economy to become more competitive. This strategy, called an "internal devaluation", worked in the sense that the total wage bill actually declined, with wage losses that could reach up to 10% to 15% at the peak of the crisis. Surprisingly, this decline in wages, which affected every sector of the economy, was relatively well accepted by the population. It was met by only a few strikes and demonstrations, even when the government decided to introduce more flexibility into the labour market (easier redundancy procedures, lifting administrative authorization for the reduction of working time, etc.). Finally, the ultimate surprise was undoubtedly GDP growth of around 8% in 2011, a fall in the unemployment rate to less than 11%, and a trade deficit of only 2% of GDP (versus 16% before the crisis). Estonia's public debt was contained at 15.5% of GDP, and for

2011 the country even recorded a budget surplus of 0.3% of GDP! This is the stuff of dreams for the other euro zone countries!

Despite all this, the strategy adopted by Estonia cannot be turned into a model for the other euro zone countries. In fact, Estonia's success story is due to a convergence of favourable factors, with two conditions being critical:

1. A strategy of lowering wages makes it possible to become more competitive relative to a country's main partners only if it is conducted in isolation. If in Europe, particularly in the euro zone, every country were to lower its wage bill, the result would simply be sluggish domestic demand, with no positive impact on the countries' exports. To date, among the members of the euro zone, only Estonia and Ireland (two "small" countries) have played the card of lowering wages in the context of the crisis. We can scarcely imagine the impact on the euro zone if Germany or France ("large" countries) had drastically lowered wages at the height of the crisis. In addition to weak demand, this would have inevitably led to a trade war between the countries, which ultimately would not have benefited anyone.

2. A strategy of lowering wages is good for the country that implements it only so long as its major trading partners are on a trajectory of growth. In this regard, the upturn in Sweden and Finland partly explains Estonia's good export performance. In 2011, GDP increased by 4.1% in Sweden and 3% in Finland (against "only" 1.6% in the euro zone). We might expect that exports from Estonia would have been less dynamic (+33% in 2011!) if the growth rate of its two major trading partners had been lower, since between them Finland and Sweden represent 33% of Estonia's export markets.

But does this mean that a slowdown in activity in Sweden and Finland – as can be anticipated for 2012 or 2013 – would negate the efforts made by Estonia's workers in terms of pay concessions? In other words, with respect to the long-term prospects of Estonia's economy, has the reduction in wages been in vain? The answer is no, it hasn't. In Estonia (as well as in the other Baltic states), the decline in wages was in fact necessary to offset the strong wage hikes granted before the crisis, which were largely disconnected from any gains in productivity. The loss of competitiveness of the Estonian economy that resulted could be seen in the winter of 2007, when GDP decelerated significantly and the trade deficit reached an abysmal level. By the spring of 2008, it had become clear that the growth model of Estonia (and of the other Baltic states), based on the equation "consumption + credit + greatly expanded construction", was unsustainable and that "adjustments" were inevitable in order to reorient the economy towards exports.

A detailed analysis of the adjustments made in the Estonian labour market during the economic crisis (see here) helps to measure the impact on business competitiveness of the pay cuts, the reduction in working time and the massive layoffs. Overall, the real effective exchange rate (measured by the unit labour costs of Estonia relative to those of its trading partners) has depreciated by some 23% since 2009. The loss of purchasing power suffered by Estonia's workers is estimated at 9% (in real terms) since 2009, or even at 20% of the gains in purchasing power obtained in 2004-2008. Among the institutional and societal factors that led Estonians to accept the wage cuts and a more flexible labour market, the absence of strong union representation seems to be an important explanatory factor. For example, in Estonia, fewer than 10% of employees are covered by collective bargaining agreements (against 67% in France). The other key explanatory factor seems to have been the desire to join the euro zone. In these difficult times for the single currency, if this willingness seems surprising, it is nevertheless still relevant for a certain number of EU countries that have not yet adopted the euro.

What new European austerity plans await us in 2012?

By Eric Heyer

To meet French commitments vis-à-vis Brussels to a general government deficit in 2012 of 4.5% of GDP, the French Prime Minister Francois Fillon announced a new plan to cut the budget by 7 billion euros. Will the plan, announced 7 November, be sufficient? Certainly not! So what new austerity plans should we expect in the coming months, and what impact will they have on growth in 2012?

In early October 2011, among the points we indicated in our forecast dossier was that, of all the finance bills approved in Europe, no major country has met its commitment to reduce the deficit.

This will be the case in particular of Italy and the UK, which could face a gap of between 1.5 and 2 percentage points between the final public deficit and their commitment. In the case of France and Spain, the gap will probably be 0.6 and 0.7 point, respectively. Only Germany will come very close to its commitments (Table 2).

Unlike in previous years, the implementation of these commitments would seem probable: in an uncertain financial context, being the only State not to comply with its promise of fiscal consolidation would be punished immediately by more expensive financial terms on the repayment of its debt.

This will therefore require the adoption of new austerity plans in the coming months. But by attempting to reduce their deficits too early, too quickly and in a synchronized fashion, the governments of the European countries are running the risk of a new downturn. Indeed, as we noted in a recent study, tightening budget policy during a cyclical downturn in all the European countries and doing so in a situation of a persistent "liquidity trap" is contributing to the formation of a strong multiplier, close to unity.

How many billion euros will be targeted by the next fiscal savings plans? What impact will they have on economic growth? Several possible cases were considered.

Case 1: Each country respects its commitment alone
In order to isolate the impact on growth of the national savings plan and those of the partners, we have assumed that each country meets its commitment alone. Under this assumption, the effort would be significant in Italy and the UK, which would present new austerity plans for, respectively, 3.5 and 2.8 points of their GDP (56 and 48.7 billion euros). France and Spain would implement an austerity plan two to three times smaller, about 1.2 points of GDP, representing 27 and 12.1 billion euros, respectively. Finally, the German savings plan would be the weakest, with 0.3 point of GDP (7 billion euros) (Table 1).

Table 1. Amount needed to meet the public deficit commitments in 2012

	Germany	France	Italy	Spain	United Kingdom
If each country meets its commitment alone					
In billions of euros	7.0	27.0	56.0	12.1	48.7
In GPD points	0.3	1.3	3.5	1.1	2.8
If the EU countries respect their commitments					
In billions of euros	22.3	39.8	63.9	19.6	55.2
In GDP points	0.9	2.0	4.0	1.8	3.2
If the euro zone countries meet their commitments					
In billions of euros	16.6	36.1	61.7	17.9	
In GDP points	0.6	1.8	3.9	1.7	

Source: OFCE calculations.

These different national austerity plans, taken in isolation, would have a non-negligible impact on the growth of the countries studied. With the exception of Germany, which would continue to have positive growth in 2012 (0.9%), this kind of strategy would plunge the other economies into a new recession in 2012, with a decline in their GDP ranging from -0.1% for Spain to -2.9% for Italy. France would experience a decline in activity of -0.5% and the British economy of -1.9% (Table 2).

Table 2. Impact on GDP of meeting the deficit reduction commitments in 2012

In %

	Germany	France	Italy	Spain	United Kingdom
OFCE forecast					
GDP	1.2	0.8	0.4	0.9	0.7
Public deficit (in GDP points)	-1.4	-5.2	-3.4	-5.0	-8.0
If each country meets its commitment alone					
GDP	0.9	-0.5	-2.9	-0.1	-1.9
Public deficit (in GDP points)	-1.3	-4.5	-1.5	-4.4	-6.5
If the EU countries respect their commitments					
GDP	-0.3	-1.7	-3.9	-1.5	-2.6
Public deficit (in GDP points)	-1.3	-4.5	-1.5	-4.4	-6.5
If the euro zone countries meet their commitments					
GDP	0.1	-1.4	-3.6	-1.2	0.3
Public deficit (in GDP points)	-1.3	-4.5	-1.5	-4.4	-8.2
Reminder of commitments for 2012	-1.3	-4.5	-1.5	-4.4	-6.5

Source: OFCE calculations.

Case 2: All the EU countries meet their commitment

Of course, if all the major European countries were to adopt the same strategy at the same time, then the savings effort would be greater. It would amount to about 64 billion euros in Italy and 55 billion euros in the UK, accounting for 4 and 3.2 percentage points of GDP, respectively. The additional effort would be about 2.0 percentage points of GDP for France and Spain (respectively 39.8 and 19.6 billion euros) and 0.9 GDP point for Germany (22.3 billion euros). In total for the five countries studied, the cumulative savings effort would represent more than 200 billion euros in 2012.

The shock on the activity of these countries would be powerful: it would cause a violent recession in 2012 for some countries, with a fall in GDP of -3.9% in Italy (against -5.1% in 2009), and -2.6 % in the UK (against -4.9% in 2009). France would be close to recession (-1.7%), as would Spain (-1.5%), while German GDP would decline slightly (-0.3%).

Case 3: Only the countries in the euro zone meet their commitment

As the UK has already implemented a substantial austerity program, and given that their constraints in terms of the deficit are more flexible than those of countries in the euro zone, we assumed that only the major countries in the euro zone complied with their commitments on the public deficit. Under these conditions, the cumulative savings effort would represent more than 130 billion euros in 2012, almost half of which would be from Italy alone (61.7 billion).

The recessionary shock would thus be focused on the euro zone, with a recession in all the countries studied except Germany (0.1%). The British economy would avoid a new period of recession (0.5%), but it would not meet the target of 6.5 percentage points of GDP for the public deficit, which would come to 8.2 GDP points.