Is the euro crisis over?

By Catherine Mathieu and Henri Sterdyniak

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

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

On the other hand, the euro zone has been unable to regain a satisfactory level of growth or to recover the 9 points of activity lost to the crisis. The Member states have been forced to implement austerity policies during a recession. According to the outlook of the Commission itself, the unemployment rate is expected to stay at about 11.8% in 2013. Imbalances between countries persist, even if they are somewhat mitigated by the deep depression that has engulfed the countries of southern Europe. The rigid standards that have been imposed on the Member states, with no real economic foundation, cannot replace the genuine coordination of

economic policies. The solidarity mechanisms implemented are conditional on the loss of any autonomy and the introduction of drastic austerity policies. In the future, national policies will be paralyzed by European constraints and by the threats of the financial markets. Social Europe is not making progress, and, even worse, Europe is requiring countries in difficulty to call into question universal health care and to cut pension, unemployment and family benefits. Tax competition is continuing, and the crisis has not been seen as a time to challenge tax havens and tax evasion. While Europe is at the forefront of the fight against climate change, it is hesitating to make a robust commitment to the ecological transition. Although many countries in the area are suffering from continuing deindustrialization, no industrial policy has been implemented. A banking union will be established, but its content is not being democratically decided. The European authorities are persisting in a strategy – paralyzing national policies and imposing free market structural reforms – which has so far failed to boost growth and has made Europe unpopular. Europe is sorely lacking a socially unifying project, an economic strategy and a means of functioning democratically.

* Issue 127 of the "Debates et Politics" collection of the *Revue de l'OFCE*, which appeared in January, contains analyses that provide contrasting insights into the origins of the euro zone crisis and into strategies for resolving the crisis. This issue brings together twelve papers following the 9th EUROFRAME conference [1] in June 2012 on issues concerning the European Union's economic policy.

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[1] EUROFRAME is a network of European economic institutes, which includes: the DIW and IFW (Germany), WIFO (Austria), ETLA (Finland), OFCE (France), ESRI (Ireland), PROMETEIA

(Italy), CPB (Netherlands), CASE (Poland) and NIESR (United Kingdom).

The euro zone in crisis

By Catherine Mathieu and Henri Sterdyniak

The 9th EUROFRAME Conference [1], which was held in Kiel on 8 June 2012, focused on economic policy issues in the European Union. The topic was "The euro zone in crisis: Challenges for monetary and fiscal policies". Issue 127 of the "Débats et Politiques" collection of the OFCE Revue has published revised versions of twelve papers presented in the Conference[2], gathered in five themes: exchange rate imbalances, indicators of the debt crisis, budget rules, banking and financial issues, and strategies for resolving the crisis.

The analysis of the origins of the euro zone crisis and economic policy recommendations to get out of the crisis have been the subject of great debate among economists, which was illustrated in the EUROFRAME Conference. In the course of these articles, the reader will see several fault-lines:

– For some, it is the irresponsible policies of the South that are the cause of the imbalances: they have allowed the development of wage and property bubbles, while the Northern countries have been implementing virtuous policies of wage austerity and structural reform. The Southern countries thus need to adopt the North's strategy and undergo a lengthy austerity cure. For others, the single currency has led to the development of twin opposing imbalances: this has led to under-valuing the economies of the North, which enabled them to offset their excessive policies on wage and social

austerity with excessive external surpluses, and it has allowed the persistence of the South's external deficits; this has resulted in the need for a controlled convergence, whereby recovery in the North facilitates the absorption of the South's external imbalances.

– Some argue that each country must implement policies that combine a strong reduction in public spending – to absorb the budget deficits and reduce the public debt burden – with structural reforms (liberalization of the markets for goods and services, deregulation of the labour market) in order to offset the depressive effect on the labour market. The financial markets have to be allowed to impose the necessary discipline on the countries. Others hold that the public deficits have to be tolerated as long as necessary to support economic activity, public debt needs to be guaranteed by the European Central Bank (ECB) to ensure that domestic interest rates converge at low rates, and an EU-wide growth strategy is needed (in particular to finance the investments required for the ecological transition).

– Some even believe that we must avoid any further extension of European solidarity, as it would enable some countries to put off the reforms needed, which would lead to persistent imbalances and thus to money creation and inflation. Others argue that errors have been made on economic policy since the inception of the euro zone, and that these have led to sharp disparities in the zone, which now need to be reduced by means of a coherent solidarity strategy. Europe is one big family and must demonstrate its solidarity and accept compromises to continue to live together.

– For some, ending the debt crisis of the euro zone countries requires the establishment of a fiscal union, which means the establishment of binding rules enshrined in the Fiscal Pact and a certain degree of fiscal federalism; the European Commission and Council should have a say on the fiscal policies of the Member States. Others think that the Member

States should have a degree of autonomy to practice the fiscal policy they choose; this is a matter of both democracy and economic efficiency: the economic situations of the different countries are too diverse to invoke a uniform fiscal policy; what is needed is the open coordination of economic policy, without rigid pre-established standards on public finances, with the aim of ensuring satisfactory growth and the winding down of external imbalances.

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[2] Ten of which are in English and two in French.

Should households pay for a competitiveness shock?

By Henri Sterdyniak

France is suffering from an industrial problem. Its current account balance went from a surplus of 2.6% of GDP in 1997 to a deficit of 1% in 2007 and then 2% in 2012, while Germany went from a deficit of 0.4% of GDP in 1997 to a surplus of 5.7%. This raises the issue of France's industrial recovery. Should a major transfer take place from households to large

companies for the purpose of a competitiveness shock or to redress business margins? There are many who advocate such a shock (including the MEDEF, but also the CFDT). This would reduce employers' social contributions (by at least 30 billion euros) and in return increase levies on households. The issue of France's industrial recovery is discussed in detail in the latest *Note de l'OFCE* (No. 24 of 30 October 2012).

It is out of the question to reduce the social security contributions of employees, as these finance only retirement and unemployment benefits, and thus contributory benefits that depend on the contributions paid and that cannot be financed through taxes. Only employer contributions intended for the family or health insurance can be reduced. And then it's necessary to find a substitute resource: VAT or the CSG wealth tax?

In fact, there is little difference between an increase in the CSG tax and an increase in VAT. In both cases, households will lose purchasing power. In the case of a VAT increase, this would involve higher prices. However, inflation is automatically reflected in the minimum wage and social benefits, and after wage bargaining, in salaries too, so any gain in business competitiveness / profitability is likely to be temporary unless indexing is suspended. In contrast, the victims of a higher CSG would not enjoy automatic indexing mechanisms and would have to accept a reduction in purchasing power. Using the CSG thus makes for a more long-term option.

The big issue at the macroeconomic level is the reaction of companies, which will have to arbitrate between maintaining their prices to rebuild their margins or lowering their prices to become more competitive.

Let's imagine ourselves in a country with a GDP of 100 and exports and imports of 25. The share of wages (including employer contributions) and consumption is 80, and the share of profits and investment is 20. In the short run, wages and

pensions are fixed. The reform consists of reducing the amount of employer contributions by 5 (*i.e.* 5% of GDP), while increasing the CSG tax by the same amount Two scenarios can be adopted based on the pricing policy chosen by companies.

In the first case, the companies maintain their prices and increase their margins. There is no *ex post* gain in business competitiveness, but profitability rises. Wages suffer a loss of 6.25% of their purchasing power (*i.e.* 5/80). Will the revival in investment offset the fall in consumption? Let's use standard assumptions, *i.e.* a propensity to consume wages of 0.8 and to invest profits of 0.4, with a multiplier of 1. GDP falls in the short term by 2% and employment first drops and then eventually recovers due to the substitution of labour for capital. The measure is costly in terms of purchasing power, and higher employment is not ensured.

In the second case, the companies fully pass on the reduction in charges in their producer prices, which fall by 5%, with consumer prices decreasing by 4% (as the prices of imported goods remain stable). The purchasing power of wages is down by only 1%. The gains in competitiveness come to 5%. Will the gains in foreign trade offset the reduction in consumption? With a price elasticity of exports of 1 and of imports of 0.5, GDP increases by 1.25%. The measure is less painful.

Should it be done?

The government needs to ask households to accept a reduction in their income, even though they have already lost 0.5% in purchasing power in 2012, consumption stagnated in 2011 and 2012, France is in a state of recession, and demand is already too low.

Should France adopt Germany's strategy: to gain competitiveness at the expense of household purchasing power, knowing that this strategy is a losing one at the level of the euro zone as a whole? Admittedly, this would replace the

devaluation that is impossible today in the euro zone, but it would hurt our European partners (which could even respond, to our detriment) and it does not guarantee gains in competitiveness vis-à-vis countries outside the euro zone, which depends primarily on changes in the exchange rate for the euro. Nor would a measure like this replace a reform of the zone's economic policy. Finally, it takes time for gains in competitiveness to translate into renewed growth. For instance, from 2000 to 2005, French growth came to 7.8% (1.55% per year), and German growth to 2.7% (0.55% per year). Can France afford to lose another 5 percentage points of GDP?

France is in an intermediate position between the Northern countries which have made strong gains in competitiveness at the expense of purchasing power and the Southern countries which have experienced excessive wage increases. On a base of 100 in 2000, the level of real wages in 2011 was 97.9 in Germany and 111.2 in France (an increase of 1% per year, corresponding to trend gains in labour competitiveness). Who is wrong? Should we ask the employees in the euro zone countries, first one then another, to become more competitive than the employees of their partner countries by accepting wage cuts?

The margin of French companies was 29.6% in 1973. This fell to 23.1% in 1982, rebounded to 30.2% in 1987, and was 30.8% in 2006, *i.e.* a satisfactory level. The decline occurring since then (28.6% in 2011) can be explained by the drop-off in activity and the retention of labour. It was not caused by higher taxation nor by excessive wage increases. Overall, the share of profits has returned to a satisfactory level historically. But in 1973 gross fixed capital formation was around the level of profits, while it is lower by 3 points of added value today and the share of net dividends paid has increased significantly. What commitments would business make in terms of investment and employment in France in exchange for a measure that would greatly boost profits? How could

companies be prevented from increasing their dividends or their investments abroad?

Making use of an internal devaluation like this implies that France is suffering primarily from a lack of price competitiveness. However, deindustrialization undoubtedly has other deeper causes. Companies prefer to develop in the emerging countries; young people are rejecting poorly paid industrial careers with an uncertain future; France is failing to protect its traditional industries or to develop in innovative sectors; the financial sector has favoured the joys of speculation over financing production and innovation; and so forth. All this will not be solved by an internal devaluation.

France needs a big industrial leap forward. It needs to carry out a different strategy: it is growth that must rebuild business margins, and it is industrial policy (via France's Public Bank Investment [the BPI], research tax credits, competitiveness clusters, support for innovative companies and for certain threatened sectors, and industrial planning) that must ensure an industrial recovery. This should be funded by the BPI, which needs to have sufficient capacity for action and specific criteria for its interventions.

The governance of public finances: from the Fiscal

pact to France's Organic law

by Henri Sterdyniak

So the French government has had Parliament enact an "Organic law relating to the planning and governance of public finances" (*loi organique relative à la programmation et à la gouvernance des finances publiques)*, which translates into French law the European Fiscal pact (the Treaty on stability, coordination and governance) that France had made a commitment to ratify. This Law can be assessed from two points of view: from the perspective of how well it conforms to the Treaty or from the viewpoint of its own relevance, *i.e.* will it improve France's fiscal policy?

In fact, the government has chosen – as the Constitutional Council had provided it with the possibility of so doing – a minimalist approach to taking into account the Treaty. The new budgetary procedure is not incorporated into the Constitution, and as we shall see, the Treaty provides for certain automatic binding procedures that the Organic law tempers or does not mention.

The Organic Law has three sections, dealing respectively with the budget plan (*loi de programmation des finances publiques – LPFP*), the High Council on the Public Finances (*Haut Conseil des finances publiques*), and a correction mechanism.

The Budget Plan

Article 1 of the Organic Law stipulates: "In accordance with the objective of balanced government accounts as set out in Article 34 of the Constitution, the LPFP sets the medium-term targets of the government administrations referred to in Article 3 of the TSCG."

Article 34 of the Constitution, adopted on 31 July 2008, set out only a medium-term non-binding target. It has had little

influence on the fiscal policy adopted since then. In times of crisis, the multi-year guidelines quickly cease to have an influence. This was the case, for example, in 2009. The 2009 deficit, which was set at 0.9% of GDP by the four-year budget plan passed in January 2008, and 3.9% of GDP according to the January 2009 plan, ultimately amounted to 7.5%. Should we give up this flexibility?

Moreover, how can the budget plan "set a target" when the target flows from Article 3 of the Treaty, which clearly states that the target should be a structural deficit of less than 0.5% of GDP and that a path for an adjustment to ensure a rapid convergence toward equilibrium will be proposed by the European Commission?

Doesn't the ambiguity of this article actually reflect an attempt to reconcile the irreconcilable: the sovereignty of Parliament in budgetary matters with France's commitment to follow the recommendations of the Commission?

Article 1 of the Organic Law continues: "The budget plan (LPFP) determines the trajectory of the successive annual actual balances and structural balances… The structural balance is the cyclically-adjusted balance net of one-off and temporary measures." Article 3 states that the period covered is at least three years.

Thus, the Law takes no account of the experience of the Stability and Growth Pact (SGP): it is impossible to fix a trajectory for the public finances, in terms of the structural and actual deficit, for a period of three years. In January 2008, France was committed to having a balanced budget in 2012. It won't even get close. Should commitments be made that are impossible to keep?

This is impossible for two reasons. First, unpredictable economic fluctuations make it necessary to constantly adapt economic policy. In case of a deep crisis, as since 2009, it

is necessary to make use of both economic stabilizers and discretionary measures (which increase what is called the structural deficit). If taken seriously, the Treaty prohibits any policy to boost activity during a downturn in activity. In the autumn of 2008, according to the Commission France had a structural deficit of 3.2% of GDP. If the Treaty had been in force, it would have had to reduce this quickly to 2.5% in 2009. In fact, France has moved to a structural deficit of 6% of GDP, according to the Commission's assessment, in other words, 3.5 percentage points higher. Is the government wrong to have promoted activity, or to have come to the rescue of the banks? Should it have embarked on a tough austerity policy to offset the fall in tax revenue?

The text is, of course, ambiguous. On the one hand, it sets out that the structural deficit does not include "one-off and temporary" measures. Assistance to banks is undoubtedly a one-off, but why not all the 2009 stimulus measures, or in the opposite direction, the 75% income tax assessment which is scheduled for 2 years? Who decides? On the other hand, the Treaty recognizes that a country may deviate from its target or its adjustment path in the event of "exceptional circumstances" which, since the revision of the Growth and Stability Pact, can be interpreted as negative growth or a large output gap. However, the Commission refuses to recognize that most euro zone countries have actually been in this situation since 2009, and it is insisting on imposing rapid deficit reduction policies on them.

On the other hand, a State has no economic reason to set itself a standard for balancing the public purse. According to the true "golden rule of public finance", which was stated by the economist Paul Leroy-Beaulieu in the late nineteenth century, it is legitimate to finance public investment through debt. In the case of France, a structural deficit of around 2.4% of GDP is legitimate.

As in the Treaty, Article 1 of the Organic Law refers to the

structural balance, the balance that would exist if France were at its potential output, the maximum output consistent with stable inflation. But the size of this potential output, which cannot simply be observed, is a subject of debate among economists. Different methods produce different results, which are subject to sharp revisions. France's structural balance in 2012 is 3.6% according to the French government, 3% according to the European Commission, 2.8% according to the OECD, and according to us 0.5%, since the crisis has caused us to lose 8% of GDP compared to our growth trend. The Treaty requires the use of the Commission's method. Is this scientifically legitimate? Can France call into question this assessment?

Article 5 states that the potential growth assumptions should be presented in an appendix, but the definition of potential growth is even more questionable than that of potential output. For example, the latest budget bill (*projet de loi de finances – PLF*) expects potential growth of 1.5% per year up to 2017 for France, thus abandoning forever the expectation of making up the 8 points of activity lost to the crisis.

The Organic Law simply forgets Article 4 of the Treaty (which requires a country with a debt of over 60% of GDP to reduce the gap by one-twentieth per year). It also ignores Article 5, which states that a country subject to an Excessive Deficit Procedure (EDP) is to be placed under supervision, and has to submit to the EU Council and Commission annual budget plans and a list of the structural reforms that it will implement in order to make a sustainable correction to its deficit. It is this article that obliges France, like many other EU countries, to do all it can to get down to a 3% deficit by 2013, regardless of the economic situation, since, in case of an EDP, the constraint pertains to the actual balance and not the structural balance. It forgets Article 7, which states that, in this context, the decisions of the Commission are obligatory (member countries can oppose it only with a qualified majority, with the country concerned not voting).

The LPFP will cover a period of four to five years, but will be voted upon again each year, so that the constraint thus introduced can be changed by a vote on a new budget plan. This has been the case in France for as long as the Fiscal Pact has existed. Thus, the LPFP does not introduce any supplementary constraint itself, other than what is already required by European legislation.

The High Council of Public Finance

The Organic Law sets up a High Council of Public Finance, which will advise on the macroeconomic forecasts underlying the budget bill (LPF), the bill financing social security, the adjustment budget bills, the stability program that France must provide to the European authorities, and the budget plan (LPFP). It will assess whether France has been meeting its European commitments, and verify that the LPF (budget bill) is consistent with the trajectory announced in the budget plan (LPFP). It will give its opinion on any evocation of "exceptional circumstances".

Chaired by the President of France's Court of Audit (Cour des comptes), the High Council consists of four members from the Court of Audit and four members appointed for their expertise in public finance by the Presidents of the National Assembly, the Senate and the two finance commissions. This predominance of the Court of Audit is problematic. The judicial officers from the Court of Audit are not *a priori* experts in macroeconomics, and they are often, based on their function, more concerned with balancing the public finances than with growth and employment. For instance, the latest reports from the Court of Audit underestimate the output gap, support the thesis that the fiscal multiplier is close to zero, and believe that it is better to reduce public spending than to increase taxes. We would like to be certain that the composition of the High Council and its work and reports reflect the diversity of opinion that exists on fiscal policy.

More fundamentally, it is questionable whether the High Council has room for flexibility in its assessments. Will it have the right to conclude that the path of adjustment is too restrictive, and that the medium-term objective is not realistic? What strategy will be advocated by the High Council in the event of an economic slowdown: an expansionary policy to support growth or an austerity policy to restore the public finances?

Assume, for example, that the government has a budget for 2013 based on growth of 1.2%, resulting in a deficit of 3%. The High Council believes that growth will instead be only 0.6%, causing a decline in tax revenues, and thus a deficit of 3.3%. It will advocate doing whatever is necessary to achieve a 3% deficit. Assuming that the fiscal multiplier is 1, it will be necessary to come up with 12 billion in tax increases (or spending cuts), or 0.6% of GDP, to have an *ex post* deficit of 3%, but no growth. There is thus a great risk that this will lead to pro-cyclical policies. This will of course be mitigated when France is longer be subject to an EDP, as the High Council can then reason in terms of the structural deficit, but this will persist because everything will then depend on evaluating the structural deficit.

Lastly, there is the question of what legitimacy the High Council will have. The choice of fiscal policy must be subject to democratic procedures. The assessment of economic policy is part of a scientific, democratic debate. Should it be entrusted to a High Council, composed mainly of judicial experts, rather than economists on the one hand and representatives of the nation on the other?

The High Council will of course only give advice, which neither the government nor parliament are obliged to follow, but the risk is great that these opinions will affect the financial markets and the Commission and that it would be risky for the government to ignore them.

The correction mechanism

To ensure that countries do indeed follow the adjustment path, the Treaty requires countries to provide an automatic correction mechanism if deviations are observed with respect to this path. In the minds of the negotiators of the North European countries and members of the Commission, this mechanism should provide that if a deviation of 1% of GDP is seen in year N, the Constitution provides that, automatically, a certain tax (*e.g.* VAT) would be raised by 0.5 GDP point and certain expenditures (*e.g.* social benefits) would be reduced by 0.5 GDP point.

In fact, Chapter 3 of France's Organic Law provides that the High Council is to report such a gap, the government is to set out the reasons for this discrepancy and then take it into account in drawing up the next budget bill. Parliament's rights are respected, but fortunately the character of being automatic is not guaranteed.

Conclusion

In the spirit of its founders, the fiscal treaty must put an end to the possibility of autonomous national fiscal policies. Fiscal policies should become automatic. The goal of fiscal policy should be balancing the budget, just as the goal of monetary policy should be fighting inflation; growth and employment are to be sought by means of free market structural reforms.

The Organic Law seems to be an ambiguous compromise. France is ratifying the Treaty, but implementing it only reluctantly. It's a safe bet that, as with the Stability Pact, there will be great tension in the euro zone between purists who demand the strict application of the Treaty and those who do not want to sacrifice growth to it.