Austerity in Europe: a change of course?

By Marion Cochard and Danielle Schweisguth

On 29 May, the European Commission sent the members of the European Union its new economic policy recommendations. In these recommendations, the Commission calls for postponing the date for achieving the public deficit goals of four euro zone countries (Spain, France, Netherlands and Portugal), leaving them more time to hit the 3% target. Italy is no longer in the excessive deficit procedure. Only Belgium is called on to intensify its efforts. Should this new roadmap be interpreted as a shift towards an easing of austerity policy in Europe? Can we expect a return to growth in the Old Continent?

These are not trivial matters. An OFCE Note (no. 29, 18 July 2013) attempts to answer this by simulating three scenarios for fiscal policy using the iAGS model. It appears from this study that postponing the public deficit targets in the four euro zone countries does not reflect a real change of course for Europe's fiscal policy. The worst-case scenario, in which Spain and Portugal would have been subject to the same recipes as Greece, was, it is true, avoided. The Commission is implicitly agreeing to allow the automatic stabilizers to work when conditions deteriorate. However, for many countries, the recommendations with respect to budgetary efforts still go beyond what is required by the Treaties (an annual reduction in the structural deficit of 0.5 percent of GDP), with as a consequence an increase of 0.3 point in the unemployment rate in the euro zone between 2012 and 2017.

We believe, however, that a third way is possible. This would involve adopting a "fiscally serious" position in 2014 that does not call into question the sustainability of the public debt. The strategy would be to maintain a constant tax burden and to allow public spending to keep pace with potential growth. This amounts to maintaining a neutral fiscal stimulus between 2014 and 2017. In this scenario, the public deficit of the euro zone would improve by 2.4 GDP points between 2012 and 2017 and the trajectory in the public debt would be reversed starting in 2014. By 2030, the public deficit would be in surplus (0.7%) and debt would be close to 60% of GDP. Above all, this scenario would lower the unemployment rate significantly by 2017. The European countries could perhaps learn from the wisdom of Jean de La Fontaine's fable of the tortoise and the hare: "*Rien ne sert de courir, il faut partir à point*", *i.e.* Slow and steady wins the race.

France: why such zeal?

By Marion Cochard and Danielle Schweisguth

On 29 May, the European Commission sent the members of the European Union its new economic policy recommendations. As part of this, the Commission granted France an additional two years to reach the deficit reduction target of 3%. This target is now set for 2015, and to achieve this the European Commission is calling for fiscal impulses of -1.3 GDP points in 2013 and -0.8 point in 2014 (see "Austerity in Europe: a change of course?"). This would ease the structural effort needed, since the implementation of the previous commitments would have required impulses of -2.1 and -1.3 GDP points for 2013 and 2014, respectively.

Despite this, the French government has chosen not to relax its austerity policy and is keeping in place all the measures announced in the draft Finance Act (PLF) of autumn 2012. The continuing austerity measures go well beyond the Commission's recommendations: a negative fiscal impulse of -1.8 GDP point, including a 1.4 percentage point increase in the tax burden for the year 2013 alone. Worse, the broad guidelines for the 2014 budget presented by the government to Parliament on 2 July 2013 point to a structural effort of 20 billion euros for 2014, *i.e.* one percentage point of GDP, whereas the Commission required only 0.8 point. The government is thus demanding an additional 0.6 GDP point fiscal cut, which it had already set out in the multi-year spending program in the 2013 Finance Act.

The table below helps to provide an overview of the effort and of its impact on the French economy. It shows the trends in growth, in unemployment and in the government deficit in 2013 and 2014, according to three budget strategies:

1. One using the relaxation recommended by the Commission in May 2013;
2. One based on the budget approved by the government for 2013 and, *a priori*, for 2014;
3. One based on an alternative scenario that takes into account the negative 1.8 GDP point fiscal impulse for 2013 and calculates a fiscal impulse for 2014 that would be sufficient to meet the European Commission's public deficit target of -3.6%.

The different scenarios for deficit reduction in France

In %

	Relaxation (1)		Approved budget (2)		Alternative scenario (3)	
	2013	2014	2013	2014	2013	2014
Fiscal impulse	-1.3	-0.8	-1.8	-1.0	-1.8	-0.2
Unemployment rate	10.5	10.6	10.7	11.1	10.7	10.5
Growth	0.2	1.3	-0.2	1.0	-0.2	1.7
Public deficit	-4.3	-3.6	-3.9	-3.1	-3.9	-3.6

Source : Authors' calculations based on the iAGS model.

According to our estimates using the iAGS model [1], the public deficit would be cut to 3.1% of GDP in 2014 in scenario (2), whereas the Commission requires only 3.6%. As a consequence of this excess of zeal, the cumulative growth for 2013 and 2014 if the approved budget is applied would be 0.7 percentage point lower than growth in the other two scenarios (0.8 point against 1.5 points). The corollary is an increase in unemployment in 2013 and 2014: the unemployment rate, around 9.9% in 2012, would thus rise to 11.1% in 2014, an increase of more than 350,000 unemployed for the period. In contrast, the more relaxed scenario from the European Commission would see a quasi-stabilization of unemployment in 2013, while the alternative scenario would make it possible to reverse the trend in unemployment in 2014.

While the failure of austerity policy in recent years seems to be gradually impinging on the position of the European Commission, the French government is persisting along its same old path. In the face of the social emergency that the country is facing and the paradigm shift that seems to be taking hold in most international institutions, the French government is choosing to stick to its 3% fetish.

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[1] iAGS stands for the Independent Annual Growth Survey. This is a simplified model of the eleven main economies in the euro zone (Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Netherlands, Portugal and Spain). For more detail, see the working document Model for euro area medium term projections.

A recession is not inevitable

By Marion Cochard, Bruno Ducoudré and Danielle Schweisguth

The cold blast from the autumn forecasts continues with the publication of the European Central Bank's latest forecasts. Revising its growth outlook for the euro zone downwards (to -0.3% for 2013, against the forecast of 0.9% in September), the ECB in turn is now pointing to the reinforced austerity measures and the growing impact of uncertainty in the financial markets. It is clear that the intensity of the fiscal consolidation is paralyzing growth in the euro zone through the interplay of the fiscal multipliers, while not managing to restore confidence. In this note we show that the recessionary spiral that the euro zone is getting sucked into is not an inevitability.

In the first edition of the 2013 iAGS report, which was produced in partnership with the German IMK institute and the Danish ECLM institute, the OFCE offers an alternative strategy to the current fiscal consolidation policy. This alternative would make it possible to restore growth in the medium term while still meeting the European budget commitments. As Jérôme Creel showed in his latest post, "Could France have a different fiscal policy?", there is room for budgetary manoeuvring in a way that is consistent with the current treaty framework.

Under the aegis of the European Commission, the European countries have pledged to continue their austerity programmes from 2013 to 2015 on a relatively large scale, especially if we take into account the efforts already made. Apart from Germany, where the cumulative fiscal impulse will be virtually nil, most European countries are planning to reduce their primary structural deficit by more than 2 GDP points between 2012 and 2015 (from -1.4 points for Finland to -7.5 points for Greece, cf. the table).

Table. Cumulative fiscal impulses in the euro zone

In GDP points

	Germany	France	Italy	Spain	Netherlands	Belgium	Greece	Portugal	Ireland	Austria	Finland
2010-2012	0,1	-4,1	-4,7	-7,0	-2,3	-1,5	-18,3	-9,1	-8,3	-1,1	-3,3
2013-2015	-0,3	-2,9	-2,1	-4,2	-2,9	-2,2	-7,5	-2,6	-5,7	-1,8	-1,4

Source : Eurostat data, iAGS simulations.

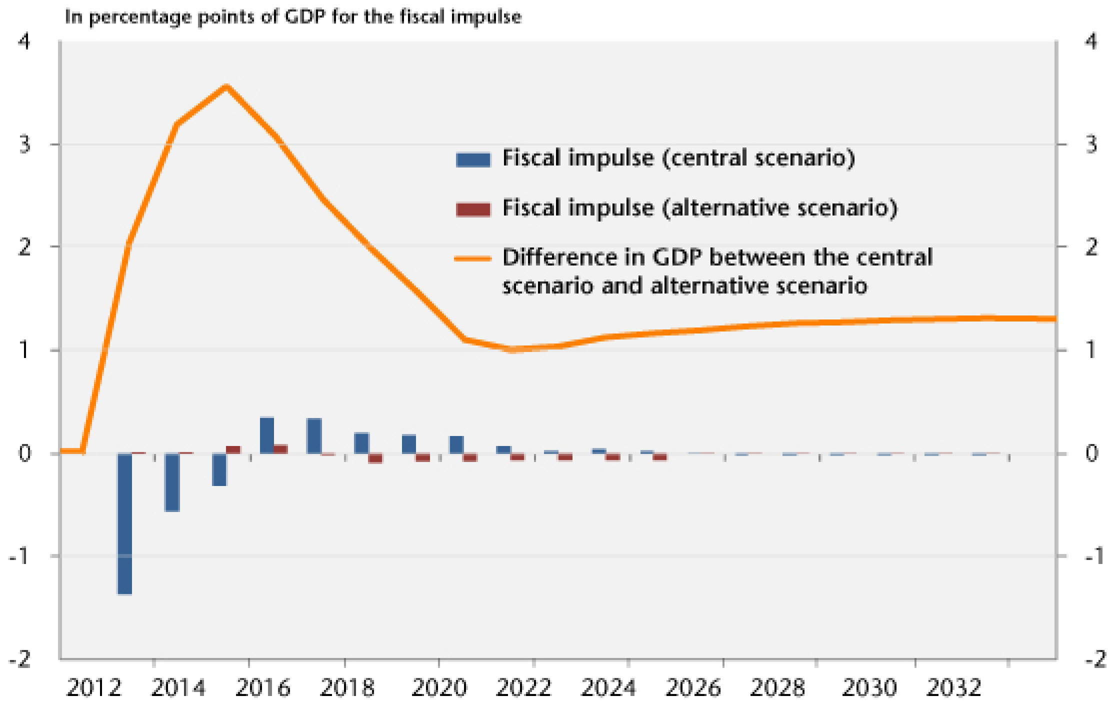
These adjustments are being undertaken in a very poor economic climate, which has been marked by austerity budgets from 2010 to 2012: growth in the euro zone will be -0.4% in 2012 and -0.3% in 2013. However, according to a series of recent theoretical and empirical studies[1], the fiscal multipliers turn upwards as the economic cycle heads downwards. In this context, the speed and magnitude of the fiscal adjustment is especially costly in terms of growth, and thus counter-productive in terms of the fiscal consolidation.[2] Encouraging a return to growth by easing the austerity would enable the economies of the euro zone to pull out of their recessionary spiral, which is marked by a steep rise in unemployment.

In order to develop this alternative strategy, we used the iAGS model to carry out simulations for the euro zone countries over a period of 20 years. These were conducted in two steps:

1. In our central scenario, we integrated the planned budget cuts announced by the various countries up to 2015. Starting from 2016, we calculated the fiscal impulses needed to achieve the 60% debt threshold by 2032, while limiting the size of these impulses to +/-0.5 GDP points per year. As shown in Figure 1 (central scenario), the structural adjustment carried out between 2010 and 2015 is significant enough in most countries to allow a relaxation of economic policy starting in 2016, while meeting the debt criterion by 2032.
2. For each country, we then decided on an alternative

budget strategy by staggering the reduction of the structural deficit over time. This strategy consists in starting in 2013 with the implementation of fiscal impulses of a more limited amount in absolute value than those announced by the current governments (maximum +/-0.5 GDP points per year), and doing this until the adjustment is sufficient to achieve the debt target of 60% of GDP by 2032. This strategy leads to more measured fiscal adjustment for the euro zone countries in difficulty and to slightly positive fiscal impulses in countries whose debt trajectory is in better shape (Germany, Finland, and Italy). For the zone as a whole, the fiscal impulse is almost zero in 2013 and 2014, with the bulk of the adjustment spread from 2017 to 2024.

Figure 1. Fiscal impulses and difference in GDP between the central and alternative scenarios

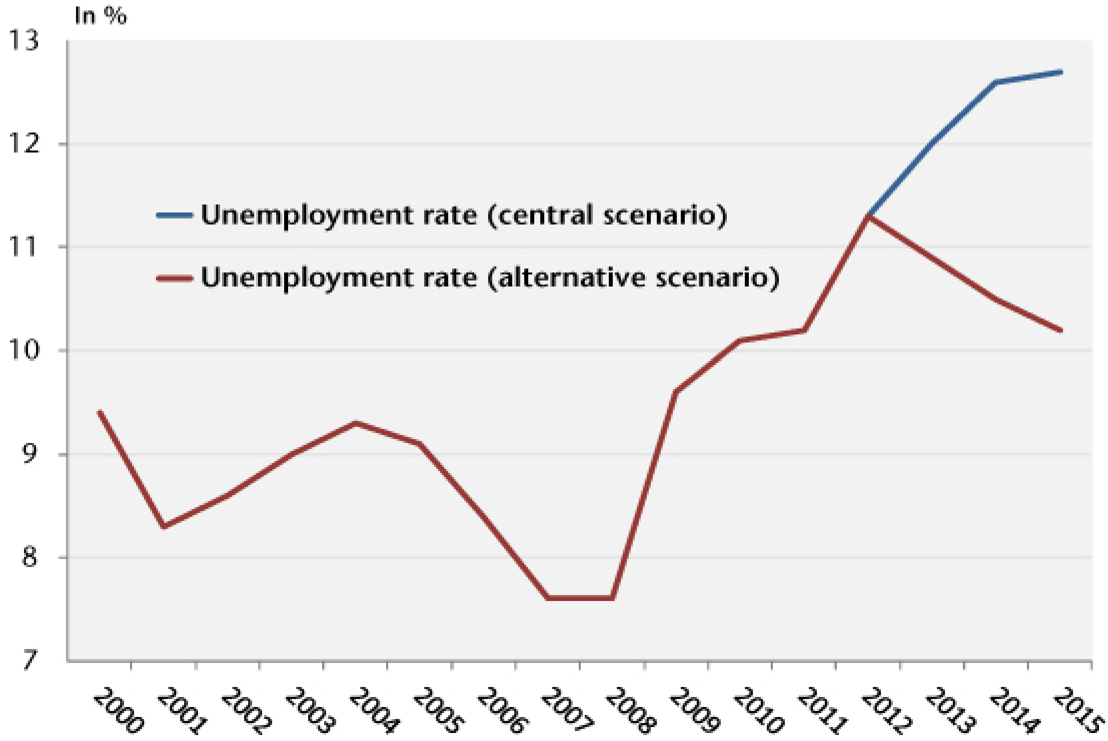


Source : iAGS, authors' calculation.

Figure 1 shows the difference in the level of GDP between the two scenarios. Limiting the size of the fiscal impulses helps to achieve a higher level of GDP and is compatible with a debt target of 60% of GDP by 2032 (alternative scenario). The effectiveness of the fiscal consolidation is enhanced when it is being conducted in an environment that is less unfavourable to the economy. This strategy achieves the same debt target with a cumulative fiscal adjustment that is 50 billion euros less than in the central scenario.

According to our calculations, the alternative scenario would restore a 2% growth rate in the euro zone in 2013, compared with -0.3% if the planned fiscal policies are carried out. The revival of activity would boost the labour market and help to turn around the unemployment rate in 2013, with a decline to 10.2% in 2015, compared with 12.8% if the austerity policies are continued, representing 3 million fewer unemployed people in 2015.

Graphique 2. Unemployment rate in the euro zone – Central and alternative scenarios



Source: Eurostat data, iAGS simulation.

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[1] A review of the recent literature on fiscal multipliers: size matters!

[2] What is the value of the fiscal multipliers today?