

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.

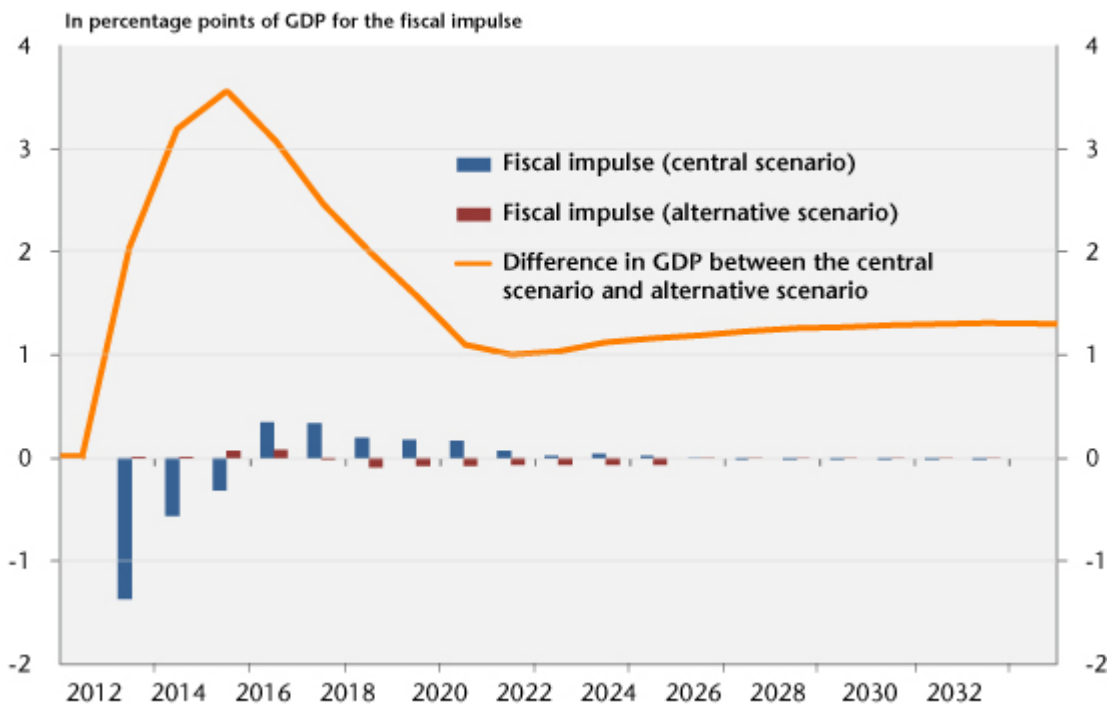
These adjustments are being undertaken in a very poor economic climate, which has been marked by austerity budgets from 2010 to 2012: growth in the euro zone will be -0.4% in 2012 and -0.3% in 2013. However, according to a series of recent theoretical and empirical studies[1], the fiscal multipliers 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



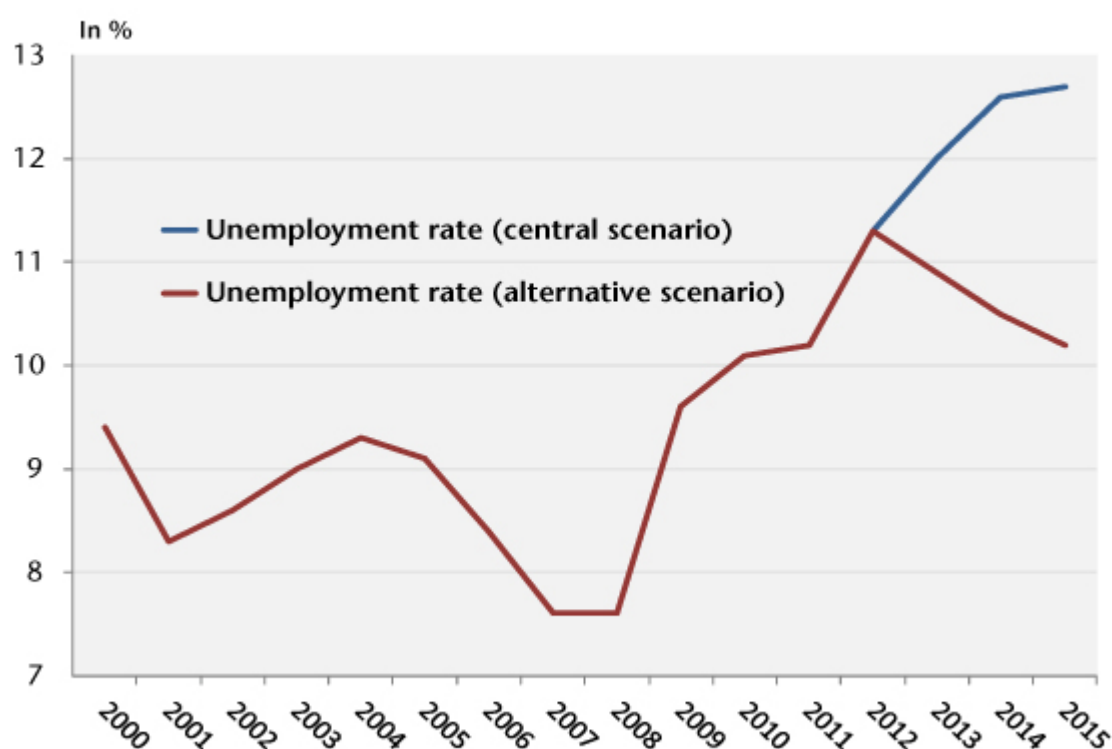
Source : iAGS, authors' calculation.

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.

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

[\[2\] What is the value of the fiscal multipliers today?](#)

2013: what impact will the (national) fiscal measures have on growth?

By [Mathieu Plane](#)

This text supplements the [October 2012 forecasts for the French economy](#)

After having detailed the multiplier effects expected for the different fiscal policy instruments, the average domestic fiscal multiplier associated with the austerity measures being implemented in France in 2013 will be 0.9. This policy will cut GDP by 1.7% in one year alone. After a cumulative fiscal effort of 66 billion euros in 2011 and 2012, the structural saving expected for 2013 represents about 36 billion euros (1.8 GDP points) if we include both the measures in the 2013 budget bill (*Projet de loi de finances – PLF*) and the various measures adopted previously (Table). The fiscal shock resulting from the PLF for 2013 comes to 28 billion euros, of which 20 billion is solely on tax and social security contributions (*prélèvements obligatoires – PO*). Of the remaining 8 billion, an increase of nearly 5 billion euros in tax and social security contributions is from the second supplementary budget (*Loi de finances rectificative – LFR*) for the summer of 2012, the rest being mainly due to the first LFR

for 2012 and to the hike in contributions resulting from the revision of the pension reform in summer 2012.

In total, the fiscal effort in 2013 can be broken down between tax and social contributions of about 28 billion euros (1.4 GDP points) and structural savings on primary public expenditure of 8 billion (0.4 GDP point). The burden of higher taxes and social contributions breaks down to nearly 16 billion euros for households and more than 12 billion for business. This breakdown does not take into account the competitiveness measures announced on 6 November by the Prime Minister. The tax credits for competitiveness and employment (CICE) will not have any fiscal impact in 2013, with the exception of the possible establishment in 2013 of an advance on their future tax credits for some companies short of cash.

Based on the variants in the fiscal multiplier, made with e-mod.fr according to the economy's position in the cycle, for the main taxes and social security contributions as well as for the key components of public expenditure [1] and based on the different evaluations we were able to carry out, particularly in the context of [the assessment of the Five-year economic programme](#), we applied a specific fiscal multiplier to each measure for 2013 (Table). The short-term multipliers take into account only the direct effects of the measures on domestic activity, regardless of the fiscal policies of our trading partners, which amplify the impact of national policy. It is also assumed that monetary policy remains unchanged. The long-term multiplier values differ from the short-term ones, being generally lower unless a long-term negative output gap is maintained.

Of the 16 billion euro increase in tax and social security contributions on households in 2013, the discretionary increase in personal income tax (IR) will be 6.4 billion, including 3.2 billion from the 2013 Budget Act (*Loi de finances*) – against 4 billion in the PLF, as the proposal to tax capital gains on securities at the income tax scale will

be largely amended, and the yield from the measure could decrease by about 0.8 billion, with the shortfall being able to be offset by the extension of the exceptional 5% contribution from the IS tax on large corporations), and with the rest coming from the supplemental LFR for 2012 (including 1.7 billion solely from the de-indexation of the personal income tax schedule). While the increase in personal income tax from the 2013 PLF is targeted at high earners, the amount this will contribute (3.2 billion) represents only 11% of the increase in tax and social security contributions (20% if we limit ourselves to households) in 2013, and less than 9% of the total fiscal effort. According to our calculations, the average fiscal multiplier associated with the different measures that increase personal income tax will be 0.7 in 2013.

The increase in taxes and social contributions from households will come mainly from the increase in payroll taxes and social security contributions (8.7 billion euros) set out in the Social Security budget act (PLF) for 2013 (2.9 billion) and the measures in the supplemental LFR for 2013 (5.3 billion, which includes changes to the tax exemption on overtime, a limitation on tax breaks and employee savings, a higher CSG wealth tax on income from capital, etc.) and pension reform, with an increase in the contribution rate (0.5 billion). The average fiscal multiplier related to these measures is 0.9. Finally, the reform of inheritance tax will raise a further 1.1 billion in tax and social contributions. On the other hand, the revenue from the ISF wealth tax will be 1.3 billion lower than in 2012. Indeed, the yield from the one-off wealth tax contribution set up under the supplemental LFR for 2012 will be greater than from the one set up under the new reform in 2013. The fiscal multiplier for these two measures is 0.3.

In total, according to our calculations, the increase in levies on households in 2013 will on average have a multiplier of 0.8 and will amputate growth by 0.6 GDP point.

For business, the measures adopted mainly involve an increase in the corporate income tax as provided in the budget bill (PLF) for 2013 (8 billion euros, of which 4 billion is related to the reform of the deductibility of financial expenses). The average multiplier for the increase in the corporate income tax (IS) is estimated at 0.7 in 2013. 2.3 billion euros will come from a rise in social security contributions and payroll taxes with a fiscal multiplier of unity. Finally, other measures such as the sectoral measures on the taxation of insurance or the exceptional contribution of the oil industry will increase the tax burden on business by 1.9 billion in 2013, with an average fiscal multiplier estimated at 0.5.

In our assessment, the increase in taxes and social contributions from companies will on average have a multiplier of 0.8 and will reduce GDP by 0.5 GDP point in 2013.

In addition, the short-term fiscal multiplier associated with public expenditure in a low phase of the cycle is, in our model, 1.3, so it is higher than that associated with tax and social contributions. This result is consistent with the most recent empirical literature (for details, see the box, "[Fiscal multipliers: size matters!](#)") The estimated loss of activity resulting from tightening up on public expenditure will come to 0.5 GDP point in 2013.

In total, the average domestic fiscal multiplier associated with the austerity policy being implemented in France in 2013 will be 0.9, and this policy will reduce GDP by 1.7%. This result is in the lower range of the [latest work of the IMF](#); using recent data on 28 countries, it has estimated the actual multipliers at between 0.9 and 1.7 since the beginning of the Great Recession.

Main measures affecting the structural public deficit in 2013

	Measures (in bn)	Fiscal multiplier estimated in the short term	Impact on GDP (%)
Households	15.7	0.8	-0.6
Income tax	6.4	0.7	-0.2
PLF 2013 (taxation of capital income at IR tax rate, new brackets, etc.)*	3.2	0.6	-0.1
LFR II 2012 (reversal of tax exemption of overtime)	0.5	0.4	0.0
LFR I 2012 (de-indexation of IR brackets, suppression tax breaks and Scellier scheme, etc.)	2.7	0.8	-0.1
ISF wealth tax	-1.3	0.3	0.0
PPLF 2013 (reform of ISF wealth tax)	1.0	0.3	0.0
LFR II 2012 (repercussions from one-off 2012 contribution)	-2.3	0.3	0.0
Inheritance tax	1.1	0.3	0.0
LFR II 2012 (reversal of breaks on inheritance tax)	1.1	0.3	0.0
Social contributions and payroll tax	8.7	0.9	-0.4
Social security PLF 2013 (reform of self-employed payroll tax, higher tax on beer and tobacco, etc.)	2.9	1.0	-0.1
LFR II 2012 (reversal of overtime exemption, limitation of tax breaks and employee savings, higher CSG wealth tax, capital income, etc.)	5.3	0.8	-0.2
Pension reform (higher contributions)	0.5	1.0	0.0
Other	0.8	0.6	0.0
PLF 2013 (higher tax on vacant housing, tougher "automobile malus", etc.)	0.9	0.6	0.0
LFR II 2012 (lower VAT on books)	-0.1	1.0	0.0
Business**	12.2	0.8	-0.5
Corporate income tax	8	0.7	-0.3
PLF 2013 (limits on financial expenses deductibility, reform of the "cinquième acompte", etc.)	8	0.7	-0.3
Payroll tax and social contributions	2.3	1.0	-0.1
Social security PLF 2013 (higher CNRACL contribution rate, reform on wage tax, etc.)	1.8	1.0	-0.1
Pension reform	0.5	1.0	0.0
Other	1.9	0.5	-0.1
PLF 2013 (sectoral measures on taxation of business insurance) (sectoral measures on taxation of business insurance)	1.3	0.8	-0.1
LFR II 2012 (one-off contribution of oil industry, taxation of financial transactions, etc.)	0.6	0.2	0.0
Total Business and Household Taxes and Contributions	27.9	0.8	-1.1
Structural saving on primary public expenditure	8.0	1.3	-0.5
Total fiscal impulse	35.9	0.9	-1.7

* This amount incorporates the downward revision of the yield initially foreseen in the PLF 2013 of the measure taxing capital gains at the personal income tax rate, which is to be offset by the extension of the exceptional 5% corporate income tax contribution for large corporations.

** This breakdown does not measure the final fiscal impact that is to be borne by households if the increase in business taxes is passed on in prices.

Sources : PLF 2013, Social security PLF 2013, LFR I and II 2012, OFCE calculations.

[1] For more on this, see Creel, Heyer, Plane, 2011, "Petit précis de politique budgétaire par tous les temps", *Revue de l'OFCE*, no. 116, January 2011.

What is the value of the fiscal multipliers today?

By [Xavier Timbeau](#)

We inherited higher public deficits and greatly increased public debts from the crisis (Table 1). Reducing these will require a major fiscal effort. But a programme that is too brutal and too fast will depress activity and prolong the crisis, not only compromising the fiscal consolidation effort but also locking the economies into a recessionary spiral. The value of the fiscal multiplier (the link between fiscal policy and economic activity) both in the short term and in the long term is thus a critical parameter for stabilizing the public finances and returning to full employment.

Public deficit and public debt 2007-2012

<i>In GDP points</i>	Public deficit		Net public debt minus financial assets	
	2012	Change 2012-2007	2012	Change 2012-2007
DEU	-0.9	-1.1	52	9
FRA	-4.5	-1.7	66	31
ITA	-1.7	-0.1	96	9
ESP	-5.4	-7.3	54	37
NLD	-4.3	-4.4	43	15
BEL	-2.8	-2.7	82	9
PRT	-4.6	-1.4	81	32
IRL	-8.4	-8.5	82	82
GRC	-7.4	-0.6	134	52
AUT	-2.9	-1.9	48	17
Euro area (EA11)	-3.0	-2.3	63	20
GBR	-7.7	-4.9	74	46
USA	-8.3	-5.3	85	37
JPN	-9.9	-7.8	134	54

Source : OECD, *Economic outlook 91*.

When the multiplier (in the short term) is greater than approximately 2 (actually $1/a$, a being the sensitivity of the public deficit to the economic cycle and valued at about 0.5 in the developed countries), then fiscal cutbacks produce such a decrease in activity that the short-term deficit increases with the cuts. When the multiplier is greater than approximately 0.7 (in fact, $1/(a+d)$, d being the ratio of debt to GDP), then fiscal restraint increases ratio of debt to GDP in the short term. In the longer term, things get complicated, and only a detailed modelling can help to understand in what circumstances today fiscal restraint would lead to a sustained reduction in the debt-to-GDP ratio. The value of the multiplier in the medium term is of course crucial (it is usually assumed to be null, or zero, but in the case of cost-effective public investment, this assumption does not hold), but hysteresis effects as well as changes in expectations about inflation or about sovereign interest rates (and therefore the critical gap, *i.e.* the gap between 10-year sovereign bond rates and the economy's nominal potential

growth rate) interact with changes in the debt and in GDP.

Until recently, most economists believed that the value of the multiplier depends on the composition of the fiscal stimulus (taxes, expenditure and the nature of taxes and expenditure), the size of the economy and its openness (the more open the economy, the lower its multiplier) and the existence of anticipations of a fiscal shock (an anticipated shock would have little effect, in the long term, it would have none, with only an unexpected shock having a temporary effect)[1]. [Recent literature \(since 2009\) has taken an interest](#) in the value of the fiscal multiplier in the short term in times of crisis . Two main conclusions emerge:

1. The multiplier is higher in “times of crisis” (in the short term or as long as the crisis lasts). In “times of crisis” means high unemployment or a very wide output gap. Another symptom may be a situation where safe long-term interest rates are very low (*i.e.* negative in real terms), suggesting a flight to safety (radical uncertainty) or a liquidity trap (expectations of deflation). Two theoretical interpretations are consistent with these manifestations of the crisis. One, price expectations are moving toward deflation, or radical uncertainty makes it impossible to form an expectation, which is consistent with very low safe interest rates and leads to the paralysis of monetary policy. Or second, more economic agents (households, firms) are subject to short-term liquidity constraints, perpetuating the recessionary spiral and preventing monetary policy from functioning. In one case as in the other, the fiscal multipliers are higher than in normal times because the expansionary fiscal policy (resp. restrictive) forces the economic agents to take on debt (resp. shed debt) collectively instead of individually. In “times of crisis” the multiplier is in play including when it is anticipated and its effect persists until a

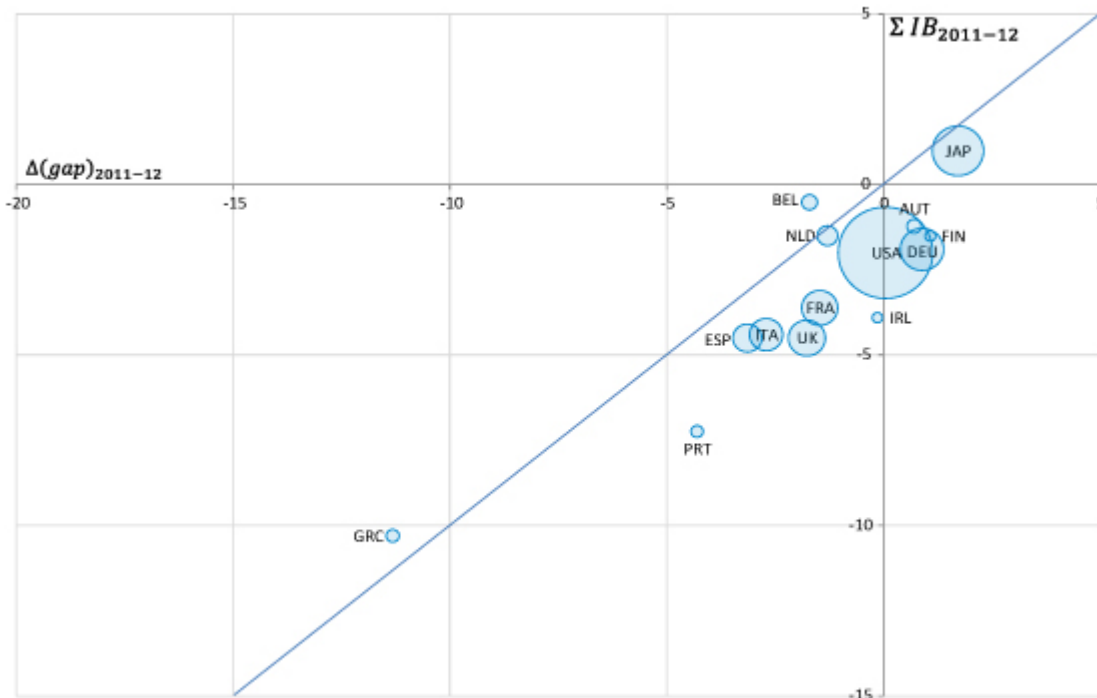
return to full employment.

2. The multiplier is higher for expenditures than it is for compulsory levies. The argument in normal times is that higher compulsory levies acts as a disincentive and spending cuts as an incentive on the supply of labour. In a small open economy, when monetary policy also induces a real depreciation of the currency, fiscal restraint can increase activity, a result that has long allowed supporters of fiscal discipline to promise all kinds of wonders. But in times of crisis, in addition to the fact that the multipliers are higher, the logic applicable in normal circumstances is reversed. The use of taxes as disincentives for the labour supply or spending cuts as incentives does not work in an economy dominated by involuntary unemployment or overcapacity. It is in fact the expectations of a recession or of deflation that act as disincentives, which is another factor indicating high multipliers.

Econometric estimates (based on past experience of “times of crisis”) lead to retaining a fiscal multiplier of around 1.5 (for an average mix of spending and compulsory levies).

Taking together 2011 and 2012, years in which a very strong fiscal impulse was carried out, confirms this econometric evaluation. By comparing on the one hand changes in the output gap from end 2010 to 2012 (on the abscissa) and on the other hand the cumulative fiscal impulse for 2011 and 2012, we obtain the short-term impact of the fiscal consolidation. Figure 1 depicts this relationship, showing a close link between fiscal restraint and economic slowdown.

Graphe 1 : Change in the output gap and the impulse 2011-2012



Source: OECD, *Economic Outlook 91*, June 2012. The year 2012 is a projection (OFCE forecast October 2012). The area of the bubbles is proportional to real GDP in 2011 (\$ PPP).

For most countries, the “apparent” multiplier is less than 1 (the lines connecting each of the bubbles are below the bisector, the “apparent” multiplier is the inverse of the slope of these lines). Figure 2 refines the evaluation. The changes in the output gap are in effect corrected for the “autonomous” dynamic of the closing of the output gap (if there had been no impulse, there would have been a closing of the output gap, which is estimated as taking place at the same rate as in the past) and for the impact of each country’s budget cutbacks on the others through the channel of foreign trade. The bubbles in orange therefore replace the blue bubbles, integrating these two opposing effects, which are evaluated here while seeking to minimize the value of the multipliers. In particular, because the output gaps have never been so extensive, it is possible that the gaps are closing faster than what has been observed in the last 30 or 40 years, which would justify a more dynamic counterfactual and therefore higher fiscal multipliers.

Austria and Germany are exceptions. As these two countries

enjoy a more favourable economic situation (lower unemployment, better business conditions), it is not surprising that the multiplier is lower there. Despite this, the “corrected apparent” multiplier is negative. This follows either from the paradoxical effects of the incentives, or more likely from the fact that monetary policy is more effective and that these two countries have escaped the liquidity trap. But the correction provided here does not take into account any stimulus from monetary policy.

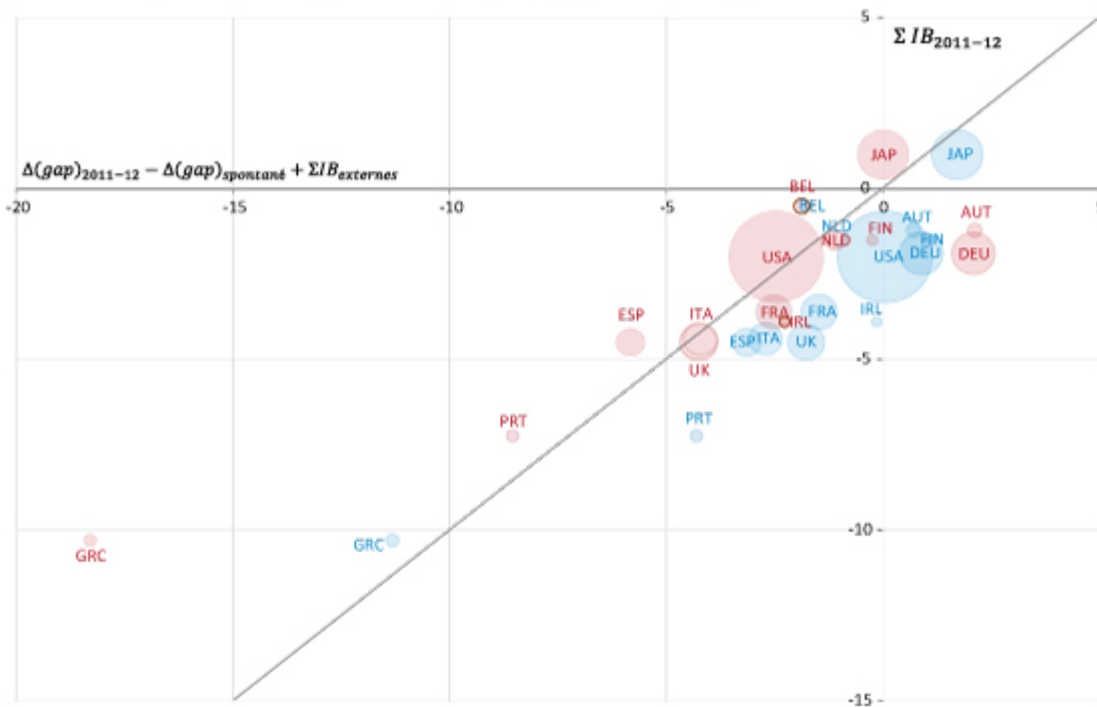
In the United States, the “2011-2012 corrected apparent” multiplier comes to 1. This “corrected apparent” multiplier is very high in Greece (~ 2), Spain (~ 1.3) and Portugal (~ 1.2), which is consistent with the hierarchy set out in point 1. This also suggests that if the economic situation deteriorates further, the value of the multipliers may increase, exacerbating the vicious circle of austerity.

For the euro zone as a whole, the “corrected apparent” multiplier results from the aggregation of “small open economies”. It is thus higher than the multiplier in each country, because it relates the impact of the fiscal policy in each country to the whole zone and no longer just to the country concerned. The aggregate multiplier for the euro zone also depends on the composition of the austerity package, but especially to the place where the measures are being implemented. However, the biggest fiscal impulses are being executed where the multipliers are highest or in the countries in the deepest crisis. The result is that the aggregate multiplier for the euro zone is 1.3, significantly higher than that derived from the US experience.

A comparison of the fiscal plans for 2011 and 2012 with the economic cycle in those years yields a high estimate for the fiscal multipliers. This confirms the dependence of the multiplier on the cycle and constitutes a serious argument against the austerity approach, which is to be continued in 2013. Everything indicates that we are in a situation where

[austerity is leading to disaster.](#)

Grphe 2 : Changes in the output gap and the impulse 2011-2012



Source: OECD, Economic Outlook 91, June 2012. The year 2012 is a projection (OFCE forecast October 2012). The area of the bubbles is proportional to real GDP in 2011 (\$ PPP).

[1] There has been an intense debate about the theoretical and especially the empirical validity of these assertions (see [Creel, Heyer and Plane 2011](#) and [Creel, Ducoudré, Mathieu and Sterdyniak 2005](#)). Recent empirical work undertaken for example by the IMF has contradicted the analyses made in the early 2000s, which concluded that anti-Keynesian effects dominate Keynesian effects. Thus, at least with regard to the short term, before the crisis and in “normal times”, the diagnosis today is that the fiscal multipliers are positive. The endogeneity of measurements of a fiscal impulse by simply varying the structural deficit interfered with the empirical analysis. The use of a narrative record of fiscal impulses addresses this issue and significantly alters estimates of the multipliers. In most macroeconomic models (including dynamic stochastic general equilibrium – DGSE – models), the fiscal

multipliers are also positive in the short term (on the order of 0.5 for a pure fiscal shock “in normal times”). In the long run, the empirical analysis does not tell us much, as the noise drowns out any possibility of measurement. The long term therefore reflects mainly an *a priori* theory that remains largely dominated by the idea that fiscal policy can have no long-term effect. However, in the case of public investment or of possible hysteresis, the assumption of a non-null effect in the long run seems more realistic.

France: will the war of the 3% take place?

By [Eric Heyer](#)

This text summarizes the [OFCE's October 2012 forecasts for the French economy](#).

The French economy is expected to see average annual growth of 0.1% in 2012 and 0.0% in 2013. This performance is particularly poor and far from the path that an economy recovering from a crisis would normally experience.

Four years after the onset of the crisis, the French economy has real potential for a rebound: this should lead to spontaneous average growth of about 3.0% per year in 2012 and 2013, making up some of the output gap built up since the start of the crisis. But this spontaneous recovery is being hampered, mainly by the establishment of budgetary savings plans in France and throughout Europe. The fiscal consolidation strategy imposed by the European Commission is

likely to slice nearly 6 percentage points off GDP in France during 2012 and 2013.

Table 1. The brakes on growth in France

En points of GDP				
Rythm	... quaterly		... annually	
	2012	2013	2012	2013
Spontaneous recovery	0,8	0,8	2,1	3,1
Budget impact	-0,4	-0,4	-1,6	-1,7
Oil shock	-0,05	0,0	-0,2	0,0
External environment	-0,4	-0,3	-1,4	-1,2
Achievement			-1,0	-0,2
Growth forecasts	-0,04	0,04	0,1	0,0

Sources : INSEE, OFCE calculations.

By setting a pace that is far from its potential, the expected growth will increase the output gap accumulated since 2008 and will lead to a further deterioration on the labour market. The unemployment rate will rise steadily and hit 11% by late 2013.

Moreover, the reduction of the budget deficit expected by the Government due to the implementation of its consolidation strategy – the target for the general government deficit is 3% of GDP in 2013 – will be partially undermined by the shortfall in tax revenue due to weak growth. The general government deficit will come to 3.5% in 2013.

Under these conditions, should the government do whatever it can to fulfil its commitment to a 3% deficit in 2013?

In a context of financial uncertainty, being the only State not to keep its promise of fiscal consolidation is a risk, *i.e.* of being punished immediately by an increase in the financial terms on the repayment of its debt. This risk is real, but limited. The current situation is that of a “liquidity trap” and abundant savings. The result is a “flight to quality” phenomenon on the part of investors seeking safe investments. But among these are both German and French government bonds. Under these conditions, reducing the government deficit by 1 GDP point instead of 1.5 point would

have very little impact on French bond rates.

However, maintaining a target of a 3% deficit in 2013 could have a dramatic impact on economic activity and employment in France. We simulated a scenario in which the French government maintains its budgetary commitment regardless of the costs and the economic situation. If this were to occur, it would require the adoption of a new programme of budget cuts in the coming months in the amount of 22 billion euros.

This strategy would cut economic activity in the country by 1.2% in 2013. It would lead to a further increase in the unemployment rate, which would reach 11.7% at year end, nearly 12%. As for employment, this obstinacy would intensify job losses, costing nearly 200,000 jobs in total.

A darker scenario is also possible: according to our forecasts, and taking into account the draft budget bills known and approved, no major European country would meet its deficit reduction commitments in 2013. By underestimating the difficulty of reaching inaccessible targets, there is a high risk of seeing the euro zone countries locked into a spiral where the nervousness of the financial markets would become the engine driving ever greater austerity. To illustrate this risk, we simulated a scenario in which the major euro zone countries (Germany, France, Italy and Spain) implement new austerity measures to meet their deficit targets in 2013. Adopting such a strategy would result in a strong negative shock to economic activity in these countries. For the French economy, it would lead to additional austerity that either at the national level or coming from its euro zone partner countries would cause a severe recession in 2013. French GDP would fall by more than 4.0%, resulting in a further increase in the unemployment rate, which would approach 14%.

Table 2. Illustrative scenarios of risks to French growth

In %

	2011	2012*	2013*
Central scenario			
GDP	1,4	0,1	0,0
Gov't deficit (in GDP points)	-7,1	-4,4	-3,5
Unemployment rate	9,4	10,2	11,0
Market employment	104	-95	-166
Scenario where France alone meets its budget commitments			
GDP			-1,2
Gov't deficit (in GDP points)			-3,0
Unemployment rate			11,7
Market employment (in 1000s)			
Change			-361
Deviation from central scenario			-195
Scénario where euro zone countries meet their budget commitments			
GDP			-4,6
Gov't deficit (in GDP points)			-3,0
Unemployment rate			18,8
Market employment (in 1000s)			
Change			-910
Déviation from central scenario			-744

* OFCE forecast October 2012

Sources : INSEE ; OFCE calculations e-mod.fr.

The situation on the labour market in France*

By [Eric Heyer](#)

The French economy is facing a number of imbalances, with the two main ones being:

– a public deficit that at end 2012 is likely to come to about 4.5 GDP points, or close to 100 billion euros;

– a lack of jobs, which is leading to mass unemployment.

While the first point is the object of great attention, and while it has been and remains the main or even the sole concern of every EU summit over the last three years and is at the heart of the European strategy on the crisis, it must be acknowledged that this is not unfortunately the case for the second point. However, it is not unreasonable to ask whether the priority in a country as rich as France should actually be to reduce the deficit at all costs even if this may worsen the plight of society's most vulnerable and make it more difficult for them to access the labour market.

Since the beginning of the crisis in early 2008, the French economy has destroyed more than 300,000 jobs, and the number of unemployed as defined by the International Labour Office has increased by 755,000. More than 2,700,000 French are now without jobs, i.e. 9.6% of the active population.

And this figure undoubtedly underestimates the real situation. The French economy is currently creating only mini part-time jobs that don't last long; in the last quarter, 4.5 million job contracts were signed: 3 out of 4 of these were contracts lasting less than one month (mostly 1 day to 1 week). Someone who signed one of these contracts and is looking for a job at the end of the same month is not counted as unemployed. Their inclusion would increase the jobless numbers and push the French economy a little further into mass unemployment.

Moreover, and this is more disturbing, the unemployed are getting older while remaining jobless – the number of long-term unemployed is continuing to shoot upwards – and thereby lose out in terms of both job skills and financially as they shift from unemployment benefits onto the social minima; in a study we conducted at OFCE for the National Observatory on Poverty and Social Exclusion (ONPES), we estimated that in France 100 additional unemployed during this crisis will lead to 45 more people in poverty in 2012. Thus,

even stabilizing unemployment would not lead to halting the deterioration of people's situation – on the contrary.

It is therefore urgent to reverse current trends with respect to employment and unemployment.

The surest way to do this is to put the French economy onto a trajectory of dynamic growth: recall that low but positive growth is not enough for the French economy to create jobs again, as, given gains in productivity, the country's economy needs to grow by more than 1% in order to unleash a spiral of job creation. Moreover, given the continuation of demographic growth and the postponement of the retirement age, the labour force is increasing by 150,000 people every year. It is thus necessary to create more than 150,000 jobs in France before unemployment will begin to fall, which corresponds to growth of over 1.5%.

However, in light of the austerity policies being implemented in France and by our European partners, this level of growth seems unthinkable in 2012 and 2013.

So how can a further explosion of unemployment be stopped in the near future?

The first step would be to change Europe's strategy by establishing, among other things, a "more moderate" austerity.

The second step would be to adopt the strategy Germany is using for the crisis, that is to say, to reduce working time by massively resorting to part-time work and to partial unemployment schemes. Remember that 35% of German employees are hired part-time, as against 17% in France. Furthermore, during the crisis 1.6 million Germans have been on a partial unemployment programme, compared with 235,000 in France. All this has helped Germany to keep unemployment down during the crisis.

The last solution is to use what in France is called the

“social treatment of unemployment”. As the private sector is still destroying jobs, the public sector would offset part of this by creating subsidized jobs.

The government seems to be taking this last path: 100,000 “jobs for the future” will be created in 2013 and 50,000 in 2014.

In the short term, given the economic situation, this strategy seems to be the most effective and the least expensive. However, in the medium term, it cannot replace a policy of growth.

* This text is taken from a series of reports by Eric Heyer for the programme “Les carnets de l’économie” on France Culture radio. It is possible to listen to the series on [France Culture](#).

European Council: wait and sink?

By [Jérôme Creel](#), Paul Hubert and [Francesco Saraceno](#)

The European Council meeting being held at the end of the week should have been spent, according to the wishes of the French authorities, on renegotiating the European Fiscal Compact adopted on 2 March 2012. However, renegotiation has not been on the agenda. Alas, the Fiscal Compact does need to be re-opened for debate: it should be denounced for being poorly drafted, and its overly restrictive character needs to be

reviewed; ultimately, the text should be amended. The focus of the debate on the structural deficit rule, which is unfairly described as the “golden rule”, is wide of the mark in so far as it is the rule on the reduction of public debt that is the more restrictive of the two rules included in the Fiscal Compact. This is the rule that demands to be discussed, and urgently, in order to avoid sinking deeper into a contagion of austerity plans that are doomed in advance...

The conflict over European growth between the French and Italians on the one side and the Germans on the other was probably defused by the agreement late last week with Spain in favour of a coordinated European recovery plan. The plan represents 1% of Europe’s GDP, *i.e.* 130 billion euros, though its contours and funding remain to be clarified. The slogan of the European Council has thus been, by a process of elimination, “banking union”, in an effort to prevent a new wave of banking and financial crises in the European Union. Is the creation of a banking union important? Certainly. Is it urgent? Less so than a return to growth, which, while it certainly cannot be decreed, can be prepared. Given the state of the current Fiscal Compact, we can conclude that what is being prepared is not economic growth, but recession [\[1\]](#).

The Fiscal Compact, which is contained in Title III of the [Treaty on Stability, Coordination and Governance in the Economic and Monetary Union](#), explicitly includes two fiscal rules. The first clarifies what constitutes a budgetary position that is “balanced or in surplus”, a term enshrined long ago in the Stability and Growth Pact. According to the Fiscal Compact of March 2012, a budgetary position that is “balanced or in surplus” means a structural deficit of at most 0.5% of GDP. The structural deficit is the cyclically adjusted public deficit, *i.e.* adjusted for the well-known automatic stabilizers; this includes interest charges, among other items. When the structural deficit is exceeded, apart from exceptional circumstances, *e.g.* a “significant” downturn in

activity, an automatic adjustment mechanism, whose nature is not specified, must bring it back below this limit. The structural deficit rule is relaxed for Member States whose public debt is below 60% of GDP: the structural deficit ceiling is increased to 1% of GDP.

The second fiscal rule is also a requirement for euro zone Member States with a public debt in Maastricht terms that is greater than 60% of GDP. In 2012, this rule applies to 12 out of the 17 Member States of the euro zone. This second rule aims to reduce the public debt by one-twentieth every year. Unfortunately, the text adopted is poorly written and opens the door to different interpretations, as we show below. It is therefore inapplicable. Even worse, given the current state of the economy, this rule is the more restrictive of the two rules in the Fiscal Compact. It is therefore urgent to pay attention to it and modify it to make it enforceable.

According to Article 4 of the Treaty, “When the ratio of a Contracting Party’s general government debt to gross domestic product exceeds the 60% reference value..., that Contracting Party shall reduce *it* at an average rate of one-twentieth per year as a benchmark...” The problem is that “it”, which we have put in italics, refers to the public debt ratio rather than to the difference between the public debt and the 60% reference value. So, in 2012 should Germany, with a public debt in 2011 of a little more than 80% of GDP, reduce its debt by 4 GDP points (one-twentieth of 80% of GDP) or by 1 GDP point (one-twentieth of the difference with the reference value of 60% of GDP)? Legally, it is essential that a clear answer can be given to this kind of question.

Moreover, the Fiscal Compact is silent on the nature of the surplus to be used to reduce the debt: if, to leave room for maneuver in case of a cyclical deficit, this rule were to address the structural deficit – which would therefore need to be explained in the Compact – the debt rule would be even more restrictive than the golden rule: a structural *surplus* would

be systematically required to reduce the public debt to 60% of GDP in the 12 Member States whose debt exceeds the reference value. Again, the formulation needs to be clear.

Suppose now that the “it” in Article 4 concerns the difference between the debt and the reference value, and that the rule on debt reduction applies to the entire public deficit. The question can then be asked, which of the two rules – the “golden rule” or the debt reduction rule – places greater restrictions on the Member States, and thus needs to be applied. We have set out, in an appendix [\[2\]](#), the small set of fiscal rules compatible with the Fiscal Compact. The total deficit is the sum of the cyclical deficit and the structural deficit. The cyclical deficit depends on the difference between actual and potential GDP, *i.e.* the output gap, which has an elasticity of 0.5 (average elasticity customary in the literature on the European countries, cf. [OECD](#)). The “golden rule” relates only to the structural deficit, while the debt reduction rule concerns the total public deficit, and thus depends on both the output gap and the structural deficit.

For what values of the public debt and the output gap is the “golden rule” more restrictive than the debt reduction rule? Answer: when the output gap is greater than 1 plus one-tenth of the difference between the original debt and the reference value. This means that, for a country like Germany, the debt reduction rule would predominate over the “golden rule” except in cases of very high growth: the real GDP would have to be at least two points higher than the potential GDP. According to the OECD economic forecast published in May 2012, Germany’s output gap in 2012 will be -0.8. The debt reduction rule is thus much more restrictive than the “golden rule”. This is also true for France (debt of 86% of GDP in 2011), which would have to have an output gap of at least 3.6 points for the “golden rule” to be binding; yet the OECD forecasts an output gap of -3.3 in 2012. The same holds true for all the countries in the euro zone with a debt greater than 60% of GDP, without

exception.

Except in cases of very strong growth, the debt reduction component dominates the structural deficit component. Yet it is the latter that is the focus of all the attention.

When a treaty is open to such differences in interpretations, isn't it normal to want to revise it? When a treaty requires intensifying austerity measures in an area like the euro zone, whose GDP is almost 4 percentage points below its potential, according to the estimates of an organization, the OECD, that is generally not suspected of overestimating the said potential, is it not desirable and urgent to renegotiate it?

[1] A recent post emphasized the risks of social instability and the potential losses that might result from austerity-induced contagion in the euro zone (cf. [Creel, Timbeau and Weil, 2012](#)).

[2] Annex:

We start by defining with *def* the total public deficit, which includes a structural component *s* and a cyclical component *dc*:

$$\text{def} = s + \text{dc}$$

All the variables are expressed as a proportion of GDP. The cyclical component is composed of the variation in the deficit that occurs, thanks principally to the action of the automatic stabilizers, when the economy deviates significantly from its potential. A reasonable estimate is that the deficit increases by 0.5 point per point of lost output. The cyclical component can thus be expressed as:

$$\text{dc} = - 0.5 y$$

where we define *y* as the output gap, *i.e.* the difference between GDP and its potential level.

The rules introduced by the fiscal compact can be expressed as follows:

$$s_1 < 0.5,$$

that is, the structural deficit can never exceed 0.5% of GDP (s_1 refers to the first aspect of the rule), and

$$\text{def} = - (b_0 - 60)/20,$$

that is, the total deficit must be such that the public debt (expressed as a proportion of GDP) is reduced every year by one-twentieth of the difference between the initial public debt (b_0) and the 60% reference level. The debt rule can thus be re-written in terms of the structural deficit as:

$$s_2 = \text{def} - \text{dc} = 0.5 y - (b_0 - 60)/20.$$

We thus have 2 possible cases for when the structural deficit component is less restrictive than the debt reduction component:

Case 1

$$s_1 < s_2 \text{ if } y > 1 + (b_0 - 60)/10.$$

Assume the case of a debt level like Germany's ($b_0 = 81.2$ % of GDP). Case 1 implies that the structural deficit component will be less restrictive than the debt reduction component if and only if $y > 3.12\%$, that is, if Germany has a GDP that is at least three points higher than its potential. If a country has a higher level of debt (e.g. Italy, at 120% of GDP), then $y > 7\%$!

Case 2

If the debt reduction rule concerns the structural deficit (rather than the total public deficit), then we have:

$$s_1 < 0.5$$

and

$$s_2 = - (b_0 - 60)/20$$

In this case, $s_1 < s_2$ if $1 < - (b_0 - 60)/10$, which will never happen so long as the public debt is greater than the reference level.

Would returning to the drachma be an overwhelming tragedy?

by [Céline Antonin](#)

Following the vote in the Greek parliamentary elections on 17 June 2012, the spectre of the country leaving the euro zone has been brushed aside, at least for a while. However, the idea is not completely buried, and it is still being evoked in Greece and by various political forces around the euro zone. This continues to pose the question of the cost of a total default by Greece for its creditors, foremost among them France. The analysis published in the latest [OFCE Note \(No. 20, 19 June 2012\)](#) shows that, despite the magnitude of the potential losses, several factors could mitigate the consequences for the euro zone countries of a default by the Greek state.

The withdrawal of Greece from the euro zone, which is not covered in the Treaties, would cause a major legal headache, as it would involve managing the country's removal from the Eurosystem [\[1\]](#). In case of a return to a new drachma, which would depreciate sharply against the euro [\[2\]](#), the burden of

the public debt still outstanding would be greatly increased, as would private debt, which would still be denominated in euros. Many financial and nonfinancial firms would go to the wall. Legally, Greece could not unilaterally convert its debt into new drachmas. Since the country's public debt is not very sustainable and it is denominated almost exclusively in euros, Greece would certainly default (at least partially) on its public debt, including its foreign debt [3]. Given that the main holders of Greek debt are euro zone countries, what would be the magnitude of the shock in the case of a Greek default?

While more detail about this can be found in the [OFCE Note \(No. 20, 19 June 2012\)](#), the focus here is on providing a breakdown of the exposure of the euro zone countries (in particular France) to Greek public and private debt. Exposure to Greek public debt involves three main channels:

- 1) The two aid packages of May 2010 and March 2012;
- 2) Participation in the Eurosystem;
- 3) The exposure of the commercial banks.

An analysis of these channels shows that the main source of exposure of the euro zone countries to losses is the two support plans. The maximum exposure of the euro zone countries through this channel is 160 billion euros (46 billion euros for Germany and 35 billion euros for France). Euro zone countries are also exposed to Greek government debt through their participation in the Eurosystem: indeed, the Eurosystem's balance sheet swelled dramatically to support the vulnerable countries in the euro zone, notably Greece. However, given the Eurosystem's capacity to absorb losses (over 3,000 billion euros), we believe that the potential losses for the countries of the euro zone are not likely to be realized if Greece were to default unilaterally on its public debt. Finally, the euro zone's banking system is exposed to 4.5 billion euros in Greek sovereign risk and up to 45 billion

euros from the Greek private sector [\[4\]](#).

The cumulative exposure of the euro zone to Greek debt, excluding the Eurosystem, amounts to a maximum of 199 billion euros (2.3% of the euro zone's GDP, cf. Table), including 52 billion euros for Germany (2% of GDP) and 65 billion euros for France (3.3% of GDP). If we include exposure to the Eurosystem, the cumulative exposure of the euro zone to Greek debt comes to 342 billion euros (4% of euro zone GDP), including 92 billion for Germany (3.6% of GDP) and 95 billion (4.8%) for France. France is the most heavily exposed euro zone country, due to the exposure of its banks to Greek private debt through subsidiaries in Greece. If we consider only Greek government debt, however, it is Germany that appears to be the country most exposed to a Greek default.

Summary of the exposure of different countries to Greek debt

In billion euros

	1) Support plans		2) Eurosystem		3) Commercial banks		Total	Total excl. Eurosystem
	1st plan	2e plan	SMP	TARGET2	Public debt	Private debt		
Germany	14.7	31.4	12.5	27.3	1.3	5.1	92.3	52.5
Austria	1.5	3.2	1.3	2.8	NC*	NC*	8.8	4.7
Belgium	1.9	4.0	1.6	3.5	0.1	0.0	11.1	6.0
Cyprus	0.1	0.2	0.1	0.2	NC	NC	0.6	0.3
Spain	6.5	13,8	5.5	12.0	0.1	0.5	38.4	20.9
Estonia	0.0	0.3	0.1	0.3	NC	NC	0.7	0.3
Finland	1.0	2.1	0.8	1.8	NC	NC	5.7	3.1
France	11.1	23.6	9.4	20.5	1.3	29.1	95.0	65.1
Ireland	0.9	0.0	0.7	1.6	NC	NC	3.2	0.9
Italy	9.7	20.7	8.3	18.0	0.2	1.1	58.0	31.7
Luxembourg	0.1	0.3	0.1	0.3	NC	NC	0.8	0.4
Malta	0.1	0.1	0.0	0.1	NC	NC	0.3	0.2
Netherlands	3.1	6.6	2.6	5.7	NC	NC	18.0	9,7
Portugal	1.4	0.0	1.2	2.5	NC	NC	5.1	1.4
Slovakia	0.5	1.1	0.5	1.0	NC	NC	3.1	1.6
Slovenia	0.3	0.6	0.2	0.5	NC	NC	1,6	0.9
Total EZ	52.9	107.7	45.0	98.0	2.9	35.8	342.3	199.3

[NC => NA]

NA: Not available, as the BIS gives only the exposures of Germany, Belgium, France, Italy and Spain. The totals are thus calculated without taking into account the second tier banks, except for Germany, Belgium, France, Italy and Spain and the Euro Zone Total.

Sources: "The Economic Adjustment Programme for Greece – First review summer 2010", ECB, EFSF, BIS *Quarterly Review* (June 2012), Bank of Greece, author's calculations.

These amounts constitute an upper bound: they represent the maximum potential losses in the worst case scenario, namely the complete default of Greece on its public and private debt. Furthermore, it is impossible to predict with certainty all the chain reactions associated with a Greek exit from the euro zone: everything depends on whether the exit is coordinated or not, whether a debt rescheduling plan is implemented, the magnitude of the depreciation of the drachma against the euro, and so on.

The "reassuring" element in this analysis is the magnitude of the potential losses (Table): the shock of a Greek exit would be absorbable, even if it would generate a shock on each member country and widen its deficit, undermining the members'

efforts to restore balanced budgets. However, this analysis also points out how intertwined the economies of the euro zone are, even if only through the monetary union, not to mention the mechanisms of the solidarity budget. A Greek exit from the euro zone could therefore open a Pandora's Box – and if other countries were tempted to imitate the Greek example, it is the euro zone as a whole that could go under.

[1] The Eurosystem is the European institution that groups the European Central Bank and the central banks of the countries in the euro zone.

[2] On this point, see [A. Delatte, What risks face the Greeks if they return to the drachma?, OFCE blog, 11 June 2012.](#)

[3] The foreign debt designates all the [debt](#) that is owed by all a country's public and private debtors to foreign lenders.

[4] This refers to a textbook case, where the drachma's depreciation would be so great that the currency would no longer be worth anything.

Japan's reconstruction: constrained by the deterioration in public finances

By Bruno Ducoudré

Following the earthquake that hit Japan in March 2011, the

government estimated the cost of the loss at 16.9 trillion yen (3.6 points of GDP). The response in terms of the structural deficit needed to deal with this exogenous shock conflicts with the government's desire to implement an austerity policy to reduce the deficit. The additional financing requirements are thus coming at the worst possible time, amidst the economic crisis that began in 2008, which has been accompanied by a sharp deterioration in public finances due to the need to prop up the economy.

On the growth front, 2011 was a difficult year for Japan, coming on the heels of a 4.4% rebound in GDP in 2010 following a 5.5% drop in 2009. While the economy saw renewed growth in Q3 of 2011 (1.9% GDP growth quarter-on-quarter), after two quarters of falling GDP, at year end floods in Thailand again disrupted the supply chains of Japanese firms, and the economy faltered (zero growth in Q4 and -0.7% growth for 2011). The period of reconstruction begins in 2012.

In fiscal year 2011, four additional budget bills were passed for a total of 3.9 percentage points of GDP, mainly to cope with emergency expenses (1.3 GDP points) and to prepare for reconstruction (2.3 GDP points). The services of the State have estimated the total bill for reconstruction at 23 trillion yen (4.8 GDP points). The reconstruction will be spread over the next ten years, with the main effort concentrated on the period 2012-2016. The government decided to allocate 0.8 GDP points for reconstruction in fiscal 2012, three-quarters of which is to be funded by debt (Table).

Contrary to expectations, the series of plans passed in 2011 have not resulted in a rapid surge in public spending: public consumption grew by 2.1% in 2011, unchanged from 2010 and less than in 2009, and public investment fell by 3.1% in 2011. Reconstruction costs were partly substituted for other expenses. Also, part of the budget adopted was set aside and so is just beginning to be spent. Public orders for construction work rose by 20% in Q4 of 2011 yoy, and public

works in progress rose sharply at year end. Thus, the additional expenses related to the reconstruction costs already approved will be spread in part over the coming quarters, and even beyond fiscal year 2012.

Japan's fiscal situation is actually precarious. The expenditures needed to rebuild the devastated areas were decided in a context of high levels of deficit and debt related to the crisis. The budget deficit has indeed deteriorated sharply since the beginning of the crisis, rising from 2.2% of GDP in 2008 to 8.1% in 2010, while the debt has risen by 31.2 GDP points since 2007, to reach 199% of GDP in 2010. In 2011, the deficit widened to 9.3% of GDP mainly due to the increased debt burden, higher social security spending and the fall in GDP in 2011. The government announced that some plans would be financed by a combination of restrictions in other areas of expenditure, surplus tax revenues related to the improvement in activity in 2010, and the accumulated reserves from past budgets (for a quarter of the budget dedicated to reconstruction in 2011-2012).

In the short term, the government has nevertheless chosen to favor growth over fiscal consolidation. We expect, for instance, a fiscal stimulus of 0.4 GDP point in 2012 and 0.5 GDP point in 2013, and the Japanese economy should see average annual growth of 1.9% in 2012 and 1.5% in 2013 (see ["Japan: reconstruction time", in our forecast dossier](#), in French). In these circumstances, the budget deficit will be stable at 9.2% of GDP in 2012, and will worsen to 9.8% of GDP in 2013.

**Provisional budgets for 2011-2012 for reconstruction
Central government**

In % GDP

	2011	2012
Revenue and financing	3.9	0.8
Tax revenue	0.3	0.1
Non-tax revenue	0.0	0.1
Bond issues	2.1	0.6
Surplus from previous years	1.1	0.0
Reduction in expenditure	0.4	0.0
Expenditure	3.9	0.8
General expenditure, including:	3.3	0.7
<i>Public works</i>	1.4	0.2
<i>Other expenditure</i>	1.9	0.6
Transfers to local government	0.6	0.1

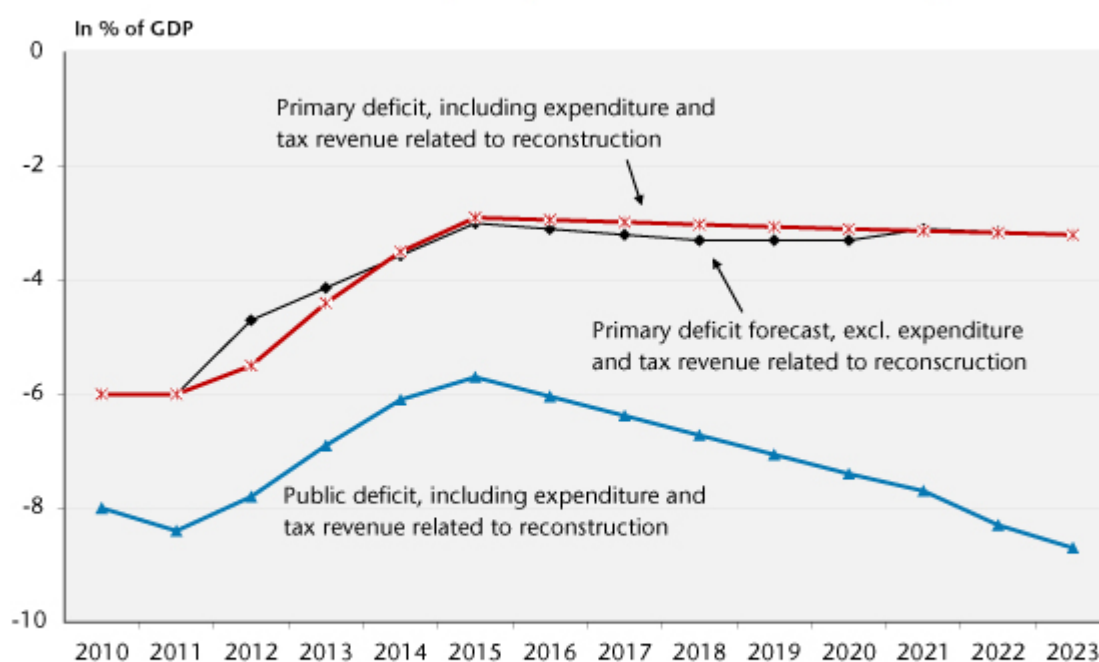
Sources: Cabinet Office, Ministry of Finance, OFCE calculations.

However, beyond 2013, there is still uncertainty about the direction of government economic policy. In the Japanese government's [medium-term fiscal strategy](#), decided in 2010, it aimed to halve the primary deficit of central and local government by 2015 compared to the level in 2010 (6.4% of GDP), and to break even by 2020. According to our calculations, balancing the primary structural deficit would require the implementation of a major fiscal consolidation effort. This would involve a negative fiscal impulse on the order of 1.1 GDP points a year in 2014, which is nevertheless a slower pace than the consolidation policies planned in the euro zone in 2012-2013 (see "[He who sows austerity reaps recession](#)" in our forecasting dossier). To this end, an increase of 5 points in the consumption tax is to be considered during the current session of the Diet, Japan's parliament, which will wind up in June. This increase would occur in two stages and yield 2.5 GDP points in tax revenue. According to [the latest medium-term forecast of the Japanese government](#), this will not be sufficient to meet its targets (Figure 1). Moreover, the means to achieve a balance by 2020 have not been clarified, and the government has not indicated how the debt built up to finance reconstruction would be

repaid. Finally, given the continuing growth of the public debt, the interest burden, which currently is low (1.8 GDP points in 2011), will place an increasing burden on state finances in the future. This will exacerbate the government's difficulties in implementing any budgetary changes aimed at stabilizing the debt-to-GDP ratio by 2020, and then to bring it down even further.

Despite all this, Japan does not seem to need a brutal fiscal consolidation, as it is currently borrowing at low interest rates (0.86% for the last issue of 10-year government bonds). Furthermore, the share of the debt held by non-residents is still low (6.7% in Q4 of 2011), and the abundant savings of the Japanese population, together with the Japanese Central Bank's programme of share purchases, considerably reduces the risk of a sovereign debt crisis like the one seen in the euro zone.

Government forecasts of the primary deficit over the reconstruction period



Note: These forecasts are based on the hypothesis of a rise in the VAT rate from 2013 and a nominal GDP growth rate of about 2% on average over the period. This includes a rise in tax revenue distributed evenly over 10 years to finance reconstruction-related expenditure. The forecast covers only central and local government.

Source: Cabinet Office.

This text refers to the economic analysis and forecast for 2011-2012, which is available on the [OFCE website](#).

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?

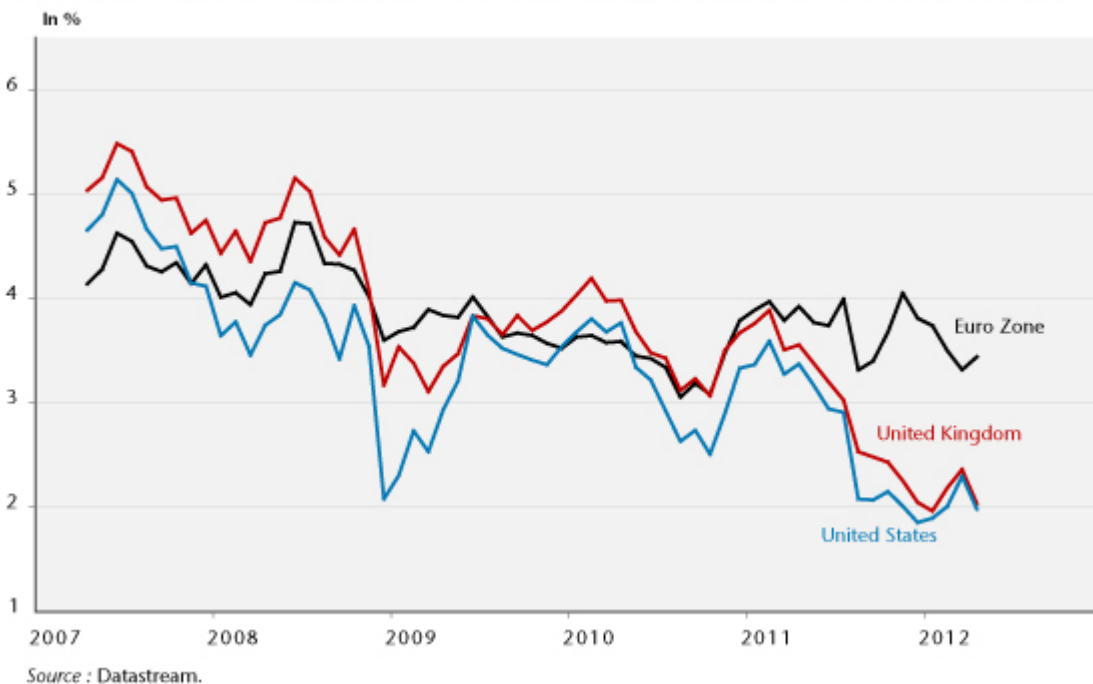
It is difficult to predict how the financial markets will behave in the wake of the French presidential election. Studying what has happened in other euro zone countries is not very informative, due to each one's specific situation. The country most "comparable" to France would undoubtedly be Italy. 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



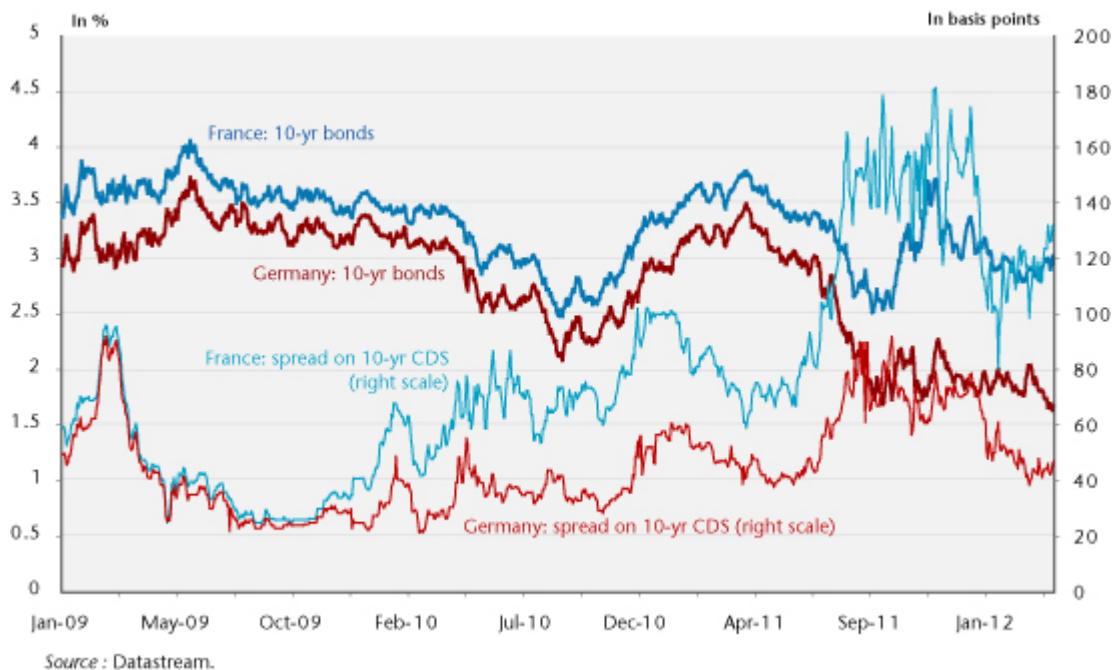
Annex: Technical functioning of Credit Default Swaps

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



[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-Börse (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.