The coming recovery

By the Analysis and Forecasting Department, under the direction of Eric Heyer and Xavier Timbeau

This text summarises the **OFCE 2015-2016 economic outlook for the euro zone and the rest of the world**

While up to now the euro zone had not been part of the global recovery, the conjunction of a number of favourable factors (the fall in oil prices and depreciation of the euro) will unleash a more sustained process of growth that is shared by all the EU countries. These developments are occurring at a time when the massive and synchronised fiscal austerity that had pushed the euro zone back into recession in 2011 is easing. The brakes on growth are gradually being lifted, with the result that in 2015 and 2016 GDP should rise by 1.6% and 2%, respectively, which will reduce unemployment by half a point per year. This time the euro zone will be on the road to recovery. However, with an unemployment rate of 10.5% at the end of 2016, the social situation will remain precarious and the threat of deflation is not going away.

The expected demand shock

After a period during the Great Recession of 2008-2009 when growth was boosted by expansionary fiscal policy, the euro zone countries quickly reversed their policy orientation and adopted a more restrictive one. While the United States also chose to reduce its budget deficit, austerity has had less effect there. First, the negative demand shock at the euro zone level was amplified by the synchronisation of the consolidation. Second, in a context of rising public debt, the lack of fiscal solidarity between the countries opened up a breach for speculative attacks, which pushed up first sovereign rates and then bank rates or the non-financial agents market. The euro zone plunged into a new recession in

2011, while globally the momentum for growth gathered pace in the other developed countries (chart). This episode of consolidation and financial pressure gradually came to an end. In July 2012, the ECB made a commitment to support the euro; fiscal austerity was eased in 2014; and the Member States agreed on a draft banking union, which was officially initiated in November 2014, with new powers on banking supervision entrusted to the ECB. All that was lacking in the euro zone then was a spark to ignite the engine of growth. The transfer of purchasing power to households that resulted from the fall in oil prices – about one percentage point of GDP if oil prices stay down until October 2015 – represents this positive demand shock, which in addition has no budget implications. The only cost resulting from the shock comes from the decline in income in the oil-producing countries, which will lead them to import less in the coming quarters.

An external demand shock will combine with this internal demand shock in the euro zone. The announcement of a quantitative easing programme in the euro zone represents a second factor accelerating growth. This programme, under which the ECB is to purchase more than 1,000 billion euros of securities at a pace of 60 billion per month until September 2016, not only will amplify the fall in sovereign yields but more importantly will also lead to a reallocation of portfolio assets and drive the euro (further) down. Investors looking for higher returns will turn to dollar-denominated securities, especially as the prospect of a gradual monetary tightening in the US improves the outlook for earnings on this side of the pond. The rising dollar will lift the currencies of the Asian countries with it, which will increase the competitive advantage of the euro zone at the expense this time of the United States and some emerging countries. It is unlikely that the fragility induced in these countries and in the oil-producing countries by the oil shock and by the decline in the euro will offset the positive effects expected in the euro zone. On the contrary, they will also be vectors for the rebalancing of growth needed by the euro zone.

Investment is the factor that will complete this growth scenario. The anticipation of higher demand will remove any remaining reluctance to launch investment projects in a situation where financing conditions are, overall, very positive, representing a real improvement in countries where credit constraints had weighed heavily on growth.

All this will lead to a virtuous circle of growth. All the signals should turn green: an improvement in household purchasing power due to the oil impact, increased competitiveness due to the lower euro, an acceleration in investment and, ultimately, growth and employment.

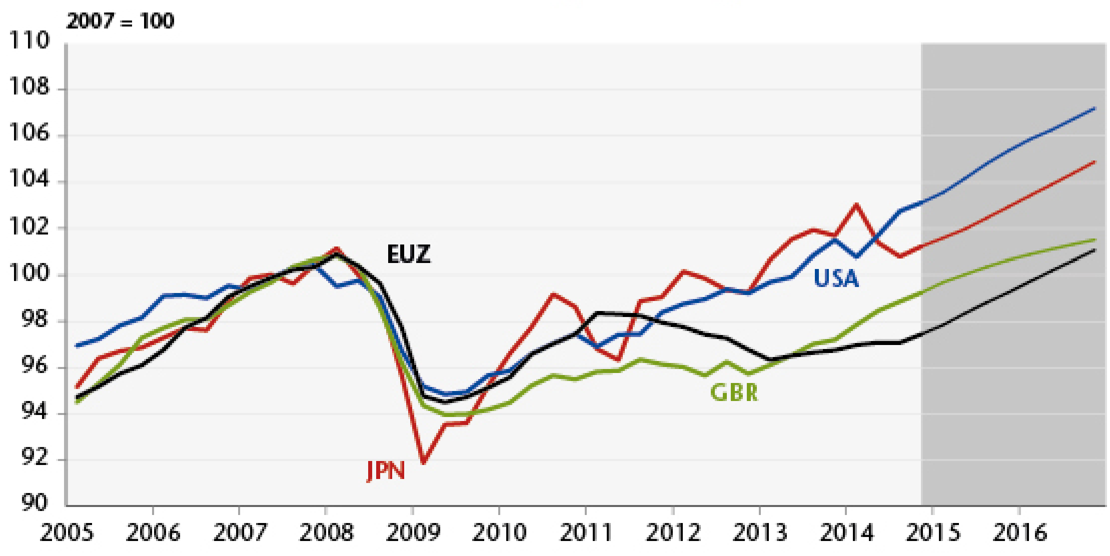
A fragile recovery?

While the elements promoting the euro zone's growth are not mere hypotheticals about the future but represent a number of tangible factors whose effects will gradually make themselves felt, the fact remains that they are somewhat fragile. The falling price of oil, for instance, is probably not sustainable. The equilibrium price of oil is closer to USD 100 than USD 50 and, ultimately, a rise in energy prices is in the cards: what has a positive effect today could undermine the resumption of a recovery tomorrow. The decline of the euro seems more long-term; it should last at least until the end of the ECB's quantitative easing programme, which officially is at least September 2016. The euro should not, however, fall below a level of 0.95 dollar per euro. The time it takes for changes in exchange rates to translate into trade volumes, however, should allow the euro zone to benefit in 2016 from a gain in competitiveness.

It is worth noting that a Greek exit from the euro zone could also put a halt to the nascent recovery. The firewalls set up at the European level to reduce that risk should limit any contagion, at least so long as the political risk has not been concretised. It will be difficult for the ECB to support a country where a party explicitly calling for leaving the euro zone is at the gates of power. The contagion that is now considered extinguished could then catch fire again and reignite the sovereign debt crisis in the euro zone.

Finally, the constraints of the Stability Pact have been shifted so as to leave more time to the Member States, particularly France, to get back to the 3% target. They have therefore not really been lifted and should soon be reinforced once it comes to assessing the budgetary efforts being made by the countries to reduce their debt.

Figure. The GDP of the euro zone, the United States, the United Kingdom and Japan



Source : National accounts, OFCE forecasts April 2015.

Does housing wealth contribute to wealth

inequality?

par Guillaume Allègre and Xavier Timbeau

In a response to *Capital in the twenty-first century,* Odran Bonnet, Pierre-Henri Bono, Guillaume Chapelle and Etienne Wasmer (2014) attempt to show that the conclusion of the book in terms of the explosion of wealth inequality is not plausible. They point out what they see as an inconsistency in the thesis: according to the authors, the capital accumulation model used by Piketty is a model of accumulation of productive capital, which is inconsistent with the choice to use housing market prices to measure housing capital. To correctly measure housing capital, one should use rent and not housing prices. By doing this, the authors conclude that capital/income ratios have remained stable in France, Britain, the United States and Canada, which contradicts the thesis of Piketty.

In *OFCE briefing note n°9* ("Does housing wealth contribute to wealth inequality? A tale of two New Yorks"), we show that the authors minimize the contribution of housing to inequality. In particular, we do not believe that trends in housing prices have "second order redistributive effects". As is often the case, the disagreement is in part due to a lack of consensus on what really matters when discussing inequality: wealth inequality or income inequality or consumption inequality? If we follow the authors, only the consumption from wealth income should matter.   We emphasize a theoretical inconsistency in the authors' main argument. In fact, they value housing capital as the sum of the present values of rents, under the assumption that what matters is the housing service, then they use a dynastic model in which what matters is the transmission of wealth and not the discounted value of the housing service.

In short, our conclusion is that with regard to inequality, wealth matters, housing wealth is in fact wealth, and should be measured in a manner consistent with the measure of other types of wealth. By doing so, one finds that housing wealth does contribute to the growth of wealth and consequently, Piketty's thesis is not refuted.

For more on this, see: Allègre, G. and X. Timbeau, 2015: "Does housing wealth contribute to wealth inequality? A tale of two New Yorks", *OFCE briefing note, n°9,* January.

The infinite clumsiness of the French budget

By Xavier Timbeau, @XTimbeau

In the draft budgetary plan presented to the European Commission on 15 October 2014, it is clear that France fails to comply with the rules on European governance and its previous commitments negotiated in the framework of the European Semester. As France is in an excessive deficit procedure, the Commission, as guardian of the Treaties, has no choice *a priori* but to reject the country's budget plan. If the Commission does not reject the plan, which departs very significantly, at least in appearance, from our previous commitments, then no budget could ever be rejected.

Recall that France, and its current President, have ratified the Treaty on Stability, Coordination and Growth (the "TSCG" came into force in October 2012), which had been adopted by the Heads of State in March 2012. There was talk during the 2012 presidential campaign of renegotiating it (which raised the hopes of the southern European countries), but the urgency of the sovereign debt crisis in Europe, among other factors, decided otherwise. France has implemented the provisions of the TSCG in Organic Law 2012-1403, for example by setting up a new fiscal council, the Haut Conseil des Finances Publiques, and establishing a multiannual system for tracking the trajectory of public finances based on structural balances (that is to say, adjusted for cyclical effects).

Everything seems to indicate that France had accepted the highly restrictive framework that had been established by the "Six-Pack" (five regulations and one directive, dated 2011, which reinforce the Stability and Growth Pact and which specify a timetable and parameters) and then reinforced by the TSCG and the "Two-Pack". France's good will was also evident when it presented its 2014 draft budgetary plan in October 2013 and a stability programme in April 2014, which more than complied. It was at a press conference in September 2014 that the French government announced that the deficit reduction target for 2015 would not be met. Low growth and low inflation were the arguments made there for a serious revision of the economic situation, which was presented as a truthful assessment. The same situation arose in 2013, with the nominal target then being set while underestimating the fiscal multipliers. However, the timing and magnitude of the adjustments had been respected, and a postponement was granted.

So until the press conference, no major difficulty had been posed to the workings of the Treaty. One of the innovations of the TSCG was in fact to no longer aim at a nominal target (3%) but to focus on the structural effort. If the economic situation proves to be worse than expected, then the nominal deficit target is not met (which is the case). In this situation, the objective is the structural effort. In the 2014-2017 Stability Programme of April 2014, the structural effort announced (page 13) is a 0.8 GDP point reduction in the structural deficit in 2015, following 0.8 GDP point in 2014. The excessive deficit procedure (also set out in a *vade-mecum* of the Commission) requires a minimum structural effort of 0.5 GDP point and that the mechanisms for achieving this be set out precisely.

It is here that the 2015 budget bill represents a concrete violation of the treaty. The effort in 2014 is now only 0.1 point, with 0.2 point announced in 2015. These figures are unacceptable to the Commission. How can such a provocative change be explained? Several factors are behind this. The first is a change in the method of booking the CICE tax credit, which means recording in 2015 the expenses generated in 2015 and paid in 2016. As the CICE ramps up, this comes to 0.2 GDP point less in France’s fiscal effort. The second is a change in the hypothesis for potential growth. Instead of 1.5% potential growth in the 2014-2017 stability programme, this is assumed to be 1.2% over the 2014-2017 period. Using a constant percentage method, the effort would have been 0.5 GDP point in 2014 and 0.6 point in 2015. The difference with the April 2014 stability programme is due to the revision downwards of inflation and to several changes in the measurements. A new presentation of the same budget, with a marginal modification of the economic situation, is marked by the absence of structural effort. Not only will the nominal target not be achieved, but furthermore the structural effort for 2014 and 2015 is abandoned – with no change in policy! Worse, this draft budget implies that the nominal target is not being achieved because the structural effort was not made in 2014 and won’t be in 2015.

The government, nevertheless, pleads extenuating circumstances. Why change the assumptions for potential growth while not having kept the previous accounting standards for presenting France’s 2015 draft budgetary plan? An effort of 0.6 GDP point in 2015 instead of the previously announced effort of 0.8 GDP point would not have posed any problems for the Commission, which itself had made overly high estimates of potential growth (as also in its remarks on the 2014 draft budgetary plan, which the Council did not adopt in November 2013). It would have been easy to answer that one does not change assumptions of potential growth every 6 months, and that this is furthermore the purpose of this concept and the reason for its introduction in EU Treaties and guidelines: to avoid a pro-cyclical character in fiscal policy, to avoid tightening up budgets at a time when bad news is piling up. It would have been accepted that the Commission had a lower assessment than France, but potential growth is not observed, and its assessment is based on numerous hypotheses. It is not, for instance, specified in the treaties or regulations whether potential growth is to be assessed in the short term or the medium term. But the Commission considers (in the 2012 Ageing Report) that France's medium-term growth potential was 1.7% per year (on average 2010 to 2060) and 1.4% in 2015. Above all, nothing obliges France to adopt the hypothesis of the Commission. EU regulation 473/2011 demands that the hypotheses be made explicit, and outside opinions might also be requested. French Organic Law 2012-043 states that, "A report attached to the draft budgetary plan (LPFP) and giving rise to parliamentary approval states: … 9) The procedures for calculating the structural effort referred to in Article 1, the distribution of this effort among the various sub-sectors of government, and the elements used to establish a correspondence between the notion of the structural effort and the notion of the structural balance; 10) The hypotheses of potential gross domestic product used in planning the public finances. The report presents and justifies any differences from the estimates of the European Commission" – which gives the government good control over the hypothesis for potential growth and makes the parliament sovereign, the final judge.

Does a truth check need to be conducted on potential growth so as to significantly alter this crucial hypothesis in the presentation of the budget? Should a truth process lead to presenting a budget as almost neutral when it reflects crucial, expensive policy choices (to finance business competitiveness by cutting public spending and increasing taxes on households)? Is the Commission's hypothesis more relevant because it has been continuously revised every 6 months for 5 years now? Couldn't it be explained that the French government's ambitious programme of structural reform would help to increase potential growth in the future (unless the government doesn't believe this)? Aren't the CICE and the Responsibility Pact a sufficient pledge of the renewed vitality of a productive system that will lead to boosting potential growth? Would it be better to follow the advice of the authors of a report for the French Council of Economic Analysis (CAE) on potential growth who did not risk producing a new estimate? Isn't it the subject of growth that needs to be discussed (constructively and technically, in discreet fora) with the Commission, rather than engaging in an explicit breach of EU rules? In the 2015 draft budgetary plan, it is written (page 5): "the trajectory is based, out of caution, on a downward revision of potential growth from the previous budgetary plan, by taking the European Commission's latest estimate of potential growth (spring 2014)". What kind of caution is this that looks more like a blunder with terrible consequences? Is it the mess that the government was in at end August 2014 that permitted this state of infinite clumsiness?

It is impossible to justify the presentation made: the Commission will rebuke France, which will not react, since it is sure of its rights (as the government has already stated). The Commission will then ramp up the sanctions, and it is unlikely that the Council will stop this process, especially as the decisions are to be taken by a reverse qualified majority vote. There will be a new round of French-bashing, which will merely show the futility of the process, because France will not deviate from the path it has chosen for its public finances. This will undercut France's persuasiveness and influence at the very time that a 300 billion euro investment plan is being developed, which is sought only by France and Poland (according to rumors), which risks derailing a rare initiative that could get us out of the crisis.

In letting the muffled fury of the technocracy express its dissatisfaction with France, what will come out is the fragility of “European governance”. But this governance relies solely on the denunciation of France and the consequent peer pressure. France could be fined, but neither the Council nor the Commission have any instruments to “force” France to meet Treaty requirements. This is the weakness of “European governance”: it works only if the member states voluntarily adhere to the rules. It is thus governance in name only, but despite this it is the foundation underpinning the path out of the sovereign debt crisis. The European Central Bank intervened in the summer of 2012 because stronger governance of public finance was intended to solve the “free rider” problem. The (numerous) critics of the European Central Bank’s intervention have broadly denounced the hypocrisy of the Treaty, which guarantees nothing since it is based on the voluntary discipline of the member states. Its violation by France and the impotence of the Commission and the Council will be such a demonstration of this weakness that there is concern that the house of cards might collapse.

France could revise its draft budget and add measures that, in the new accounting system and with a lowered estimate of potential, would enable it to fulfil its April 2014 commitment on its structural effort. This scenario is highly unlikely, and that’s a good thing (see the post by Henri Sterdyniak). It’s unlikely, because the almost 2 points of VAT at the full rate required to achieve an effort of 0.8% of GDP (and thus without compensating for the delay in 2014) would not be approved by the French Parliament. And it’s good because this would trigger a recession (or serious slowdown) in France and a completely unacceptable rise in unemployment simply to save face for the Commission and diligently apply European legislation.

It would have been more clever to stick to the hypotheses (and methods) of the 2014 stability program, France’s Haut Conseil would have protested, the Commission would have complained, but Europe’s rules of governance would have been saved. They say that statistics are the most advanced form of lying. Between two lies, it’s best to choose the less stupid.

Doesn’t real estate capital really contribute to inequality?

By Guillaume Allègre and Xavier Timbeau

In a response to *Capital in the twenty-first century*, Odran Bonnet, Pierre-Henri Bono, Guillaume Chapelle and Etienne Wasmer (2014) attempt to show that the book’s conclusions regarding an explosion in wealth inequality are “not plausible”. The authors point out an inconsistency in Thomas Piketty’s thesis: the model of capital accumulation is implicitly a model of the accumulation of productive capital, which is inconsistent with the decision to include real estate capital at its market value in measuring capital. If valued correctly, the ratio of capital to income would have remained stable in France, Britain, the United States and Canada, which contradicts the thesis of Piketty’s work.

In *OFCE Briefing Note*, no.9/2015 (“Does housing wealth contribute to wealth inequality? A tale of two New York”), we respond that the authors minimize the contribution of housing to inequality. In particular, we do not believe that trends in real estate prices have “second order effects (actual distributional effects) that are attenuated”. As is often the case, the disagreement is due in part to a lack of consensus about what kind of inequality actually matters: inequality in wealth? Income? Consumption? The potentially divergent dynamics of these inequalities? The disagreement is also due to the type of model used. The authors use a dynastic model in which property is passed from parents to children and grandchildren. In this model, changes in real estate prices do not have any real effect. This model is not relevant to accounting for inequalities generated by property in a society where people are mobile and have different life projects from their parents.

The housing bubble could fuel the development of inequality. Home ownership in the world's metropoles is more and more becoming a closed club for the wealthy, which partitions young people between those with social, educational or financial capital, who can acquire property, and those who can only rent or move to less prosperous areas, with the consequence of further reducing their access to different types of capital. Would it not be better to build enough for everyone to find housing at a price that is in line with the amenities offered? Isn't it apparent that this latter situation is more egalitarian than the former?

For more on this, see: Allègre, G. and X. Timbeau, 2014 : "*Welcome to Nouillorc* : Le capital-logement ne contribue-t-il vraiment pas aux inégalités?", *Note de l'OFCE,* no. 42 of 25 June 2014.

Unemployment insurance for the euro zone?

By Xavier Timbeau

In the latest publication of France’s Treasury Department, *Lettre Trésor-Eco, no. 132, June 2014* (Ministère des Finances et des Comptes publics and Ministère de l’Économie du Redressement productif et du Numérique), Thomas Lellouch and Arthur Sode develop the operating methods and the merits of a common unemployment insurance for the euro zone. They specify the main steps of how it would be applied, which would ensure neutrality between the Member States. They argue for harmonized employment and labour market policies, leading in the long term to a single contribution rate in the euro zone:

– “Harmonization at the euro zone level of an unemployment insurance component would provide the euro zone a new solidarity instrument capable of giving a social Europe real substance while ensuring greater stability of the zone as a whole…

– This common base could compensate *e.g.* those who are unemployed less than one year (the most cyclical component) at 50% of their past salary, with financing determined on a harmonized base (*e.g.* payroll). It would be supplemented by national compensation in accordance with the preferences of each state, thus ensuring the continuation of the current level of compensation…

– Modulating the contribution rate of each member according to its unemployment level, with regular updates based on past trends, would ensure *ex ante* budget neutrality between the Member States…

– In the longer term, and after the unemployment rates of the various Member States converge, a system marking greater solidarity between the Member States could be considered, with financing through a single contribution rate …”.

New solidarity, but posing three problems …

Unemployment insurance functions as an important automatic stabilizer. Having a common system for the euro zone members would have made possible significant transfers during the crisis we have just been through. Based on the scheme proposed by the authors (pooling the most cyclical component), Spain could have benefited from almost 35 billion euros by end 2012, mainly from Germany and France. This would not be sufficient to cancel Spain’s public deficit, but it would have kept down its level.

A system like this could play a major role in avoiding the sovereign debt crises that dry up a State’s credit. It would introduce solidarity and neutral transfers during cycles, but would be responsive to the state of the cycle.

However, this proposal raises three problems: the first is that unemployment insurance systems are the fruit of a national social compromise that has won general acceptance and is consistent with the rest of the country’s labour market policies, whether these are active policies or not. A European unemployment insurance component built on top of national systems could lead to confusion and to questions about the national balance. This could disrupt the social dialogue, since the social partners would have a potential resource for which they are not responsible, in addition to the issue of whether the European authorities or partner countries might also wish to have a say. Furthermore, unemployment insurance is often a sensitive subject, as was seen by the issue of entertainers and artists (*intermittents*) in France in early summer 2014.

This could be solved by limiting the sharing to macroeconomic transfers, independent of national arrangements. But, and this is the second problem, to ensure that transfers between states do not become permanent, the transfers need to be balanced over the business cycle. This requires a procedure for identification of the cycle that the stakeholders agree on. The recent experiences of the crisis and the calculation of structural deficits show that this is far from the case today. Another option would be to “replenish” the system prior to using it by accumulating contributions over a number of years before a major downturn. It would suffice to limit use to what has been accumulated to resolve discrepancies. But then the system would be bereft of value in the face of a systemic crisis. The day the buffer collapses, the Kings would be as naked as before. At best the crisis is delayed, at worst it is aggravated.

A final option would be to give up balancing the transfers *a priori* (or by the mechanics of the way it operates), leaving it to polarize gradually one way or another and to ensure an asymptotic convergence. But in this case the system could lead to undesired structural transfers that could very well call it into question.

Spain for instance has high unemployment, well above its structural rate; entering into a transfer system based on the differences between current unemployment and structural unemployment could be done only on an equilibrium basis, or would run the risk of a long-lasting initial transfer.

This then raises the third issue, governance. It is difficult to design such a system without implying, at least potentially, significant transfers between States. How could such transfers be justified without a legitimate common representation? Furthermore, what could be done to avoid these transfers becoming an instrument for control of macroeconomic policy as a whole? The establishment of a banking union is a reminder of how key this problem is. Likewise, Spain’s refusal to submit to the conditions set for a conventional assistance program (EU / IMF) clearly indicates that in the absence of legitimate and sincere solidarity, the beneficiaries of transfers will be as suspicious as the payers.

The critique of capital in the 21st century: in search of the macroeconomic foundations of inequalities

By Guillaume Allègre and Xavier Timbeau

In his book *Capital in the 21st Century*, Thomas Piketty offers a critical analysis of the dynamics of capital accumulation. The book is at the level of its very high ambitions: it addresses a crucial issue, it draws on a very substantial statistical effort that sheds new light on the dynamics of distribution, and it advances public policy proposals. Thomas Piketty combines the approach of the great classical authors (Smith, Ricardo, Marx, Walras) with impressive empirical work that was inaccessible to his illustrious predecessors.

Thomas Piketty shows the mechanisms pushing towards a convergence or divergence in the distribution of wealth and highlights how the strength of divergence is generally underestimated: if the return on capital (r) is higher than economic growth (g), which historically has almost always been the case, then it is almost inevitable that inherited wealth will dominate built-up wealth, and the concentration of capital will reach extremely high levels: “The entrepreneur inevitably tends to become a rentier , more and more dominant over those who own nothing but their labour. Once constituted, capital reproduces itself faster than output increases. The past devours the future."

The book thus seeks the basis for inequality in macroeconomics (r> g), whereas the usual suspects are found at the microeconomic level. In [*OFCE Working document no.* 2014-06 [in French]], we argue that this macro-foundation for inequality is not convincing and that the same facts can be interpreted using a different causality, in which inequality arises from the operation of (imperfect) markets, scarcity rents and the establishment of property rights. It is not r>g that turns entrepreneurs into rentiers, but the establishment of mechanisms that allow the extraction of a perpetual rent that explains the historical constancy of r>g.

This different interpretation of the same phenomena has consequences for public policy. The *ex post* taxation of capital, where necessary, can only be a second-level choice: first the constraints of scarcity have to be removed and the definition of property rights and the rights of owners and non-owners must be defined. Are landlords going to be free to charge any rent they like? Can they limit other construction around their property? How much protection is labour law going to give workers? To what extent can they influence managerial decisions within the company? In our opinion it is the answers to these questions that determine the relationship between economic growth and the return on capital, as well as capital's weight in the economy. The point is to prevent owners of capital from exploiting a favourable balance of power. In this respect, while its shape has changed, capital in the twenty-first century is much like it was in the late nineteenth century. Dealing with it will require more than a tax on capital.

For more information, see: "La critique du capital au XXI^{e} siècle : à la recherche des fondements macroéconomiques des inégalités", ***Document de travail de l'OFCE, n°2014-06***.

The responsibility pact's obligation of a result

By Xavier Timbeau, @XTimbeau, OFCE

The original French text was published in the "Rebonds" section of the newspaper Libération *on 28 February 2014.*

Is the policy supply-side or demand-side? This debate takes us back decades to a time when the advocates of supply-side policy, Ronald Reagan and Margaret Thatcher, wanted to put Keynesian practices into the closet. With respect to the responsibility pact, the debate is moot. There is a clear diagnosis that companies are suffering from such low margin rates that their very survival is threatened. The losses of market share since the 2000s cannot be explained solely by the transition to a post-industrial society. It is thus a priority to boost corporate margins by whatever means necessary. But the restoration of business margins will not be sufficient to put them back on a path of increasing productivity, ensuring their competitiveness in the medium term. Getting back on this path will require numerous reforms, ranging from a better education system to a stable tax system that is as neutral as possible, while making use of the impact of agglomeration and specialization. Coordinating everyone's projects around a comprehensive strategy to make the energy transition is also a powerful instrument. But the responsibility pact remains silent on this.

To be clear, the responsibility pact aims to improve the situation of business, which could partially offset the decline in activity resulting from the 2008 crisis and the

French economy's loss of competitiveness relative to its partners undergoing deflation (including Spain) or due to a rise in the euro. In so far as the pact is financed by taxes or spending cuts, this will constitute a tax depreciation, which will make consumers, employees and those on social benefits pay for the reduction in business costs. When the decrease in the cost of doing business is more focused on lower wages, then we can expect the creation of something like 130,000 jobs in five years, taking into account the financing (see for example the article by Heyer and Plane in the *revue de l'OFCE* no. 126). The counterparties, the support of the trade unions and the MEDEF employer association and the general mobilization around a shared bleak diagnosis, will not lead to the revolution that some expect, but it is part of the solution.

A fiscal devaluation at a time when the countries of southern Europe are flirting with deflation and everyone is chasing after a balanced current account, including by curbing domestic demand, will of course not lead the euro zone out of crisis, but instead keep it in prolonged stagnation. Fiscal devaluation is not the right policy for Europe. But so long as Europe has no path other than mass suicide, then fiscal devaluation is the logical response for France.

130,000 jobs will not be sufficient to reverse the trend in unemployment. In the face of the more than one million additional unemployed since 2008, it is downright derisory. But the responsibility pact could be something other than a fiscal devaluation. The obligation of a result, namely to reduce unemployment, does not leave much choice. For the responsibility pact to be accompanied by a significant reduction in unemployment, the key is not to finance it. The proposal to be made to our partners consists of laxity on our public deficit trajectory in exchange for reforms that everyone would consider structural. Public spending cuts, favourable taxation of business, the prioritization of competitiveness, are all measures that can generate some manoeuvring room.

France has made a commitment to Brussels to reduce its structural deficit by 50 billion euros. If this fiscal effort is made by 2017, almost 1 point of growth will be lopped off every year, and unemployment will virtually not decline at all by 2017. In fact, only the public deficit would be reduced, to 1.2 percent of GDP; this would open up very favourable prospects after 2017, since the public debt will fall without further budgetary cuts and therefore without hindering the decline in unemployment. It’s a comfortable scenario for François Hollande’s successor, assuming there is one, as they can even use the situation to lower taxes for the rich. With a combination of lower taxes, lower unemployment and a declining public debt, it will look like a “magician” has succeeded an “incompetent”.

On the other hand, using the flexibility offered by the 50 billion euros, that is to say, renouncing the 50 billion goal for structural deficit reduction, would yield a very different result. Simulations at the OFCE indicate that unemployment could be cut by nearly 2 points by 2017. Admittedly, the structural deficit would remain unchanged, but the public deficit, what we see, would be on a downward trajectory: in 2017, it would come to just over 2 GDP points (against 4.2 points at end 2013), bringing the public debt into the region of a reduction in the debt-to-GDP ratio. The situation on the eve of the presidential election would be better, and the voting more open.

To develop this manoeuvring room, our partners (and the European Commission) need to be convinced of just how drastic the situation is. The results of the European elections are likely to remind them and make the obligation of a result clear to all.

Reagan had a great ability to look towards fiscal policy for the motor of his supply-side policy. He thus created the myth that lowering taxes on the rich is good for growth, with consequences for inequality that we are still seeing today. Thatcher believed until the end that reducing the public debt was the right policy. This merely prepared the ground for Tony Blair a few years later. This is the way that political cycles are made, based on results. In the same way, we are responsible for the long-term consequences of the choices we make today.

Manic-depressive austerity: let’s talk about it!

By Christophe Blot, Jérôme Creel, and Xavier Timbeau

Following discussions with our colleagues from the European Commission [1], we return to the causes of the prolonged period of recession experienced by the euro zone since 2009. We continue to believe that premature fiscal austerity has been a major political error and that an alternative policy would have been possible. The economists of the European Commission for their part continue to argue that there was no alternative to the strategy they advocated. It is worth examining these conflicting opinions.

In the iAGS 2014 report (as well as in the iAGS 2013 report and in various OFCE publications), we have developed the analysis that the stiff fiscal austerity measures taken since 2010 have prolonged the recession and contributed to the rise in unemployment in the euro zone countries, and are now exposing us to the risk of deflation and increased poverty.

Fiscal austerity, which started in 2010 (mainly in Spain, Greece, Ireland and Portugal, with a fiscal impulse [2] for the euro zone of -0.3 GDP point that year), and then was intensified and generalized in 2011 (a fiscal stimulus of -1.2 GDP point across the euro zone, see table), and then reinforced in 2012 (-1.8 GDP point) and continued in 2013 (-0.9 GDP point), is likely to persist in 2014 (-0.4 GDP point). At the level of the euro zone, since the start of the global financial crisis of 2008, and while taking into account the economic recovery plans of 2008 and 2009, the cumulative fiscal impulse boils down to a restrictive policy of 2.6 GDP points. Because the fiscal multipliers are high, this policy explains in (large) part the prolonged recession in the euro zone.

The fiscal multipliers summarize the impact of fiscal policy on activity [3]. They depend on the nature of fiscal policy (whether it involves tax increases or spending cuts, distinguishing between transfer, operating and investment expenditure), on the accompanying policies (mainly the ability of monetary policy to lower key rates during the austerity treatment), and on the macroeconomic and financial environment (including unemployment, the fiscal policies enacted by trading partners, changes in exchange rates and the state of the financial system). In times of crisis, the fiscal multipliers are much higher, *i.e.* at least 1.5 for the multiplier of transfer spending, compared with near 0 in the long-term during normal times The reason is relatively simple: in times of crisis, the paralysis of the banking sector and its inability to provide the credit economic agents need to cope with the decline in their revenues or the deterioration in their balance sheets requires the latter to respect their budget constraints, which are no longer intertemporal but instantaneous. The impossibility of generalizing negative nominal interest rates (the well-known “zero lower bound”) prevents central banks from stimulating the economy by further cuts in interest rates, which increases the multiplier effect during a period of austerity.

Table. Fiscal impulses in the euro area

In GDP points

	2010	2011	2012	2013	2014
DEU	1,3	-1,1	-1,2	0,2	0,1
FRA	-0,5	-1,8	-1,2	-1,4	-0,7
ITA	-0,7	-0,4	-3,0	-1,5	-0,6
ESP	-1,4	-1,3	-3,4	-1,6	-1,0
NLD	-1,1	-0,5	-1,4	-1,5	-1,0
BEL	-0,1	0,1	-0,6	-1,0	-0,5
IRL	-4,2	-1,5	-2,0	-1,7	-1,7
PRT	-0,3	-3,7	-3,9	-1,5	-1,5
GRC	-7,6	-5,5	-3,9	-3,3	-1,7
AUT	0,5	-1,4	-0,3	-0,9	-0,4
FIN	1,3	-0,7	-0,3	-1,4	-0,3
EA (11)	-0,3	-1,2	-1,8	-0,9	-0,4

Sources: Eurostat, National accounts.

If the fiscal multipliers are higher in times of crisis, then a rational reduction in the public debt implies the postponement of restrictive fiscal policies. We must first get out of the situation that is causing the increase in the multiplier, and once we are back into a "normal" situation then reduce the public debt through tighter fiscal policy. This is especially important as the reduction in activity induced by tightening fiscal policy may outweigh the fiscal effort. For a multiplier higher than 2, the budget deficit and public debt, instead of falling, could continue to grow, despite austerity. The case of Greece is instructive in this respect: despite *real* tax hikes and *real* spending cuts, and despite a partial restructuring of its public debt, the Greek government is facing a public debt that is not decreasing at the pace of the budgetary efforts – far from it. The "fault" lies in the steep fall in GDP. The debate on the value of the multiplier is old but took on new life at the beginning of the crisis.[4] It received a lot of publicity at the end of 2012 and in early 2013, when the IMF (through the voice of O. Blanchard and D. Leigh) challenged the European Commission and demonstrated that these two institutions had, since 2008, systematically underestimated the impact of austerity on the euro zone countries. The European Commission recommended remedies that failed to work and then with each setback called for strengthening them. This is why the fiscal policies pursued in the euro zone reflected a considerable error of judgment and are the main cause of the prolonged recession we are experiencing. The magnitude of this error can be estimated at almost 3 percentage points of GDP for 2013 (or almost 3 points of unemployment): If austerity had been postponed until more favourable times, we would have reached the same ratio of debt-to-GDP by the deadline imposed by treaty (in 2032), but with the benefit of additional economic activity. The cost of austerity since 2011 is thus almost 500 billion euros (the total of what was lost in 2011, 2012 and 2013). The nearly 3 additional points of unemployment in the euro zone are now exposing us to the risk of deflation, which will be very difficult to avoid.

Although the European Commission follows these debates on the value of the multiplier, it (and to some extent the IMF) developed another analysis to justify its choice of economic policy in the euro zone. This analysis holds that the fiscal multipliers are *negative* in times of crisis *for the euro zone*, and for the euro zone alone. Based on this analysis, austerity should *reduce* unemployment. To arrive at what seems to be a paradox, we must accept a particular counterfactual (what would have happened if we had not implemented austerity policies). For example, in the case of Spain, without an immediate fiscal effort, the financial markets would have threatened to stop lending to finance the Spanish public debt. The rise in interest rates charged by the financial markets to Spain would have pushed its government into brutal fiscal restraint, the banking sector would not have survived the collapse of the value of Spain’s sovereign notes, and the increased cost of credit due to the fragmentation of the financial markets in Europe would have led to a crisis that spiralled way beyond what the country actually experienced. In this analytical model, the austerity recommended is not the result of dogmatic blindness but an acknowledgement of a lack of choice. There was no other solution, and in any case, delaying austerity was not a credible option.

Accepting the European Commission's counterfactual amounts to accepting the idea that the fiscal multipliers are negative. It also means accepting the notion that finance dominates the economy, or at least that judgments on the sustainability of the public debt must be entrusted to the financial markets. According to this counterfactual, quick straightforward austerity would regain the confidence of the markets and would therefore avoid a deep depression. Compared to a situation of postponed austerity, the recession induced by the early straightforward budget cuts should lead to less unemployment and more activity. This counterfactual thesis was raised against us in a seminar held to discuss the iAGS 2014 report organized by the European Commission (DGECFIN) on 23 January 2014. Simulations presented on this occasion illustrated these remarks and concluded that the austerity policy pursued had been beneficial for the euro zone, thereby justifying the policy *a posteriori*. The efforts undertaken put an end to the sovereign debt crisis in the euro zone, a prerequisite for hoping one day to get out of the depression that began in 2008.

In the iAGS 2014 report, publically released in November 2013, we responded (in advance) to this objection based on a very different analysis: massive austerity did not lead to an end to the recession, contrary to what had been anticipated by the European Commission following its various forecasting exercises. The announcement of austerity measures in 2009, their implementation in 2010 and their reinforcement in 2011 never convinced the financial markets and failed to prevent Spain and Italy from having to face higher and higher sovereign rates. Greece, which went through an unprecedented fiscal tightening, plunged its economy into a deeper depression than the Great Depression, without reassuring anyone. Like the rest of the informed observers, the financial market understood clearly that this drastic remedy would wind up killing the patient *before* any cure. The continuation of high government deficits is due largely to a collapse in activity. Faced with debt that was out of control, the financial markets panicked and raised interest charges, further contributing to the collapse.

The solution is not to advocate more austerity, but to break the link between the deterioration in the fiscal situation and the rise in sovereign interest rates. Savers need to be reassured that there will be no default and that the state is credible for the repayment of its debt. If that means deferring repayment of the debt until later, and if it is credible for the State to postpone, then postponement is the best option.

Crucial to ensuring this credibility were the intervention of the European Central Bank during the summer of 2012, the initiation of the project for a banking union, and the announcement of unlimited intervention by the ECB through Outright Monetary Transactions (Creel and Timbeau (2012), which are conditional upon a programme of fiscal stabilization. These elements convinced the markets almost immediately, despite some institutional uncertainty (particularly concerning the banking union and the state of Spain's banks, and the judgment of Germany's Constitutional Court on the European arrangements), and even though OMT is an option that has never been implemented (in particular, what is meant by a programme to stabilize the public finances conditioning ECB intervention). Furthermore, in 2013 the European Commission negotiated a postponement of fiscal adjustment with certain Member States (Cochard and Schweisguth (2013). This first tentative step towards the solutions proposed in the two IAGS reports gained the approval of the financial markets in the form of a relaxation of sovereign spreads in the euro zone.

Contrary to our analysis, the counterfactual envisaged by the European Commission, which denies the possibility of an alternative, assumes an unchanged institutional framework [5]. Why pretend that the macroeconomic strategy should be strictly conditioned on institutional constraints? If institutional compromises are needed in order to improve the orientation of economic policies and ultimately to achieve a better result in terms of employment and growth, then this strategy must be followed. Since the Commission does not question the rules of the game in political terms, it can only submit to the imperatives of austerity. This form of apolitical stubbornness was an error, and in the absence of the ECB's "political" step, the Commission was leading us into an impasse. The implicit pooling of the public debt embodied in the ECB's commitment to take all the measures necessary to support the euro (the "Draghi put") changed the relationship between the public debt and sovereign interest rates for every country in the euro zone. It is always possible to say that the ECB would never have made this commitment if the countries had not undertaken their forced march towards consolidation. But such an argument does not preclude discussing the price to be paid in order to achieve the institutional compromise. The fiscal multipliers are clearly (and strongly) positive, and it would have been good policy to defer austerity. There was an alternative, and the policy pursued was a mistake. It is perhaps the magnitude of this error that makes it difficult to recognize.

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[1] We would like to thank Marco Buti for his invitation to present the iAGS 2014 report and for his suggestions, and also Emmanuelle Maincent, Alessandro Turrini and Jan in't Veld for their comments.

[2] The fiscal impulse measures the restrictive or expansionary orientation of fiscal policy. It is calculated as the change in the primary structural balance.

[3] For example, for a multiplier of 1.5, tightening the budget by 1 billion euros would reduce activity by 1.5 billion euros.

[4] See Heyer (2012) for a recent review of the literature.

[5] The institutional framework is here understood broadly. It refers not only to the institutions in charge of economic policy decisions but also to the rules adopted by these institutions. The OMT is an example of a rule change adopted by an institution. Strengthening the fiscal rules is another element of a changing institutional framework.

Important change of course at the Elysée Palace. Austerity is no longer the priority

By Xavier Timbeau, Twitter: @XTimbeau

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When he was elected François Hollande made fiscal discipline his main goal. The 2008 crisis was continuing to have an impact on the developed economies; in the face of a sovereign debt crisis, Europe’s governments had been implementing austerity measures that were to cause a second recession, a “double dip”, to use the language of economists. For example, when François Hollande came to power, the situation in France seemed disastrous: the public deficit was 5.2%, with a rise in the public debt of more than 600 billion euros since 2008 along with a 2-point rise in unemployment (to 9.6% of the workforce). The pressure was intense, and, the euro zone states were falling like dominos, with Spain and Italy in danger of following Greece, Portugal and Ireland. In this context, it seemed that only budgetary discipline could help Germany to support a faltering euro zone.

Yet the worst was still to come. By underestimating the magnitude of the fiscal multipliers (the impact of fiscal policy on activity), as was eventually recognized by the International Monetary Fund (IMF) and the European Commission, and as we had pointed out in July 2012, the consequences of generalizing this unprecedented fiscal effort throughout the European Union were dismissed.

What Francois Hollande had presumed would be a painful recovery preceding a rebound that would open up new possibilities proved instead to be a period of economic stagnation, where rising unemployment went in hand with bad fiscal news. When the fiscal multiplier is high, nothing works. The budget efforts were weighing down economic activity, and there was no real re-absorption of the government deficits. If this infamous multiplier had been low, François Hollande’s strategy – and that of the euro zone as a whole – would have worked. But the multiplier is not at our beck and call; it was the result of an economic situation in which the balance sheets of agents were degraded, with the banks suffocating and expectations dire.

The second part of François Hollande’s five-year term, which the press conference of 14 January 2014 was to launch, is now much more complicated than expected. Instead of a recovery in public finances, the debt has barely been stabilized despite an incredible effort. Instead of a strong recovery, what we have is, in the understated language of the INSEE, a “sluggish recovery”, which really amounts to continuing recession, with unemployment rising relentlessly. Our businesses are anaemic, and to try to restore their margins, the tax credit for competitiveness and employment (the “CICE”), inspired by the

Gallois report, has not really injected new blood.

To lower the cost of labour without increasing the deficit, households, though exhausted, have to be hit again. The fiscal multiplier is still high, and growth, along with a reversal in the trend in unemployment, is being postponed. Worse, the commitment to Brussels to reduce the public deficit (a structural effort of 0.8 GDP point by the end of the five-years, *i.e.* 50 billion euros in total) will postpone a reduction in unemployment until after 2017. The patient may well die from the cure, and at best it will be Hollande's successor in the 2017 elections, which he's lost in advance, who might hope to reap the benefits of a policy that prioritized deficit reduction at the worst possible time.

The responsibility pact now proposed by François Hollande is setting out a different path, a different choice. Instead of austerity, a reduction in the cost of labour is to be financed not by taxes but by fiscal spending (amounting to 1 GDP point). The bet is that the growth stimulated will bring in additional revenue to meet the commitments on the public deficit. A reduction in social charges of thirty billion euros was announced, replacing the current CICE (20 billion). This means an additional 10 billion euros that can be obtained by companies that are to engage in collective bargaining under the watchful eye of a bipartisan watchdog. While this does not simplify the complex CICE, it will promote social dialogue.

On the other hand, François Hollande confirmed that the target for cutting public expenditure remains, *i.e.* 16 billion euros in 2015 and 18 billion in 2016 and 2017, for a total of 50 billion, with no increase on previous announcements. The CICE was partially funded by an increase in VAT (6 billion euros from 2014) and environmental taxes (4 billion). Replacing the CICE with cuts in social charges gives room for finesse: if companies benefit from the lower labour costs to boost their profits, then taxes on these profits will reduce the bill for the state by 10 billion euros (one-third of 30 billion). If, however, they increase employment and wages or lower their prices or invest, then there will be an increase in activity and the financing will come through growth.

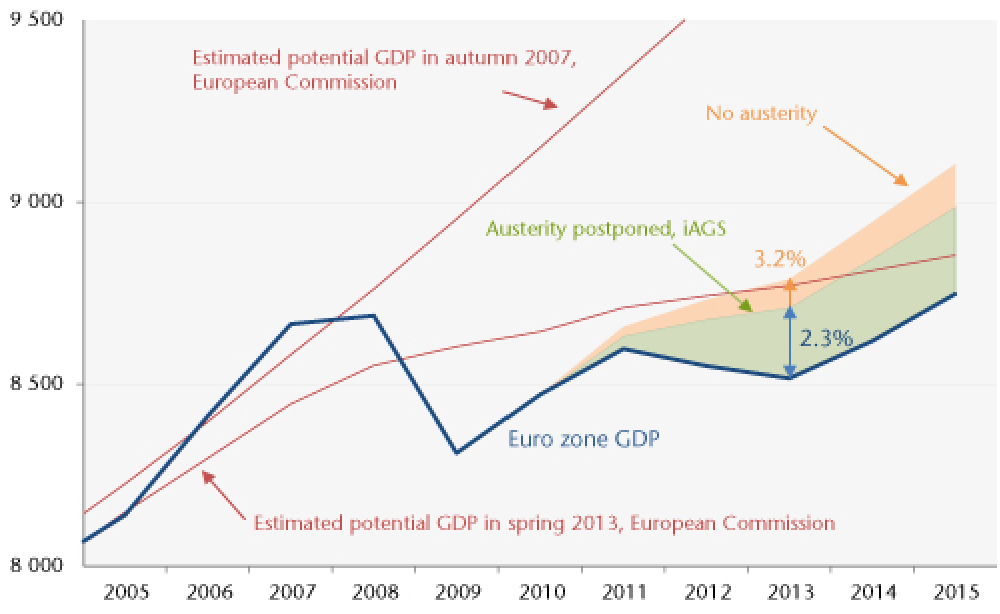
Compared with France's budget commitments to Brussels (an 0.8 point reduction in the structural deficit every year), there will be a 20 billion euro fiscal stimulus based on lowering labour costs by 2017. This GDP point could lead to the creation of 250,000 jobs by 2017 and allow a one-point drop in unemployment. This is a substantial change of course from the priority given up to now to deficit reduction. A choice has been made to focus on business and push companies to create new activity or jobs through a pact. This is a significant step, but there is still more to be done to put an end to austerity, to repair the social damage done and to take radical action to reduce unemployment.

From austerity to stagnation

By Xavier Timbeau

Since 2010, the European Commission has published the Annual Growth Survey to stimulate discussion on the occasion of the European semester, during which the governments and parliaments of the Member States, the Commission, and civil society discuss and develop the economic strategies of the various European countries. We considered it important to participate in this debate by publishing simultaneously with the Commission an independent Annual Growth Survey (iAGS), in collaboration with the IMK, a German institute, and the ECLM, a Danish institute. In the 2014 iAGS, for instance, we estimate the cost of the austerity measures enacted since 2011. This austerity policy, which was implemented while the fiscal multipliers were very high and on a scale unprecedented since the Second World War, was followed simultaneously by most euro zone countries. This resulted in lopping 3.2% off euro zone GDP for 2013. An alternative strategy, resulting after 20 years in the same GDP-to-debt ratios (*i.e.* 60% in most countries), would have been possible by not seeking to reduce public deficits in the short term when the multipliers are high. In order to lower the fiscal multipliers again, it's necessary to reduce unemployment, build up agents' balance sheets and get out of the liquidity trap. A more limited but ongoing adjustment strategy, just as fiscally rigorous but more suited to the economic situation, would have led to 2.3 additional points of GDP in 2013, which would have been much better than under the brutal austerity we find ourselves in today. This means there would not have been a recession in 2012 or 2013 for the euro zone as a whole (see the figure below: GDP in million euros).

Impact of austerity on economic activity, 2011-2015



Source: iAGS 2014, Eurostat and European Commission.

It is often argued that the state of euro zone public finances left no choice. In particular, market pressure was so great that certain countries, like Greece for example, were concerned that they would lose access to private financing of their public debt. The amounts involved and the state of the primary deficit are advanced to justify this brutal strategy and convince both the markets and the European partners. However, the sovereign debt crisis, and hence market pressure, ended when the European Central Bank announced that no country would leave the euro and set up an instrument, Outright Monetary Transactions, which makes it possible under certain conditions to buy back public debt securities of euro zone countries and therefore to intervene to counter the distrust of the markets (see an analysis here). From that point on, what matters is the sustainability of the public debt in the medium term rather than demonstrating that in an emergency the populace can be compelled to accept just any old policy. Sustainability does however require an adjustment policy that is ongoing (because the deficits are high) and moderate (because fiscal policy has a major impact on activity). By choosing the difficult path of austerity, we paid a high price for the institutional incoherence of the euro zone, which was exposed by the crisis. In the 2014 iAGS, we point out costs due to austerity that go beyond the loss of activity. On the one hand, inequality is increasing, and "anchored poverty", *i.e.* as measured from the median incomes of 2008, is increasing dramatically in most countries affected by the recession. The high level of unemployment is leading to wage deflation in some countries (Spain, Portugal and Greece). This wage deflation will result in gains in cost competitiveness but, in return, will lead the countries' partners to also take the path of wage deflation or fiscal devaluation. Ultimately, the adjustment of effective exchange rates either will not take place or will occur at such a slow pace that the effects of deflation will wind up dominant, especially as the appreciation of the euro will ruin the hopes of boosting competitiveness relative to the rest of the world. The main effect of wage deflation will be a greater real burden (*i.e.* relative to income) of private and public debt. This will mean a return to centre stage of massive public and private defaults, as well as the risk of the euro zone's collapse. It is possible nevertheless to escape the trap of deflation. Possible methods are explored and calculated in the 2014 iAGS. By reducing sovereign spreads, the countries in crisis can be given significant maneuvering room. The levers for this include the continuation of the ECB’s efforts, but also a credible commitment by the Member states to stabilizing their public finances. Public investment has been cut by more than 2 points of potential GDP since 2007. Re-investing in the future is a necessity, especially as infrastructure that is not maintained and is allowed to collapse will be extremely expensive to rebuild. But it is also a way to stimulate activity without compromising fiscal discipline, since the latter must be assessed by trends not in the gross debt but in the net debt. Finally, the minimum wage should be used as an instrument of coordination. Our simulations show that there is a way to curb deflationary trends and reduce current account imbalances if surplus countries would increase their minimum wage faster in real terms than their productivity while deficit countries would increase their minimum wage slower than their productivity. Such a rule, which would respect both national practices in wage bargaining as well as productivity levels and the specific features of labour markets, would lead to gradually reducing macroeconomic imbalances in the euro zone.