The strange forecasts of the European Commission for 2014

By Mathieu Plane

The figures for French growth for 2014 published by the European Commission (EC) in its last report in May 2013 appear to reflect a relative consensus. Indeed, the Commission expects GDP to grow by 1.1% in 2014, which is relatively close to the forecasts by the OECD (1.3%) and the IMF (0.9%) (Table 1). However, these forecasts of broadly similar growth hide some substantial differences. First, in defining future fiscal policy, the Commission, unlike the other institutions, considers only the measures already approved. While the Commission's growth forecasts for 2013 included the measures enacted by the Finance Act for 2013 (and therefore the austerity measures), the forecasts for 2014 do not include any forthcoming fiscal measure, even though according to the stability programme submitted to Brussels in April 2013 the government plans austerity measures amounting to 20 billion euros in 2014 (a fiscal impulse of -1 GDP point). The exercise carried out by the Commission for 2014 is thus closer to an economic framework than an actual forecast, as it fails to include the most likely fiscal policy for the year. As a result, the French government has no reason to rely on the Commission's growth forecast for 2014 as it makes radically different assumptions about fiscal policy. But beyond this difference, there is also a problem with the overall coherence of the economic framework set out by the Commission for 2014. It is indeed difficult to understand how for 2014 the Commission can forecast an increase in the unemployment rate with a significantly worsened output gap and a positive fiscal impulse.

Overall, all the institutions share the idea that the output gap in France is currently very wide, lying somewhere between

-3.4 percent of GDP (for the EC) and -4.3 percent (for the OECD) in 2013 (Table 1). Everyone thus believes that current GDP is very far from its long-term trajectory, and this deficit in activity should therefore lead, in the absence of an external shock or a constraint on fiscal and monetary policy, to a spontaneous catch-up in growth in the coming years. This should result in a growth rate that is higher than the potential, regardless of the latter's value. So logically, if there is a neutral or positive fiscal stimulus, GDP growth should therefore be much greater than the trend potential. For the IMF, the negative fiscal impulse (-0.2 percent of GDP) is more than offset by the spontaneous catch-up of the economy, resulting in a slight closing of the output gap (0.2) in 2014. For the OECD, the strongly negative fiscal impulse (-0.7 percent of GDP) does not allow closure of the output gap, which continues to widen (-0.3), but less than the negative impact of the impulse due to the spontaneous process of catching up. In both these cases (OECD and IMF), the restrictive fiscal policy holds back growth but leads to an improvement in the public accounts in 2014 (0.5 percent of GDP for the OECD and 0.3 for the IMF).

As for the Commission, its budget forecasts include a positive fiscal impulse for France in 2014 (+0.4 GDP point). As we saw above, the Commission takes into account only the fiscal measures already approved that affect 2014. However, for 2014, if no new fiscal measures are taken, the tax burden should spontaneously decrease due to the fall between 2013 and 2014 in the yield of certain tax measures or the partial financing of other measures (such as the CICE Tax credit for competitiveness and jobs). This could of course result in a positive fiscal impulse in 2014. But despite this impact, which is similar to a stimulus policy (on a small scale), the closure of the output gap (0.1 percent of GDP) is less than the fiscal impulse. This suggests implicitly that fiscal policy has no effect on activity and especially that there is no spontaneous catch-up possible for the French economy despite the very large output gap. But it is not clear why this is the case. Suddenly, the government balance deteriorates in 2014 (-0.3 percent of GDP) and the unemployment rate rises by 0.3 percentage points (which may seem paradoxical with an output gap that doesn't worsen). The French economy is thus losing on all fronts according to the major macroeconomic indicators.

In view of the potential growth, the output gaps and the fiscal impulses adopted by the Commission (the OECD and the IMF), and based on incorporating relatively standard assumptions (a short-term fiscal multiplier equal to 1 and spontaneous closure of the output gap in 5 years), one would have expected the Commission to go for growth in France in 2014 of 2.1% (1.7% for the OECD and 1.2% for the IMF), and thus a steep reduction in unemployment.

Paradoxically, we do not find this same logic in the Commission's forecasts for Germany and the euro zone as a whole (Table 2). In the case of Germany, despite a slight deterioration in the output gap in 2013 (-1 GDP point), which would normally point to some spontaneous catch-up by the German economy in 2014, and an almost neutral fiscal impulse (0.1 GDP point), Germany's growth in 2014 is expected to be 1.8%, thus permitting the output gap to close by 0.5 GDP point, resulting in a fall in the unemployment rate and a reduction in Germany's public deficit in 2014.

In the case of the euro zone, we find the same scenario: a marginally positive fiscal impulse (0.2 percent of GDP) and a rapid reduction in the output gap (0.7 percent of GDP), which translates both into an improvement in the public accounts despite the positive fiscal impulse and a fall in the unemployment rate (even if we would have expected a greater reduction in the latter in light of the improvement in the output gap).

Given the potential growth, the output gaps and the fiscal impulses adopted for each country by the Commission, the forecast for 2014 could have been for growth of 2.1% in France, 1.6% in Germany and 1.3% for the euro zone.

Finally, why would France, despite a greater output gap than Germany and the euro zone and a stronger positive fiscal impulse, experience an increase in its unemployment rate in 2014 while the rate falls in the other countries? Should we interpret this as reflecting that it is a problem or even impossible for the Commission to include in a forecast that a policy without fiscal consolidation could lead to growth and reduce unemployment spontaneously in France?