

Trump's budget policy: Mortgaging the future?

By [Christophe Blot](#)

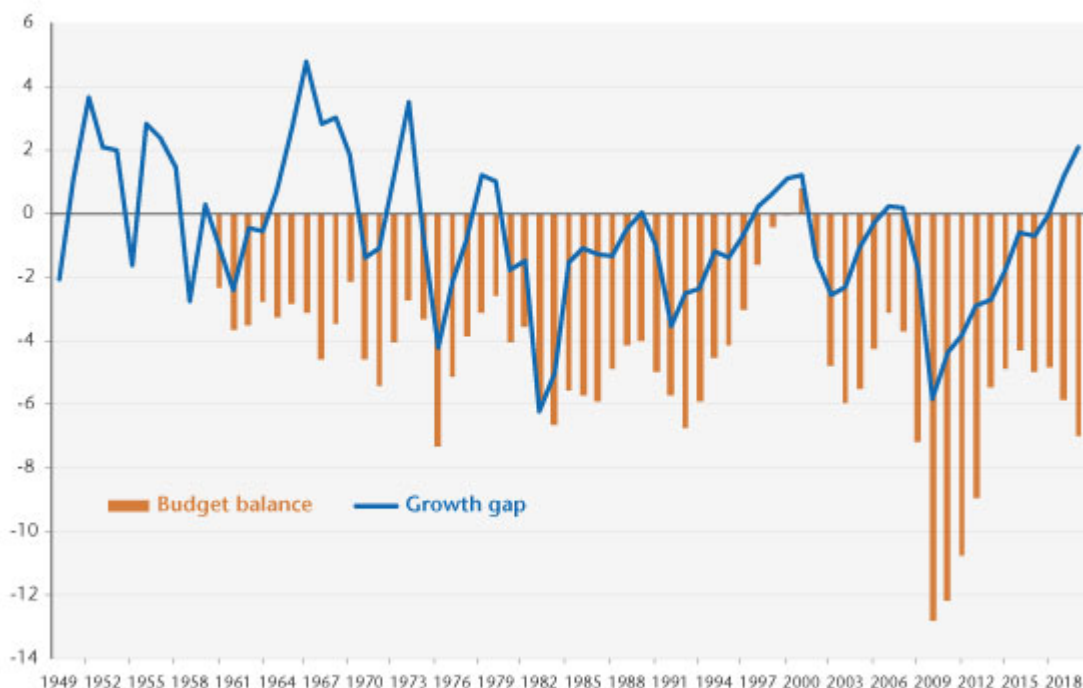
While the momentum for growth has lost steam in [some countries](#) – Germany, France and Japan in particular – GDP in the United States is continuing to rise at a steady pace. Growth could even pick up pace in the course of the year as a highly expansionary fiscal policy is implemented. In 2018 and 2019, the fiscal stimulus approved by the Trump administration – in December 2017 for the revenue component, and in February 2018 for the expenditure side – would amount to 2.9 GDP points. This level of fiscal impulse would come close to that implemented by Obama for 2008. However, Trump's choice has been made in a very different context, since the unemployment rate in the United States fell back below the 4% mark in April 2018, whereas it was accelerating 10 years ago, peaking at 9.9% in 2009. The US economy should benefit from the stimulus, but at the cost of accumulating additional debt.

Donald Trump had made fiscal shock one of the central elements of his presidential campaign. Work was begun in this direction at the beginning of his mandate, and came to fruition in December 2017 with the passing of a major tax reform, the Tax Cuts and Jobs Act [\[1\]](#), which provided for a reduction in household income tax – in particular by reducing the maximum marginal income tax rate – and corporation tax, whose effective rate would fall from 21% to 9% by 2018 [\[2\]](#). In addition to this initial stimulus, expenditure will also rise in accordance with the agreement reached with the Democrats in February 2018, which should lead to [raising federal spending](#) by USD 320 billion (1.7 GDP points) over two years. These choices will push up domestic demand through boosting household disposable income and corporate profitability, which should stimulate consumption and investment. The multiplier

effect – which measures the impact on GDP of a one dollar increase in public spending or a one dollar cut in taxes – will nevertheless be relatively small (0.5) because of the US position in the cycle.

Moreover, the public deficit will expand sharply, to reach a historically high level outside a period of crisis or war (graph). It will come to 5.8% of GDP in 2018 and 7.0% in 2019, while the growth gap will become positive [3]. While the risk of overheating seems limited in the short term, the fact remains that the fiscal strategy being implemented could push the Federal Reserve to tighten monetary policy more quickly. However, an excessive rise in interest rates in a context of high public debt would provoke a snowball effect. Above all, by choosing to re-launch the economy in a favourable environment, the government risks being forced to make adjustments later when the economic situation deteriorates. This pro-cyclical stance in fiscal policy risks amplifying the cycle by accelerating growth today while taking the risk of accentuating a future slowdown. With a deficit of 7% in 2019, fiscal policy's manoeuvring room will actually shrink.

Figure. A pro-cyclical budget policy



Sources: CBO and NIPA, OFCE April 2018 forecasts.

[1] See the section on Budget policy: Crisis-free acceleration [“Politiques budgétaires : accélération sans crise”] in our [April 2017 forecast](#) for greater detail.

[2] See [here](#) for more on this.

[3] The growth gap expresses – as a % of potential GDP – the difference between observed GDP and potential GDP. Recall that potential GDP is not observed but estimated. The method of calculation used by the Congressional Budget Office (CBO) is explained [here](#).

The end of a cycle?

OFCE Analysis and Forecasting Department

This text is based on the 2018-2019 outlook for the world economy and the euro zone, a full version of which is available [here](#) [in French].

Global growth remained buoyant in 2017, allowing both the recovery and the reduction in unemployment to continue, especially in the advanced countries where growth rose to 2.3%, up from 1.6% the previous year. Although there are still a few countries where GDP has not recovered to its pre-crisis level, this improvement will gradually erase the stigma of the Great Recession that hit the economy 10 years ago. Above all, activity seemed to be gathering pace at the end of the year as, with the exception of the United Kingdom, annual GDP growth continued to pick up pace (Figure 1). However, the gradual return of the unemployment rate to its pre-crisis

level and the closing of growth differentials, particularly in the United States and Germany, which had widened during the crisis, could foreshadow a coming collapse of growth. The first available estimates of growth in the first quarter of 2018 seem to lend credence to this assumption.

After a period of improvement, euro zone growth stalled in the first quarter of 2018, falling from 2.8% year-on-year in the fourth quarter of 2017 to 2.5%. While the slowdown has been more significant in Germany and France, it can also be seen in Italy, the Netherlands and, to a lesser extent, Spain (Figure 2). As for the United Kingdom, the slowdown is continuing as the prospect of Brexit draws nearer, while the country's budgetary policy is also more restrictive than in the other European countries. Japan is experiencing rather more than a slowdown, with quarterly GDP growth even falling in the first quarter. Finally, among the main advanced economic countries, growth is still gathering steam only in the United States, where GDP rose 2.9% year-on-year in the first quarter of 2018.

Does the slowdown testify to the end of the growth cycle? Indeed, the gradual closing of the gaps between potential GDP and actual GDP would steadily lead countries towards their long-term growth paths, with estimates converging at what is indicated to be a lower level. In this respect, Germany and the United States would be representative of this situation since the unemployment rate in the two countries is below its pre-crisis level. In these conditions, their growth would be slowed. It is clear that this has not been the case in the United States. We must therefore refrain from any generalized conclusion. In fact, despite the fall in unemployment, other indicators – the employment rate – provide a more nuanced diagnosis of the improvement in the state of the labour market in the US. Furthermore, in the case of France this performance is mainly the consequence of the fiscal calendar, which caused a decrease in household purchasing power in the first quarter

and therefore a slowdown in consumption [\[1\]](#). This would therefore amount more to an air pocket than the sign of a lasting slowdown in French growth.

Above all, the factors that have supported growth will not generally be reversed. Monetary policy will remain expansionary even if a normalization is already underway in the United States, with the euro zone to start in 2019. On the fiscal side, the focus is more often neutral and should become highly expansionary for the United States, pushing growth above its potential. Finally, there are many uncertainties about estimates of the growth gap, meaning that maneuvering room might not necessarily be exhausted in the short term. An economic recovery is in fact still not being accompanied by a return of inflationary pressures or sharp wage increases, which would then indicate that the labour market is overheating. We anticipate continued growth in the industrialized countries in 2018 and accelerating growth in the emerging countries, bringing global growth to 3.7% in 2018. Growth should then peak, slowing down very slightly in 2019 to 3.5%. In the short term, the growth cycle would not then be over.

Figure 1. Growth in the advanced countries

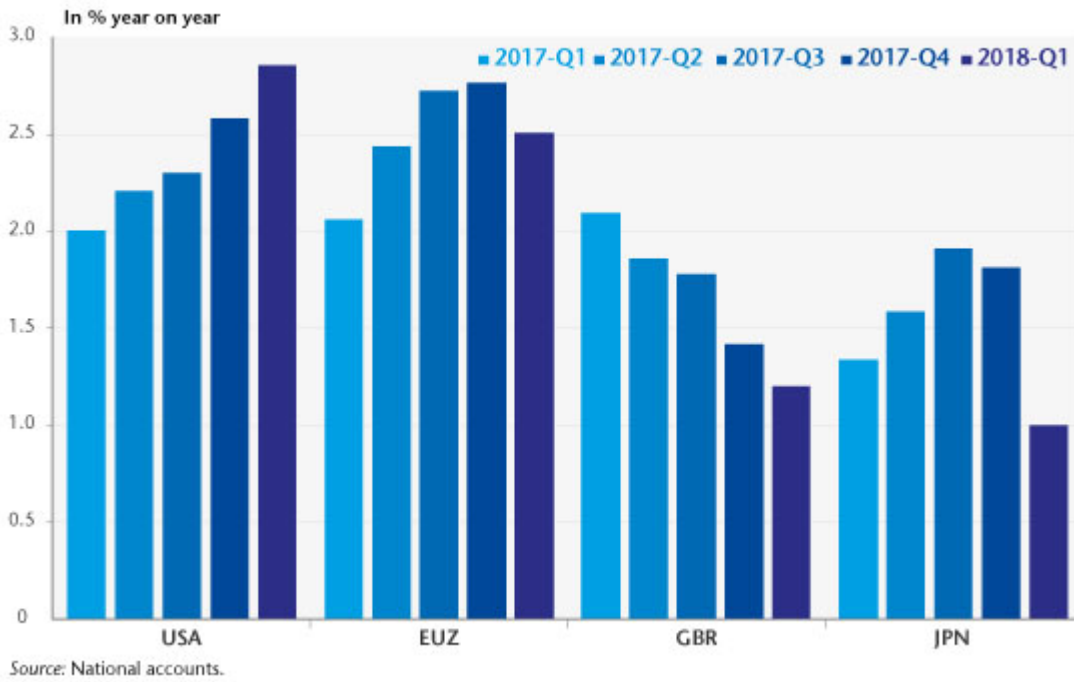
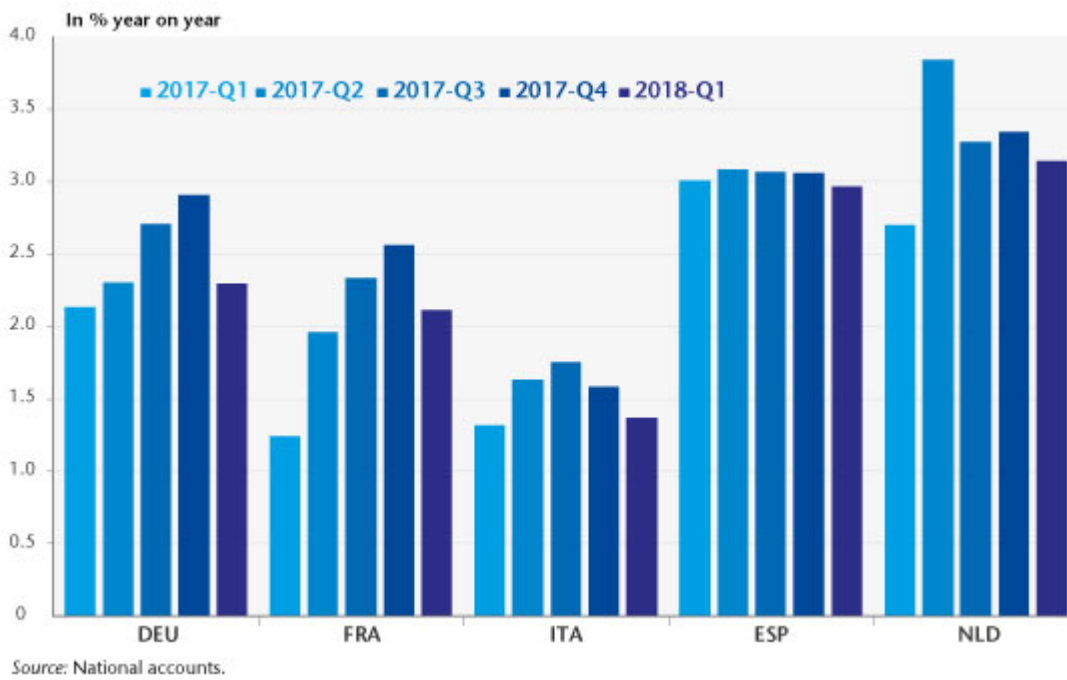


Figure 2. Growth in eurozone



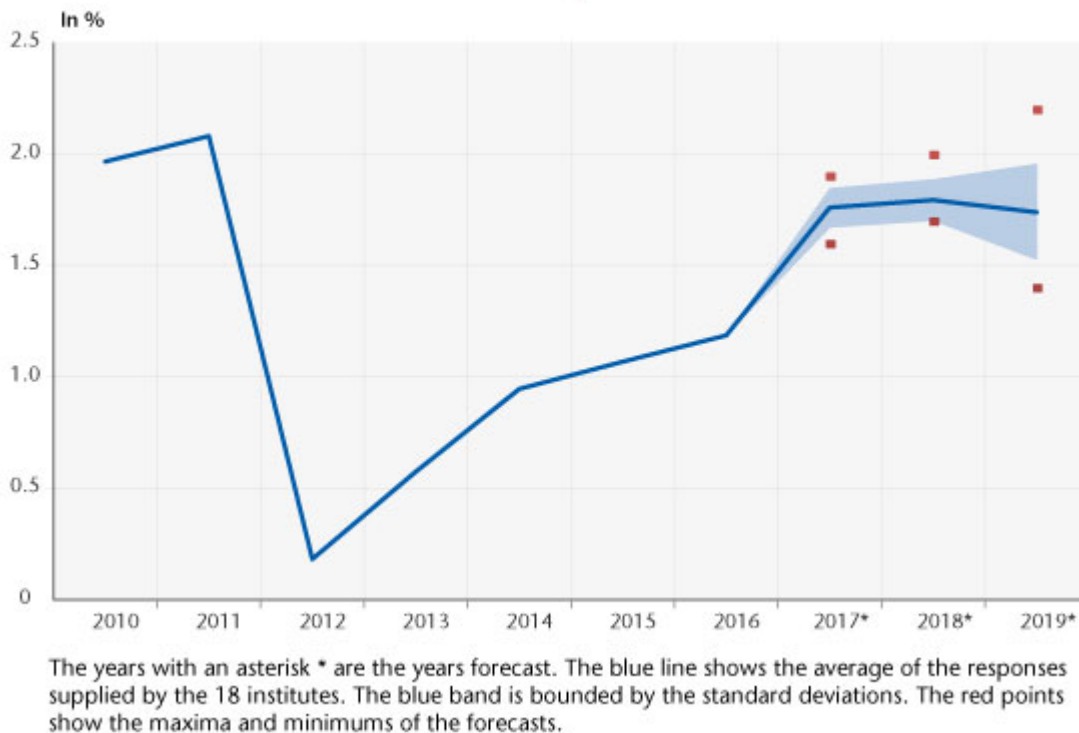
France's growth in 2018-2019: What the forecasters say ...

By [Sabine Le Bayon](#) and [Christine Rifflart](#)

Following the INSEE's publication of the [first version of the accounts for the fourth quarter of 2017](#) and a first estimate of annual growth, we have been considering the outlook for 2018 and 2019 based on a comparative analysis of forecasts made for France by 18 public and private institutes, including the OFCE, between September and December 2017. This post presents the highlights of this analysis, which are given in detail in [OFCE Policy Brief No. 32 of 8 February 2018](#) entitled, "A comparison of macroeconomic forecasts for France" and the associated [working paper \(No. 06-2018\)](#) (which contains the tables of the institutes' forecasts).

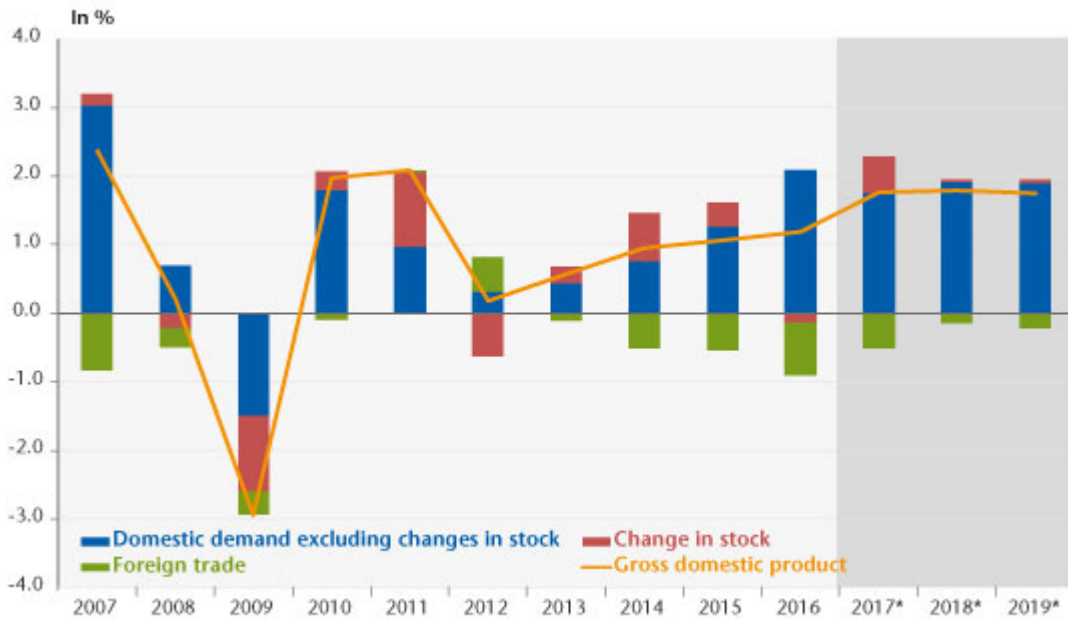
Following the deep recession of 2008-2009 and the euro zone crisis of 2011, the French economy started a slow recovery, which picked up pace in late 2016. The year 2017 was thus a year of recovery, with slightly higher growth than most forecasters had recently expected: 1.9% according to the INSEE's first estimate, compared to an average forecast of 1.8%. This momentum is expected to continue in 2018 and 2019, with the forecasts averaging 1.8% and 1.7%, respectively. The standard deviations are low (0.1 point in 2018 and 0.2 in 2019), and the forecasts are fairly close for 2018 but diverge more sharply in 2019 (ranging from a low of 1.4% to a high of 2.2%) (Figure 1). In 2019, 5 out of 15 institutes expect growth to accelerate while 8 foresee a slowdown.

**Figure 1. GDP growth in the forecasts
(forecasts conducted between September and December 2017)**



Overall, all but four of the institutes anticipate a rebalancing of the drivers of growth over the period, with trade having less of an adverse effect than in the past and domestic demand still buoyant (Figure 2). However, the recovery in foreign trade is under debate in light of the chronic losses in market shares recorded since the beginning of the 2000s. Indeed, it seems that the expected pick-up in exports in 2018 will be due more to a recovery in foreign demand for France's output and to the rundown of the export-oriented stocks accumulated in 2016 and 2017 in certain sectors (in particular transport equipment and aeronautics) than to any recovery in competitiveness. For 2019, there are differences in opinion about the impact of the supply policies implemented since 2013 on French companies' price and non-price competitiveness. Some institutes expect an improvement in export performance and thus a regain of market share by 2019, while others foresee a loss of share due to insufficient investment in high value-added sectors and labour costs that still burden business.

Figure 2. Contributions to GDP growth (in % points)



The years with an asterisk * correspond to the average forecasts of the institutes.

There is also debate over the forecasts for jobs and wages, in particular over the impact of the cutbacks in subsidized jobs, the effect of the policies to lower labour costs in 2019 (transformation of the CICE competitiveness tax credit into lower employer social contributions) and productivity (trend and cycle). On average, the unemployment rate should fall from 9.5% in 2017 to 8.8% in 2019, with forecasts ranging from 8.1% for the most optimistic to 9.2% for the most pessimistic. Some differences in the forecasts on wages can be attributed to differing assessments both of the degree of tension on the labour market and also of the impact on wages of the more decentralized collective bargaining set up in 2017. Wages are expected to rise by 1.8% in 2017 and on average by 1.9% in 2018 and 2% in 2019 (ranging from 1.3% for the lowest forecast to 2.6% for the highest).

In this context, growth will rise much faster than potential growth, which is estimated by most institutes at around 1.25% (some institutes expect an acceleration due to the positive impact of structural reforms and investment, while others foresee lower potential growth). While in 2017, the growth gap – the difference between observed GDP and potential GDP – is

clearly negative (between -2.2 and -0.7 points of potential GDP), this will close by 2019. Most of the institutes (from those that provided us with data or qualitative information) believe the output gap will close (close to 0 or clearly positive) and inflationary pressures could appear. For four institutes, the output gap will be around -0.7 point.

Finally, for all the institutes the budget deficit should fall below the threshold of 3% of GDP by 2017. France will exit the excessive deficit procedure in 2018. But despite the vigorous growth, and in the absence of stricter fiscal consolidation, for most of the institutes the public deficit will remain high over the period.

Italy: The horizon seems to be clearing

By [Céline Antonin](#)

With growth in Italy of 0.4% in the third quarter of 2017 (see **table** below), the country's economy seems to have recovered and is benefiting from the more general recovery in the euro zone as a whole. The improvement in growth is linked to several factors: first, the continued closing of the output gap, which had worsened sharply after a double recession (2008-2009 and 2012-2013). In addition, the expansionary fiscal policy in 2017 (+0.3 fiscal impulse), mainly targeted at businesses, and thriving consumption driven by expanding employment and rising wages explain this good performance. The increase in employment is the result of the reduction in social contributions that began in 2015 as well as the pick-up

in growth in 2016 and 2017.

Despite all this, Italy remains the “sick man” of the euro zone: GDP in volume is still more than 6% below its pre-crisis level, and the recovery is less solid than for its euro zone partners. Furthermore, the public debt, now over 130%, has not yet begun to fall, potential growth remains sluggish (0.4% in 2017), and the banking sector is still fragile, as is evidenced by recent bank recapitalizations, in particular the rescue of the Monte dei Paschi di Siena bank (see below).

In 2018-2019, Italy’s growth, while remaining above potential, should slow down. Indeed, fiscal policy will be neutral and growth will be driven mainly by domestic demand. Unemployment will fall only slowly, as the employment support measures implemented in 2017 wind down and productivity returns to its trend level [\[1\]](#) over the forecasting horizon (see [OFCE, La nouvelle grande modération \[in French\], p. 71](#)). Furthermore, the banking sector will continue its long and difficult restructuring, which will hold back the granting of bank loans.

In the third quarter of 2017, the contribution of domestic demand to growth (consumption and investment) reached 0.8 point, but massive destocking attenuated the impact on growth (-0.6 point). Gross Fixed Capital Formation (GFCF) leapt 3% in the third quarter of 2017, returning to its 2012 level, thanks to a strong increase in the productive sector (machinery, equipment and transport). Private consumption, the other pillar of domestic demand, grew on average by 0.4% per quarter between the first quarter of 2015 and the third quarter of 2017, thanks to falling unemployment and a reduction in precautionary savings. Credit conditions have improved slightly due to the quantitative easing policy pursued by the ECB, even though the channel for the transmission of monetary policy is suffering from the difficulties currently hitting the banking sector.

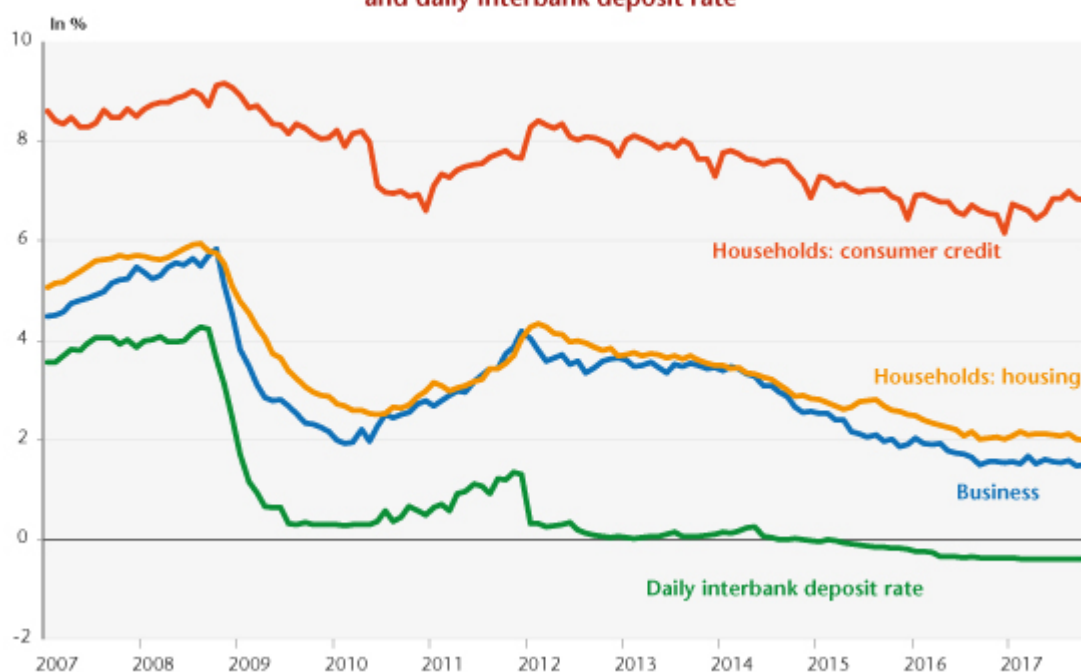
The number of people in employment rose to 23 million in the second quarter of 2017, back to its pre-crisis level, while the unemployment rate is declining only slowly due to the steady increase in the labour force [\[2\]](#). Job creation did indeed take place between 2014 and 2017 (around 700,000 jobs created, 450,000 of them permanent), mainly due to the lowering of charges on new hires in 2015 and 2016 and the resumption of growth. Moreover, according to INPS figures, the number of new hires on permanent contracts decreased (between January-September 2016 and January-September 2017) by -3.1%, as did conversions from temporary contracts to fixed-term contracts (-10.2%), while the numbers of new hires on temporary contracts exploded (+ 27.3%): in other words, it is mainly precarious contracts that are currently contributing to job growth. From 2018, the pace of job creation is expected to decline due to the winding down of the measures cutting employer social contributions (which represented a total of 3 billion euros) and the slowdown in economic growth. This underpins a forecast of a very slow decline in unemployment: employment is expected to rise more slowly in 2018 and 2019, but the labour force is also growing more slowly, due to a bending effect, a distortion linked to the slowdown in job creations and the retirement of the baby boom generation.

The productivity cycle in Italy is still in poor shape, despite the downward revision of the productivity trend (-1.0% for the period 2015-2019). The measures taken to cut social security contributions over the 2015-2016 period will have enriched employment growth by 27,000 jobs per quarter (extrapolating the estimates by [Sestito and Viviano, Bank of Italy](#)). Our hypothesis was for a closure of the productivity cycle over the forecast horizon, with productivity picking up pace in 2018 and 2019 [\[3\]](#).

Moreover, the productive investment rate recovered strongly in the third quarter of 2017: it should continue to rise in 2018 and 2019, thanks in particular to a higher pace of extra-

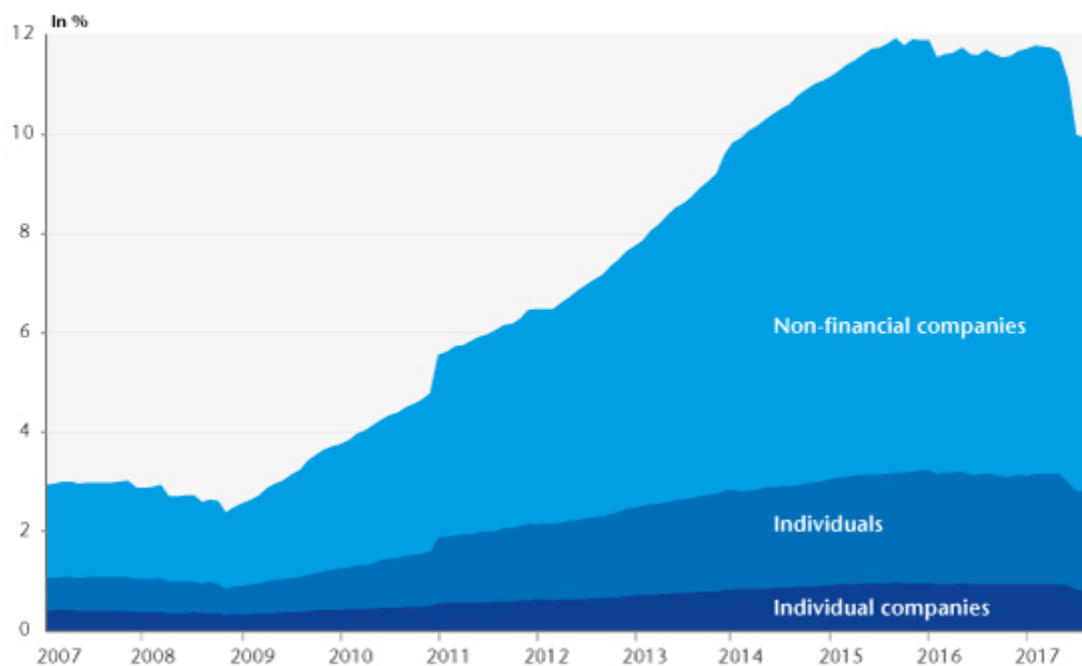
depreciation, to the ECB's quantitative easing programme and to clearing up the situation of the banks, which should allow a better transmission of monetary policy (**Figure 1**). In addition, the amount of bad debt (*sofferenze*) began to fall sharply (down 30 billion euros between January and October, 2 GDP points – **Figure 2**). This is linked to the gradual restructuring of bank balance sheets and the economic recovery in certain sectors, particularly construction, which accounts for 43% of business bad debt.

Figure 1. Interest rates on new loans to households and business and daily interbank deposit rate



Source: Bank of Italy.

Figure 2. Bad debt (*sofferenze*) as a share of GDP



Sources: Istat, Bank of Italy.

In 2017, it was domestic demand that was driving growth; the contribution of foreign trade was zero because of the dynamism of imports and the absence of any improvement in price competitiveness. We anticipate that the contribution of foreign trade will be null in 2018 and slightly positive in 2019 thanks to an improvement in competitiveness (Table).

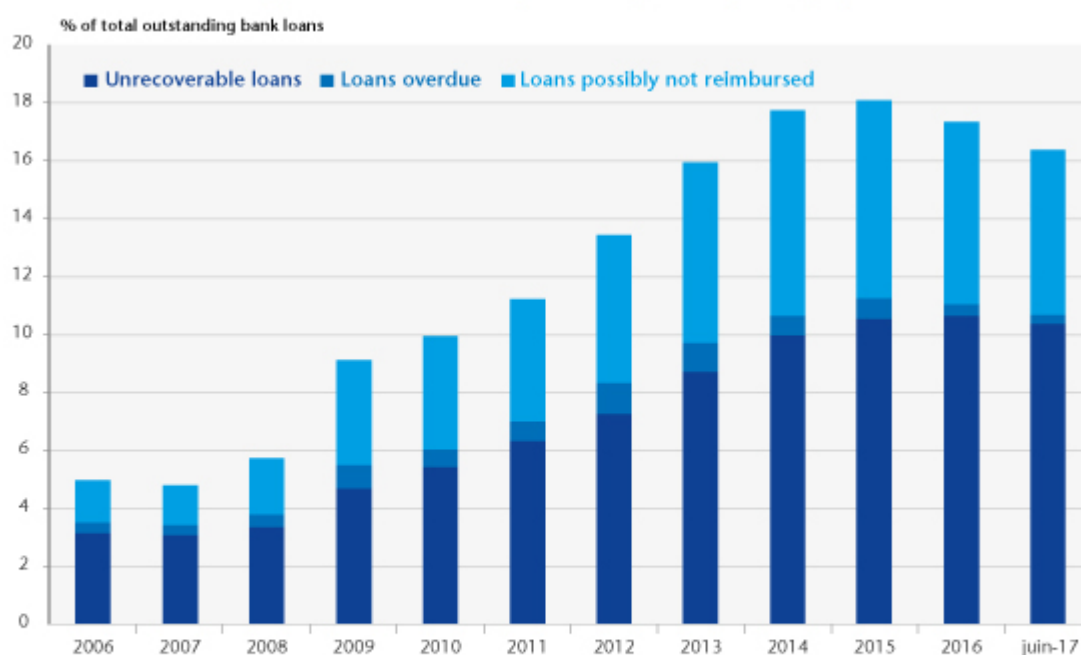
Fiscal policy was expansionary in 2017 (+0.3 point impulse) and supported growth. This has mainly benefited business: support for the world of agriculture, extra-depreciation, the reduction of the corporate tax rate (IRES) from 27.5% to 24% in 2017, a boost in the research tax credit, etc. 2018 should not see a noticeable increase in taxation, and spending is expected to increase slightly (0.3%). The additional public expenditure should reach 3.8 billion euros, for: youth bonuses (youth employment measures), prolongation of extra-depreciation in industry, the renewal of civil service contracts and the fight against poverty. As for public revenue, the government has ruled out a VAT hike that would have brought in 15.7 billion euros; the adjustment will therefore come from a smaller reduction in the deficit and an increase in revenue (5 billion euros forecast). To boost

revenue, the government is counting on the fight against tax evasion (repatriation, recovery of VAT with electronic invoicing), and the establishment of a web tax on large companies on the Net.

A banking sector in full convalescence

The deterioration in the situation of Italy's businesses, in particular small and medium-sized enterprises, has led since 2009 to a sharp increase in non-performing loans. Since 2016, the situation of the Italian banking sector has improved somewhat, with a return on equity of 9.3% in June 2017 against 1.5% in September 2016. The ROE is higher than the European average (7% in June 2017) and puts the country ahead of Germany (3.0%) and France (7.2%). In addition, at the end of June 2017, the ratio of bad debt to total loans came to 16.4% (8.4% net of provisions), of which 10.4% was for unrecoverable loans (**Figure 3**). Banks are shedding these loans at an increasing pace with various partners (Anglo-American hedge funds, doBank, Atlante and Atlante 2 funds, etc.). Hence, between 2013 and 2016, the share of bad loans that were repaid in the year rose from 6 to 9%. Overall, the amount of bad loans was cut by 25 billion euros between 2016 and June 2017, down to 324 billion euros, of which 9 billion euros came from the liquidation of the Venetian banks (Banca Popolare di Vicenza and Veneto banca). This improvement reflects the fact that the banks are increasingly adopting active management policies for bad debts. In addition, the 2015 Asset Seizure Reform reduced the length of property seizure proceedings.

Figure 3. Share of non-performing debt by category



Note: Non-performing loans can be broken down into three mutually exclusive categories:

- Unrecoverable loans, which designates exposure to a debtor who's insolvent;
- Loans possibly not reimbursed, which designates exposure to a debtor who has little chance of reimbursing in full without some action such as the invoking of guarantees;
- Loans with overdue repayments, which designates any exposure where the delay in reimbursement exceeds 90 days.

Sources: Bank of Italy, Financial stability reports.

The Italian government has implemented various reforms to cope with the difficulties facing the country's banking sector. First, it has been working to accelerate the clearance of bad debts and to reform the law on bankruptcy. Legislative Decree 119/2016 introduced the "martial pact" (*patto marciano*), which makes it possible to transfer real estate used as collateral to creditors (other than the debtor's principal residence); the real estate can then be sold by the creditor if the default lasts more than 6 months. Other rules aim at speeding up procedures: the use of digital technologies for hearings of the parties, the establishment of a digital register of ongoing bankruptcy proceedings, the reduction of opposition periods during procedures, an obligation for judges to order provisional payments for amounts not in dispute, the simplification of the transfer of ownership, etc.

In April 2016, the government introduced a public guarantee system (*Garanzia Cartolarizzazione Sofferenze, GCS*) covering bad debts, for a period of 18 months (extendable for another 18 months). To benefit from this guarantee, the bad debt must

be securitized and repurchased by a securitization vehicle; the latter then issues an asset-backed security, the senior tranche of which is guaranteed by the Italian Treasury.

The Atlante investment fund was also set up in April 2016, based on public and private capital, in order to recapitalize troubled Italian banks and redeem bad debt.

There are many lessons to be drawn from the case of the Monte dei Paschi di Siena bank (MPS, the country's fifth-largest bank), which has been a cause of major concern. The Italian State, working in coordination with the European Commission and the ECB, had to intervene as a matter of urgency, following the failure of the private recapitalization plan at the end of 2016. A system of public financial support for banks in difficulty was introduced after a government proposal – “*Salva Risparmio*” [\[4\]](#) of 23 December 2016 – was enacted on 16 February 2017. The precautionary recapitalization of MPS was approved by the Commission on 4 July 2017 [\[5\]](#), in the amount of 8.1 billion euros. The Italian State increased its stake in the bank's capital by 3.9 billion euros on the one hand, and on the other 4.5 billion euros of the bank's subordinated bonds were converted into shares. The State is also to buy 1.5 billion euros of shares resulting from the forced conversion of bonds held by individuals (i.e. a total of 5.4 billion euros injected by the State, giving it a 70% holding in the capital of MPS). MPS will also sell 26.1 billion euros of bad debt to a special securitization vehicle, and the bank will be restructured.

Two other banks, the Venetian banks Banca Popolare di Vicenza and Veneto banca (the 15th and 16th largest banks in the country in terms of capital), were put into liquidation on 25 June 2017, in accordance with a “national” insolvency procedure, which lies outside the framework set by the European BRRD Directive [\[6\]](#). The Intesa Sanpaolo bank was selected to take over, for one symbolic euro, the assets and liabilities of the two banks, with the exception of their bad

debts and their subordinated liabilities. The Italian State will invest 4.8 billion euros in the capital of Intesa Sanpaolo in order to keep its prudential ratios unchanged, and it can grant up to 12 billion euros of public guarantees.

The Italian banking sector is thus in the midst of restructuring, and the process of clearing up bad debt is underway. However, this process will take time; the ECB nevertheless seems to want to tighten the rules. In early October 2017, the ECB unveiled proposals demanding that the banks fully cover the unsecured portion of their bad debt within two years at the latest, with the secured portion of the debt to be covered within at most seven years. These proposals will apply only to new bad debt. The Italian parliament and the Italian government reacted to these announcements by warning of the risk of a credit crisis. Even though these are only proposals, for now, this indicates that it is a priority to clear Italy's bad debt rapidly, and that the government must stay the course.

Table. Italy: Summary of forecasts

Change from the preceding period (%)												
	2017				2018				2016	2017	2018	2019
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4				
GDP	0.5	0.3	0.4	0.3	0.3	0.3	0.2	0.3	1.1	1.5	1.2	0.9
GDP per capita	0.4	0.3	0.3	0.2	0.2	0.2	0.2	0.2	1.0	1.2	0.9	0.7
Household consumption	0.7	0.2	0.3	0.3	0.3	0.3	0.3	0.3	1.5	1.5	1.2	1.0
Public consumption	0.4	0.2	0.1	0.0	0.0	0.0	0.0	0.0	0.5	0.8	0.1	-0.2
Total GFCF, of which:	-2.2	1.1	3.0	0.5	0.4	0.3	0.3	0.4	3.0	3.2	3.0	1.3
Productive	-7.2	3.6	8.2	0.6	0.5	0.4	0.4	0.3	7.1	6.6	6.4	1.3
Housing	0.7	-0.3	0.4	0.2	0.2	0.2	0.2	0.2	2.8	1.8	0.7	0.6
Exports of goods and services	1.8	0.1	1.6	0.6	0.7	0.7	0.7	0.7	2.6	5.1	2.9	2.3
Imports of goods and services	0.7	1.6	1.2	0.6	0.6	0.6	0.6	0.6	3.3	5.4	2.8	2.0
<i>Contributions:</i>												
Domestic demand excl. stock	0.1	0.4	0.7	0.3	0.3	0.2	0.2	0.2	1.5	1.6	1.3	0.8
Change in stock	0.1	0.4	-0.5	0.0	0.0	0.0	0.0	0.0	-0.3	-0.1	-0.2	0.0
Foreign trade	0.3	-0.4	0.1	0.0	0.0	0.0	0.0	0.0	-0.2	0.0	0.1	0.1
Consumer prices (HICP) ¹	1.4	1.6	1.2	1.2	0.8	0.8	0.8	0.9	-0.1	1.0	0.5	1.0
Unemployment rate	11.6	11.2	11.2	11.1	11.0	10.9	10.9	10.8	11.7	11.3	10.9	10.8
Current balance as % of GDP									2.7	2.6	2.6	2.5
Current deficit as % of GDP									-2.5	-2.0	-1.5	-1.2
Public debt as % of GDP									132.8	132.3	131.1	129.9
Fiscal impulse in GDP points									0.3	0.3	0.1	0.1
GDP – euro zone	0.6	0.7	0.6	0.4	0.4	0.4	0.4	0.4	1.8	2.4	1.9	1.6

1. For the quarters, year-on-year. For the years, annual average.

Sources: ISTAT, Author's calculations, OFCE October 2017 forecast.

[1] Estimated according to a model using trend breaks, we estimate the productivity trend at -1.0% for the period 2015-2019, due to growth that is more job-rich.

[2] This increase in the labour force is due to a higher participation rate among older workers (aged 55-64), which is linked to the lowering of the minimum retirement age. It is also due to women's increased participation in the labour market, as a result of the Jobs Act (extension of maternity leave, telecommuting, financial measures to reconcile work and family life, a budget of 100 million euros for the creation of childcare services, etc.).

[3] The increase in productivity per capita in market waged employment rose from -0.7 % in 2017 to 0.3 % in 2018 and 0.6 % in 2019.

[4] The Salva Risparmio Decree Law provides for the creation of a fund with 20 billion euros to support the banking sector. This allows the State to carry out precautionary recapitalizations of banks; it provides guarantees on new issues of bank debt; and it provides liquidity from the central bank under Emergency Liquidity Assistance (ELA). It also protects savers by providing the possibility of the State buying back subordinated bonds converted into shares prior to the public intervention.

[5] European Parliament, [The precautionary precaution of Monte dei Paschi di Siena](#)

[6] For greater detail, see the note [in French] by Thomas Humblot, [Italie : liquidation de Veneto Banca et de Banca Popolare di Vicenza](#), July 2017.

The euro zone: A general recovery

By [Christophe Blot](#)

This text is based on the 2017-2019 outlook for the global economy and the euro zone, a full version of which is available [here](#).

The euro zone has returned to growth since mid-2013, after having experienced two crises (the financial crisis and the sovereign debt crisis) that led to two recessions: in 2008-2009 and 2011-2013. According to [Eurostat](#), growth accelerated during the third quarter of 2017 and reached 2.6% year-on-year (0.6% quarter-on-quarter), its highest level since the first quarter of 2011 (2.9%). Beyond the performance

of the euro zone as a whole, the current situation is marked by the generalization of the recovery to all the euro zone countries, which was not the case in the previous phase of recovery in 2010-2011. Fears about the sustainability of the debt of the so-called peripheral countries were already being reflected in a sharp fall in GDP in Greece and the gradual slide into recession of Portugal, Spain and a little later Italy.

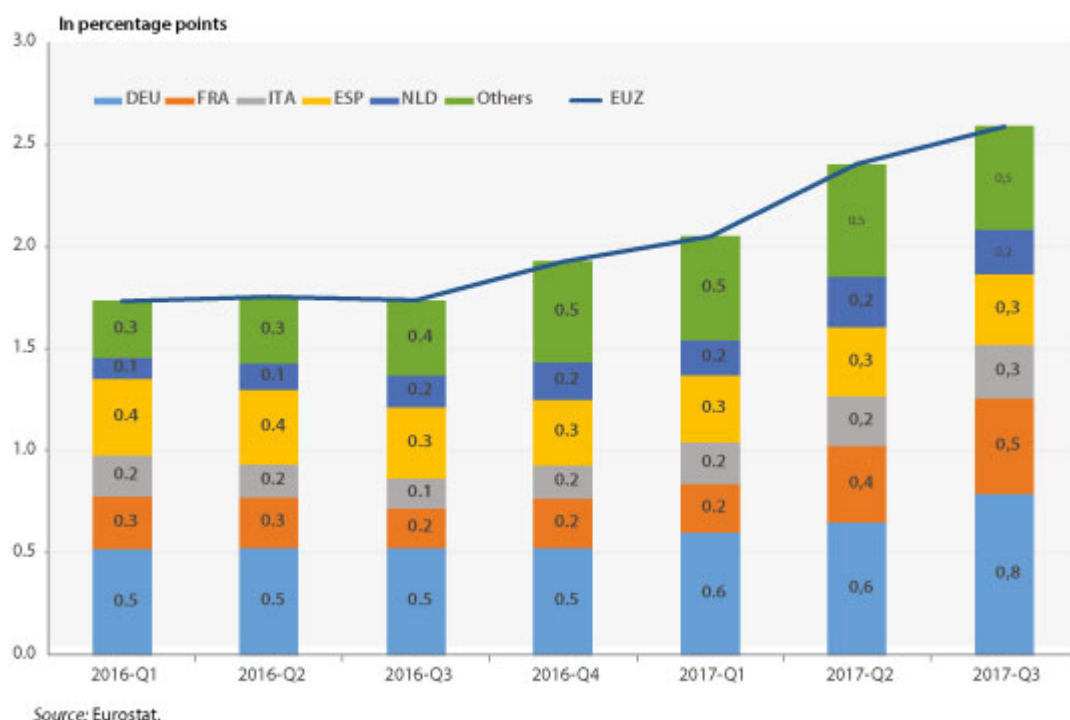
Today, while Germany remains the main engine of European growth, all of the countries are contributing to the accelerating recovery. In the third quarter of 2017, Germany's contribution to euro zone growth was 0.8 point, a faster pace than in the previous two quarters, reflecting the vitality of the German economy (see the Figure). However, this contribution was even greater in the first quarter of 2011 (1.5 points for growth of 2.9% year-on-year). This catching-up trend is continuing in Spain, which in the third quarter of 2017 had quarterly growth of 3.1% year-on-year (0.8% quarter-on-quarter), making a 0.3 point contribution to the euro zone's overall growth. Above all, activity is accelerating in the countries that up to now had been left a little bit out of the recovery, particularly in France and Italy, which contributed respectively 0.5 and 0.3 points to the growth of the zone over the third quarter^[1]. Finally, the recovery is taking root in Portugal and Greece.

This renewed dynamism of the European economy is due to several factors. Monetary policy is still very expansionary, and the securities purchases being carried out by the Eurosystem help to keep interest rates low. Credit conditions are favourable for investment, and the access to credit for SMEs is being loosened up, especially in the countries that were hit hardest by the crisis. Finally, fiscal policy is generally neutral or even slightly expansionary.

The current optimism must not nevertheless hide the scars left by the crisis. The euro zone unemployment rate is still higher

than its pre-crisis level: 9% against 7.3% at the end of 2007. The level still exceeds 10% of the active population in Italy, 15% in Spain and 20% in Greece. The social consequences of the crisis are therefore still very visible. These conditions justify the need to continue to support growth, particularly in these countries.

Figure. The contributions to growth in the euro zone



A new Great Moderation?

by Analysis and Forecasting Department

This text summarizes the OFCE's 2017-2019 forecast for the global economy and the euro zone; the full version can be found [here](#).

Ten years after the financial crisis broke out in the summer of 2007, the world economy finally seems to be embarking on a trajectory of more solid growth in both the industrialized and

most of the emerging countries. The figures for the first half of 2017 indicate that global growth is accelerating, which should result in GDP growth of 3.3% over the year as a whole, up 0.3 percentage point over the previous year. Some uncertainty remains, of course, in particular concerning the outcome of Brexit and the ability of the Chinese authorities to control their economic slowdown, but these are the types of irreducible uncertainties characteristic of an economic system that is subject to political, technological, economic and financial shocks[1]. Beyond these risks, which should not be underestimated, lies the question of the ability of the world's economies to reduce the imbalances inherited from the crisis. While current growth is sufficient to bring down the unemployment rate and improve the employment rate, it needs to be long-lasting enough to get back to full employment, reduce inequalities, and promote debt reduction.

In this respect, not all the doubts have been lifted by the current upturn in the world's economic situation. First, growth has remained moderate in light of the past recession and previous episodes of recovery. Since 2012, the global economy has grown at an average rate of 3.2%, which is lower than in the 2000s (graphic). The growth trajectory seems to be closer to what was observed in the 1980s and 1990s. This period, the so-called Great Moderation, was characterized by lower macroeconomic volatility and a disinflationary trend, first in the advanced countries, then in the emerging countries. This second element is also an important point in the global economic situation today. Indeed, the pick-up in growth is not translating into renewed inflation. The low rate of inflation reflects the persistence of underemployment in the labor market, which is holding back wage growth. It also illustrates the difficulties the central banks are having in (re)-anchoring inflation expectations on their target.

Finally, there is the matter of the growth potential. Despite numerous uncertainties about measuring growth potential, many

estimates are converging on a projection of weaker long-term growth, due mainly to a slowdown in trend productivity. It should be noted, however, that the methods used to determine this growth trajectory sometimes lead to prolonging recent trends, and can therefore become self-fulfilling if they lead private and public agents to reduce their spending in anticipation of a slowdown in growth. Conversely, boosting future growth requires private and public investment. Economic policies must therefore continue to play a leading role in supporting the recovery and creating the conditions for future growth.

Figure. The recovery of the global economy



Sources: National accounts, OFCE calculations, October 2017.

[1] See OFCE (2017): [La routine de l'incertitude](#) [in French].

France: growth as inheritance

by OFCE Department of Analysis and Forecasting (France team)

This text summarizes the OFCE's 2017-2019 forecast for the French economy; the full version can be found [here](#).

After five years of sluggish growth (0.8% on average over the period 2012-16), a recovery is finally taking shape in France, with GDP expected to rise by 1.8% in 2017, 1.7% in 2018 and 1.9% in 2019. Some negative factors that affected 2016 (a fall in agricultural production, impact of terrorist attacks on tourism, etc.) were no longer at work in 2017, and the economy should now feel the full benefit of the supply-side policies implemented during the Hollande presidency. Added to this is the ripple effect from stronger growth in the European economies. Fiscal consolidation should be at a lower level in the coming two years [\[1\]](#) (0.3 GDP point over 2018-2019), and should not jeopardize the ongoing recovery or the fall in unemployment that started in 2015. In total, by incorporating the delayed impact of past supply-side policies, fiscal policy will have a neutral impact on GDP growth in 2018 and a slightly positive one in 2019 (+0.2 GDP point). The reduction of the public deficit will be slow (2.9% of GDP in 2017, 2.6% in 2018 and 2.9% in 2019), but this masks a sharp improvement in the public balance in 2019, excluding the one-off impact from the conversion of the CICE tax credit. The reduction should be sufficient to stay below the 3% mark and ensure the exit from the corrective arm of the Stability Pact.

The brighter financial prospects for French business and the pick-up in productive investment since 2015 should boost export market shares. Given the more buoyant economic environment in the euro zone, foreign trade should no longer be a drag on France's growth. Ultimately, economic growth will be relatively robust, creating jobs in the commercial sector (247,000 in 2017, 161,000 in 2018 and 223,000 in 2019) and

bringing down the unemployment rate in metropolitan France to 9.2% by the end of the second quarter 2017, to 8.9% by the end of 2018 and to 8.5% by the end of 2019. But the sharp decline in new subsidized contracts in the second half of 2017, which will continue in 2018 (falling from 320,000 in 2017 to 200,000 in 2018) and the completion of the implementation of tax plans to enrich job growth (the CICE, Liability pact), and sometimes their elimination (hiring bonus), will be a significant drag on efforts to cut unemployment in 2018.

[\[1\]](#) This forecast does not take into account measures included in the 2018 supplemental Budget Bill (PLFR).

Is the recovery on the right path?

Analysis and Forecasting Department

This text is based on the 2016-2018 outlook for the world economy and the euro zone, a full version of which is available [here](#) [in French].

The growth figures for 2016 have confirmed the picture of a global recovery that is gradually becoming more general. In the euro zone, which up to now had lagged behind, growth has reached 1.7%, driven in particular by strong momentum in Spain, Ireland, the Netherlands and Germany. The air pocket that troubled US growth at the start of the year translated into slower GDP growth in 2016 than in 2015 (1.6% vs. 2.6%), but unemployment has continued to decline, to below the 5% threshold. The developing countries, which in 2015 were hit by

the slowdown in the Chinese economy and in world trade, picked up steam, gaining 0.2 point (to 3.9%) in 2016.

With GDP growing at nearly 3%, the world economy thus seems resilient, and the economic situation appears less gloomy than was feared 18 months ago – the negative factors have turned out to be less virulent than expected. The Chinese economy's shift towards a growth model based on domestic demand has led not to its abrupt landing but to a controlled slowdown based on the implementation of public policies to prop up growth. Even though the sustainability of Greece's debt has still not been resolved, the crisis that erupted in the summer of 2015 did not result in the disruption of the monetary union, and the election of Emmanuel Macron to the presidency of the French Republic has calmed fears that the euro zone would break up. While the question of Brexit is still on the table, the fact remains that until now the shock has not had the catastrophic effect some had forecast.

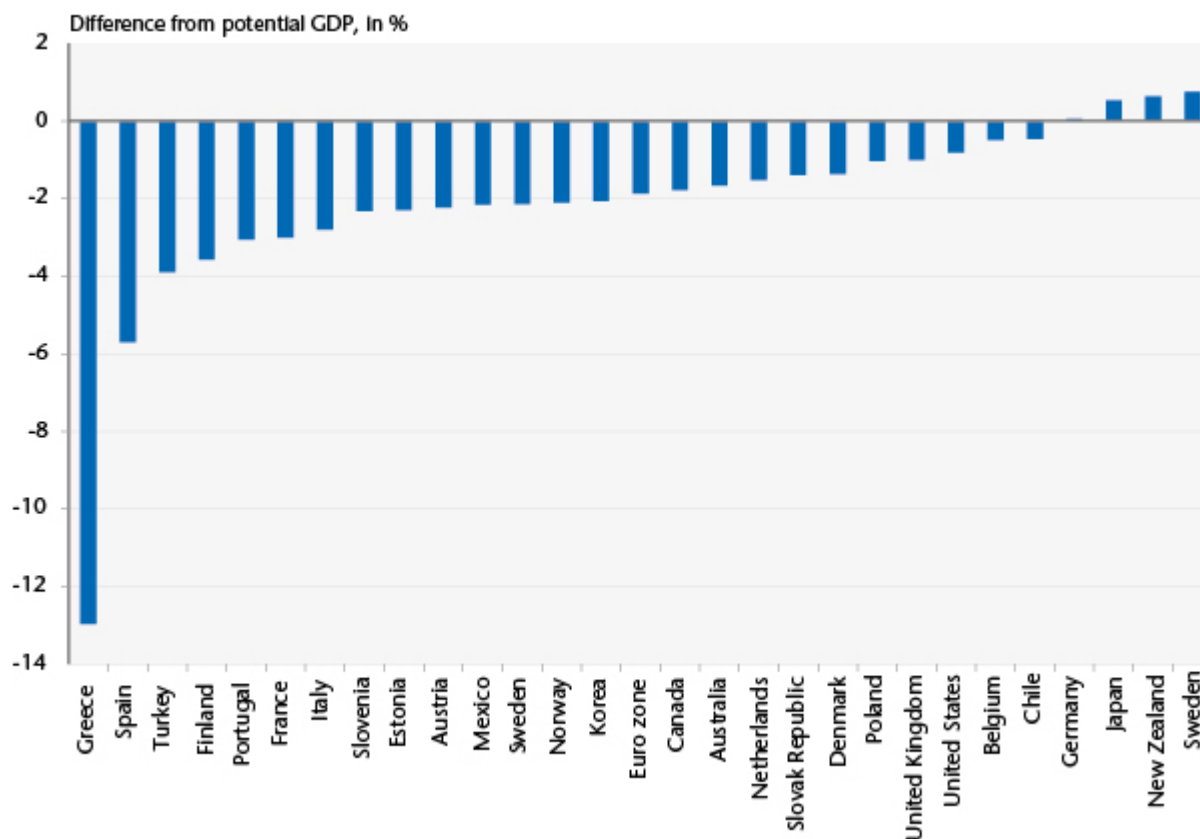
This pattern is expected to continue in 2017 and 2018 as a result of monetary policies that will continue to boost economic activity in the industrialized countries and somewhat scaled down fiscal efforts. US fiscal policy should become even more expansionary, allowing for a rebound in growth, which should once again surpass 2% in 2018. While oil prices have recently risen, they are not expected to soar, which will limit the negative impact on household purchasing power and business margins. The rise should even revive the previously moribund rate of inflation, thereby lowering the deflationary risk that has hovered over the euro zone. Pressure on the European Central Bank to put an end to unconventional measures could mount rather quickly.

Although the recovery process is consolidating and becoming more widespread, output in most of the developed economies is still lagging behind in 2016, as is illustrated by the gap in output from the potential level, which is still negative (Figure). This situation, which contrasts sharply with the

past cyclical behavior of economies as GDP swung back towards its potential, raises questions about the causes for the breakdown in the growth path that has been going on for almost ten years now. One initial element in an explanation could be the weakening of potential GDP. This could be the result of the scale of the crisis, which would have affected the level and / or growth of the supply capacity of the economies due to the destruction of production capacity, the slowdown in the spread of technological progress and the de-skilling of the unemployed.

A second factor would be the chronic insufficiency of demand, which would keep the output gap in negative territory in most countries. The difficulty in once again establishing a trajectory for demand that is capable of reducing underemployment is related to the excessive indebtedness of private agents prior to the recession. Faced with swelling liabilities, economic agents have been forced to cut their spending to shed debt and restore their wealth. In a situation like this, unemployment or underemployment should continue to fall, but this will take place more slowly than in previous recovery phases. Ten years after the start of the Great Recession, the global economy has thus still not resolved the macroeconomic and social imbalances generated by the crisis. The recovery is therefore well under way, but it is still not fast enough.

Figure: Output gaps in 2016



Sources : OECD, *Economic Outlook*, November 2016, OFCE Calculations.

Inflationary pressures are mounting

By [Hervé Péléraux](#)

The publication of the price index by the INSEE on November 15 confirmed the return of inflation to positive territory, +0.4%, in October and September, after it oscillated around 0 since the end of 2014. The deflationary phase experienced over the past two years has in part replicated the trajectory of the energy price index, which saw the price of oil fall in early 2016 to one-third of its price in mid-2014. With a weighting of almost 8% in the all-items index, the energy price index, which incorporates the price of fuel but also of

oil-indexed products such as gas and electricity, automatically pushed down inflation. This phase of energy-related disinflation now seems to have come to an end, with crude oil prices rising to between USD 45 and 50 a barrel since the low in mid-January 2016 at under USD 30. The gradual rise in the year-on-year change in the energy price index since spring has in fact pulled along the overall index.

Figure 1. Inflation in France



Source : INSEE.

However, the euro's depreciation against the dollar, which paralleled the fall in oil prices (from 1.35 dollars per euro on average in the first half of 2014 to 1.10 on average since spring 2015), has had a contrary inflationary effect, first by moderating the fall in the prices of energy imports after

their conversion from dollars to euros, and second by increasing the price of non-energy imports. Changes in the underlying price index, which excludes products with volatile prices (energy, some fresh food products) and products with administered prices (health care, tobacco, public prices) from the overall index, reflected this second effect by rebounding from early 2015. This increase in underlying inflation was not, however, due solely to the depreciation of the euro. The gradual end of the period of stagnation that marked the French economy between Q2 2011 and Q2 2014 reactivated inflationary mechanisms that had previously been thwarted by the easing of tension and the rise in unemployment.

The inflationary upturn begun in the last few months is expected to continue until 2018. The exhaustion of the disinflationary impact of the oil counter-shock and the rise in the price of crude oil, which has already largely occurred but will continue through the forecasting horizon up to 52 euros per barrel from its low point in early 2016 (31 euros per barrel) should mark the end of the disinflationary phase linked to energy prices. On top of this, the depreciation of the European currency, also already accomplished in large part, will continue, with a fall from 1.10 euros per dollar in mid-October 2016 to 1.05 according to our forecast. This will contribute to higher import prices. Inflation should therefore have hit a low point in the second quarter of 2016 before becoming positive again in the second half of 2016. By 2017, price increases will be close to 2% year-on-year, partly due to the effect of the recovery in oil prices and the depreciation of the euro. Excluding these two effects, inflation would just exceed 1% by end 2017 and then reach 1.5% the following year.

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The price-wage loop

Inflation forecasts are based on the modelling of a price-wage loop that estimates the parameters of the relationship between employees and companies: employers pass wage increases on to prices to preserve their margins, while employees respond to price increases by trying to obtain higher wages to preserve their purchasing power. Two equations model this process.

The wage formation equation (1) has terms for indexing wages to prices (PC), labour productivity (π), a part of which is redistributed in the form of wages, the unemployment rate (U), which governs workers' bargaining power, and the minimum wage (SMIC), which can have impacts on the scale of adjacent wages.

Equation (2) gives the prices of value added (PVA), a function of unit wage costs, which can be broken down into the difference between wages (W) and labour productivity. The elasticity between the value-added prices and the unit wage cost ($W - \pi$) is set to 1, which means that, in the long run, fluctuations in unit labour costs do not affect companies' target margin rate. Since there is inflationary pressure on the productive apparatus, the rate of utilization of production capacity (TU) is added to the unit labour costs.

$$W_t = f_1 [P_t^C (+), \pi_t (+), U_t (-), SMIC_t (+)] \quad (1)$$

$$P_t^{VA} = f_2 [(W_t - \pi_t) (+), TU_t (+)] \quad (2)$$

The formation of prices in the domestic market also depends on the prices of imported goods excluding taxes (MP), which are a function of the price of oil expressed in euros (PPétrole) and the nominal effective exchange rate (TCEN).

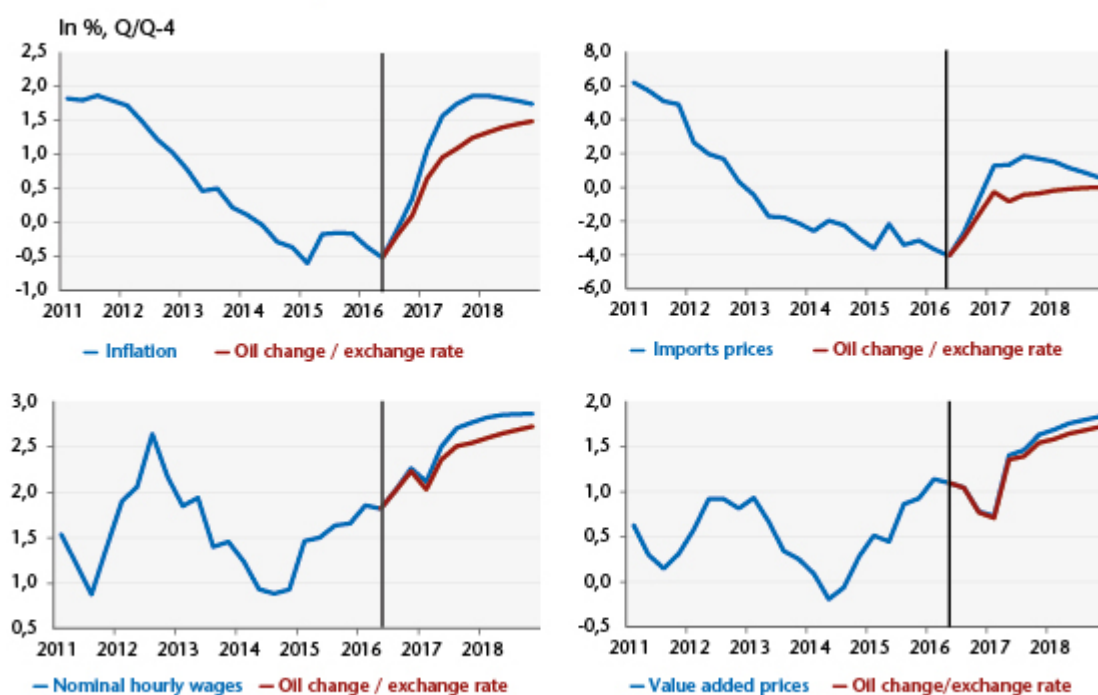
$$P_t^M = f_3 [P_t^{PETROLE} (+), TCEN_t (-)] \quad (3)$$

Finally, an accounting equation for the formation of domestic prices combines the value-added prices and the pre-tax import prices, with the total being increased by the rate of VAT to simulate the after-tax price index on the domestic market (here the deflator of household consumption from the national

accounts). The different equations are estimated using error correction models.

In accordance with this model, the trajectory of inflation by 2018 will be affected both by external impulses, namely changes in the effective exchange rate and in oil prices, and by internal impulses, namely the response of wages to these external shocks through indexation and the fall in unemployment. The renewed rise in oil prices and the depreciation of the effective exchange rate will revive imported inflation. Import prices will thus once again begin to rise in the first quarter of 2017, and will therefore contribute accounting-wise to the rebound in inflation. The indexing mechanisms will then push up wages, due to the added inflation. The fall in the unemployment rate begun at the end of 2015 will add to this impulse. Nevertheless, the rebound in inflation in the second half of 2016 cannot be reduced solely to the impact of external shocks. By neutralizing these effects and holding the nominal effective exchange rate and oil prices constant at their mid-2016 values, the rebound in inflation would not disappear, but it would be 0.6 percentage point lower at end 2017 (and 0.2 point lower at end 2018) relative to what comes from the central accounts (Figure 2).

Figure 2. Inflation and its determinants



Sources : INSEE, OFCE estimates and forecasts.

An end to growth?

Analysis and Forecasting Department (international team)

This text relies on the 2016-2018 forecast for the global economy and the euro zone, the full version of which [is available here, in French](#).

After avoiding a Grexit in the summer of 2015, Europeans will now have to face a Brexit. In addition to what should be a significant impact on the UK economy lies the question of the effect this shock will have on other countries. Given that all the indicators seemed to be green for finally allowing the euro zone to recover from the double-dip recession following the 2007-2008 financial crisis and then the sovereign debt crisis, will a Brexit risk interrupting the trend towards a recovery? This fear is all the more credible as the delayed

recovery was not sufficient to absorb all the imbalances that built up over the years of crisis. The unemployment rate for the euro zone was still over 10% in the second quarter of 2016. A halt to growth would only exacerbate the social crisis and in turn fuel doubt – and therefore mistrust – about Europe's ability to live up to the ambitions set out in the preamble to the [Treaty on the Functioning of the European Union](#) and reiterated in [Lisbon in 2000](#).

Nevertheless, despite fears of a new financial shock, it is clear that it hasn't happened. Brexit will of course be the fruit of a long process that has not yet started, but it seems that the worst has been avoided for now. The British economy will see growth halved in 2017. But the short-term negative effects on other euro zone countries should be fairly limited, except perhaps Ireland which is more interdependent on the United Kingdom. In any case the global recovery should continue, but growth will be down in the euro zone from 1.9% in 2015 to 1.3% in 2018.

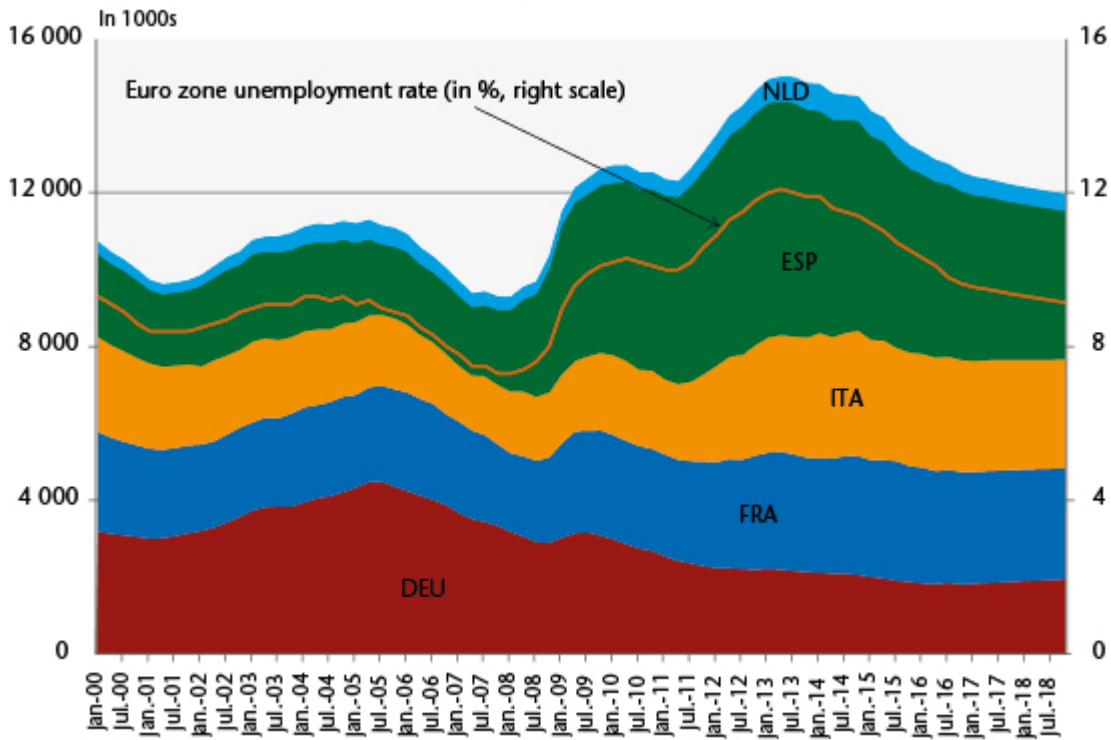
The many factors that helped initiate the recovery^[1] will to some extent lose steam. The price of oil has already begun to rise after hitting a low of under USD 30 in January 2016. It is now once again over 50 dollars a barrel. As for the euro, it has fluctuated since the beginning of the year at around 1.10 dollar, while in 2014 and 2015 it depreciated by 12.5% and 11.3%, respectively. In contrast, the European Central Bank has stuck to its expansionary monetary policy, and fiscal policy is much less restrictive than from 2011 to 2014. In 2015 and 2016, the aggregate fiscal impulse was even slightly positive.

Finally, world trade is slowing significantly, well beyond what would be expected simply from the change in China's economic model, which is resulting in a deceleration of imports. There were hopes that after the recovery kicked off, a virtuous cycle of growth would be triggered in the euro zone. Higher growth partly driven by exogenous factors would

lead to job creation, higher incomes and better prospects for households and businesses. These elements would be conducive to a return of confidence and in turn stimulate investment and consumption. The dynamics of productive investment in France and Spain in the last quarter have given credence to this scenario.

The recovery will certainly not be aborted, but this rate of growth seems insufficient to reduce the imbalances brought about by long years of recession and low growth. At the end of 2018, the unemployment rate in the euro zone will still be nearly 2 percentage points higher than at end 2007 (graphic). For the five largest countries in the euro zone, this represents nearly 2.7 million additional people without jobs. In these conditions, it is undoubtedly the social situation of the euro zone which, even more than Brexit, is putting the European project in jeopardy. Europe certainly cannot be held solely responsible for low growth and high unemployment in the various countries, but the current forecast indicates that we have undoubtedly not achieved the goals that were set in Lisbon in 2000, i.e. making the European Union “the most competitive and dynamic knowledge-based economy in the world capable of sustainable economic growth with more and better jobs and greater social cohesion”.

Figure: Unemployment in the euro zone



Source: Eurostat, OFCE forecasts – October 2016.

[1] View See the OFCE's earlier [synthesis](#) (in French) of the international outlook (summarized [here](#) in English).