The debacle of austerity

By Xavier Timbeau

This text summarizes the OFCE's October 2012 forecasts.

The year 2012 is ending, with hopes for an end to the crisis disappointed. After a year marked by recession, the euro zone will go through another catastrophic year in 2013 (a -0.1% decline in GDP in 2013, after -0.5% in 2012, according to our forecasts – see the table). The UK is no exception to this trend, as it plunges deeper into crisis (-0.4% in 2012, 0.3% in 2013). In addition to the figures for economic growth, unemployment trends are another reminder of the gravity of the situation. With the exception of Germany and a few other developed countries, the Western economies have been hit by high unemployment that is persisting or, in the euro zone, even rising (the unemployment rate will reach 12% in the euro zone in 2013, up from 11.2% in the second quarter of 2012). This persistent unemployment is leading to a worsening situation for those who have lost their jobs, as some fall into the ranks of the long-term unemployed and face the exhaustion of their rights to compensation. Although the United States is experiencing more favourable economic growth than in the euro zone, its labour market clearly illustrates that the US economy is mired in the Great Recession.

Was this disaster, with the euro zone at its epicentre, an unforeseeable event? Is it some fatality that we have no choice but to accept, with no alternative but to bear the consequences? No – the return to recession in fact stems from a misdiagnosis and the inability of Europe's institutions to respond quickly to the dynamics of the crisis. This new downturn is the result of massive, exaggerated austerity policies whose impacts have been underestimated. The determination to urgently rebalance the public finances and restore the credibility of the euro zone's economic

management, regardless of the cost, has led to its opposite. To get out of this rut will require reversing Europe’s economic policy.

The difficulty posed by the current situation originates in widening public deficits and swelling public debts, which reached record levels in 2012. Keep in mind, however, that the deficits and public debts were not the cause of the crisis of 2008-2009, but its consequence. To stop the recessionary spiral of 2008-2009, governments allowed the automatic stabilizers to work; they implemented stimulus plans, took steps to rescue the financial sector and socialized part of the private debt that threatened to destabilize the entire global financial system. This is what caused the deficits. The decision to socialize the problem reflected an effort to put a stop to the freefall.

The return to recession thus grew out of the difficulty of dealing with the socialization of private debt. Indeed, in the euro zone, each country is forced to deal with financing its deficit without control of its currency. The result is immediate: a beauty contest based on who has the most rigorous public finances is taking place between the euro zone countries. Each European economic agent is, with reason, seeking the most reliable support for its assets and is finding Germany’s public debt to hold the greatest attraction. Other countries are therefore threatened in the long-term or even immediately by the drying up of their market financing. To attract capital, they must accept higher interest rates and urgently purge their public finances. But they are chasing after a sustainability that is disappearing with the recession when they seek to obtain this by means of austerity.

For countries that have control of their monetary policy, such as the United States or the United Kingdom, the situation is different. There the national savings is exposed to a currency risk if it attempts to flee to other countries. In addition, the central bank acts as the lender of last resort. Inflation

could ensue, but default on the debt is unthinkable. In contrast, in the euro zone default becomes a real possibility, and the only short-term shelter is Germany, because it will be the last country to collapse. But it too will inevitably collapse if all its partners collapse.

The solution to the crisis of 2008-2009 was therefore to socialize the private debts that had become unsustainable after the speculative bubbles burst. As for what follows, the solution is then to absorb these now public debts without causing the kind of panic that we were able to contain in the summer of 2009. Two conditions are necessary. The first condition is to provide a guarantee that there will be no default on any public debt, neither partial nor complete. This guarantee can be given in the euro zone only by some form of pooling the public debt. The mechanism announced by the ECB in September 2012, the Outright Monetary Transaction (OMT), makes it possible to envisage this kind of pooling. There is, however, a possible contradiction. In effect this mechanism conditions the purchase of debt securities (and thus pooling them through the balance sheet of the ECB) on acceptance of a fiscal consolidation plan. But Spain, which needs this mechanism in order to escape the pressure of the markets, does not want to enter the OMT on just any conditions. Relief from the pressure of the markets is only worthwhile if it makes it possible to break out of the vicious circle of austerity.

The lack of preparation of Europe’s institutions for a financial crisis has been compounded by an error in understanding the way its economies function. At the heart of this error is an incorrect assessment of the value of the multipliers used to measure the impact of fiscal consolidation policies on economic activity. By underestimating the fiscal multipliers, Europe’s governments thought they could rapidly and safely re-balance their public finances through quick, violent austerity measures. Influenced by an extensive economic literature that even suggests that austerity could be

a source of economic growth, they engaged in a program of unprecedented fiscal restraint.

Today, however, as is illustrated by the dramatic revisions by the IMF and the European Commission, the fiscal multipliers are much larger, since the economies are experiencing situations of prolonged involuntary unemployment. A variety of empirical evidence is converging to show this, from an analysis of the forecast errors to the calculation of the multipliers from the performances recorded in 2011 and estimated for 2012 (see the full text of our October 2012 forecast). We therefore believe that the multiplier for the euro zone as a whole in 2012 is 1.6, which is comparable to the assessments for the United States and the United Kingdom.

Thus, the second condition for the recovery of the public finances is a realistic estimate of the multiplier effect. Higher multipliers mean a greater impact of fiscal restraint on the public finances and, consequently, a lower impact on deficit reduction. It is this bad combination that is the source of the austerity-fuelled debacle that is undermining any prospect of re-balancing the public finances. Spain once again perfectly illustrates where taking this relentless logic to absurd lengths leads: an economy where a quarter of the population is unemployed, and which is now risking political and social disintegration.

But the existence of this high multiplier also shows how to break austerity's vicious circle. Instead of trying to reduce the public deficit quickly and at any cost, what is needed is to let the economy get back to a state where the multipliers are lower and have regained their usual configuration. The point therefore is to postpone the fiscal adjustment to a time when unemployment has fallen significantly so that fiscal restraint can have the impact that it should.

Delaying the adjustment assumes that the market pressure has been contained by a central bank that provides the necessary

guarantees for the public debt. It also assumes that the interest rate on the debt is as low as possible so as to ensure the participation of the stakeholders who ultimately will benefit from sustainable public finances. It also implies that in the euro zone the pooling of the sovereign debt is associated with some form of control over the long-term sustainability of the public finances of each Member State, *i.e.* a partial abandonment of national sovereignty that in any case has become inoperative, in favour of a supranational sovereignty which alone is able to generate the new manoeuvring room that will make it possible to end the crisis.

OFCE growth forecasts, October 12

Annual growth in GDP, %

	2011	2012	2013
Euro zone	1,5	-0,5	-0,1
Germany	3,1	0,8	0,6
France	1,7	0,1	0,0
Italy	0,5	-2,4	-1,1
Spain	0,4	-1,4	-1,2
Netherlands	1,1	-0,2	0,3
Belgium	1,8	-0,1	0,9
Finland	2,8	0,8	1,1
Austria	2,7	1,0	0,5
Portugal	-1,7	-2,8	-1,2
Greece	-6,2	-6,2	-3,7
Ireland	0,8	-0,4	-0,1
United Kingdom	0,9	-0,4	0,3
United States	1,8	2,2	0,9
Japan	-0,7	2,4	1,3

Sources : National calculations, OFCE forecasts October 2012.

Does inequality hurt economic performance?

By Francesco Saraceno

Economic theory has long neglected the effects of income distribution on the performance of the economy. Students were taught right from Introduction to Economics 101 that the subject of efficiency had to be separated from considerations of equity. The idea is that the size of the cake had to be expanded to the maximum before it is shared. It was implicit in this dichotomy that economists should address the issue of efficiency and leave the question of distribution (or redistribution) to the politicians. In this framework, the economist's role is simply to ensure that choices about the channels for redistribution through taxation and public spending do not affect growth by interfering with the incentives of economic agents. Echoes of this view can be found both in the debate about the taxation of very large incomes envisaged by the French Government as well as in authors like Raghuram Rajan who justify inequality with references to technical progress and international trade, a view refuted by Paul Krugman.

Since the work of Simon Kuznets in the 1950s, some economists have of course questioned whether excessive inequality might not inhibit economic growth, in particular by blocking the accumulation of human capital. But this has long been a minority view among economists. Indeed, the dramatic increase in inequality documented among others by Atkinson, Piketty and Saez as well as by institutions such as the OECD and the IMF failed to give rise to a deep-going reflection about the relationship between inequality and economic performance.

It was the crisis that revived this concern. Growing inequality is now suspected of being a source of increasing household debt and speculative bubbles, leading to the accumulation of internal and external imbalances that have set off the current crisis. This is the argument developed by authors like Joseph Stiglitz and James Galbraith.

Today the dichotomy between efficiency and distribution is no longer tenable. Inequality is becoming an essential theme in

economic analysis, for both the short and long terms. To stimulate discussion on this topic, the OFCE and the SKEMA Business School are holding a workshop on "Inequality and Economic Performance" in Paris on 16 and 17 October 2012.

Who will pay the bill in Sicily?

by Augusto Hasman and Maurizio Iacopetta

Rumors of a Sicily's possible default are in the air again. The employees of the Sicilian parliament did not receive their checks at the end of September. Another possible default of Sicily made already the international headlines in July (see the New York Times 22/07/12) due to the contagion effects it could have had on other regions. But in that occasion, the central Italian government prevented Sicily's default by providing an immediate injection of liquidity in the order of 400 million euros.

Other Italian regions are in trouble. In recent months the provision of basic health care services has deteriorated; regions are renegotiating contracts with their creditors to obtain deadline extensions. The figures reported by Pierre de Gasquet in *Les Echos* of 02/10/2012, give a good idea of the deterioration of the Italian regional public finance over the last decade.

It will take a good deal of imagination for regional

governments to come out of the impending budget crisis, not only in Italy but also in other European countries that have difficulties in managing their public debts, such as Spain, Ireland and Greece.

In recent weeks we learned that some local politicians are endowed with a good deal of creativeness, but they hardly use it to find a solution to the budget crises. The governor of the region Lazio –where Rome is located – resigned a few days ago in the midst of a political scandal due to revelations that members of the regional parliament funneled electoral funds to pay extravagant personal expenses, including car upgrades and luxury vacations.

Why don't regional governments issue their own money to finance public expenditures? It may seem absurd that now that European countries have finally accepted a common currency, regional and possibly local governments might be tempted to create some sort of fiat money. But historically it would not be the first time that local monies emerge when the central government has its hands tight.

Argentina in the early 1990s (convertibility law n° 23.928, 27/03/1991) pegged the currency on a one-to-one basis with the U.S. dollar (See Anne-Laure Delatte's article on this blog for a parallel between the Argentinean events and hypothetical scenarios for Greece.). For most of the decade, things seemed to be working well; the economy was growing at the impressive annual rate of almost 5.7%, notwithstanding (or perhaps thanks to) the fact that Argentina, in practice, gave up the monetary policy instrument. But by 1998, the load of public debt started to become unbearable. Financing it by printing money was out of question. The IMF was called for help to prevent the panic of Argentinean savers. It granted a loan of 40 thousands million dollars but it also asked the government to impose a severe austerity plan, which had, among many effects, that of depriving provinces under financial difficulties from the prospect of being rescued by the central government.

It was at this point, in 2001, that a number of provinces began to print their own money in order to pay wages and current expenses. (Krugman's open editorial of ten years ago at the New York Times – Crying with Argentina, 01.01. 2002 – gives a fresh reading on the unfolding of the events). Fifteen out of twenty-two provinces ended up using newly issued interest-bearing notes, which earned the name of 'quasi-money'. At the beginning, thanks to an agreement between provinces and large stores, quasi-money had a high level of acceptability. Indeed, competition led more and more stores to accept the quasi-money. Local trade seemed to resuscitate. In August 2002, 5 thousands million pesos of quasi-money circulated side-by-side with 12 thousands million of (real) Argentinean pesos.

Interesting, although the case of Argentina seems very surprising, the academic literature has always been puzzled of why it does not happen more often. The question is why government non-interest bearing banknotes circulate side-by-side with government bonds that promise an interest. In principle the phenomenon defies an elementary no-arbitrage principle.

One of the first to pose the puzzle was Hicks in 1935 in a famous article by the title of 'A suggestion for simplifying the theory of money'. An answer to Hicks' puzzle was offered by Bryant and Wallace (1980). Their argument is based on observation that private banks are not allowed to slice large denomination government bonds in small denomination banknotes. If banks could issue their own small denomination notes that are fully backed by large denomination government bonds, then, competition among banks would presumably drive the return on private banknotes in line with the return on bonds. If interest rates on bonds are positive, the argument goes, the demand for non-interest bearing money should then fall to zero. For Bryant and Wallace only the legal restriction on intermediation would prevent this from happening.

But Makinen and Woodward (1986) report that, during the period from 1915 to 1927, French government treasury bonds circulated at a relatively small denomination of 100 Francs (roughly 50-60 euros of today). The bonds were issued with terms of 1 month, 3 months, 6 months, and 1 year. These bonds were continuously available to all banks (including branches of the Bank of France), post offices, and numerous local offices of the Finance Ministry. This historical episode casts some doubts on the legal hypothesis, for the Bank of France kept issuing Francs.

Why then in Argentina bonds emerged as money – albeit for a limited period? It seems to us that the key was the promise offered by the issuer to accept the regional bonds in settling a debt – typically a tax obligation. The rules on what the regions can and cannot do in Europe are different from country to country. In Italy for instance regions, provinces, and municipalities have been authorized to issue bonds by the law of ‘rationalization of public finance’, introduced in the first half of the 1990s (art. 32 of the law of 8.6.1990 n.142, for municipalities and provinces, and art.35, law 23.12.1994 n. 724). The law set several conditions for an administration to qualify to issue bonds. First, bonds can be issued only to finance investment projects. The law explicitly forbids the issue of bonds to finance current expenditures. Second, the issuer has to demonstrate a good history of balanced budgets. Third, the maturity of the bonds cannot be shorter than five years. Fourth, the bonds cannot go in direct competition with the central government bonds, namely cannot be offered a real return above the one offered by the central government for bonds with similar maturities. Fifth, the central government is not allowed to back-up bonds of the regions who, in turn, cannot take responsibility for the bonds issued by provinces or municipalities

Is it desirable to relax these conditions? Perhaps it is useful to see the end of the story in Argentina –not

particularly that of a Hollywood movie. The acceptability of quasi-money outside the region that issued it was very low. More importantly, the central government did not allow tax payers to use quasi-money for their federal taxes. Consequently, in a few months the de-facto exchange rate between the quasi-money and the national currency dropped from 1 to around 0.7 – it was somewhat higher for Buenos Aires quasi-money, for this was accepted in many other provinces.

At the beginning of 2002, a new government, presided by Eduardo Duhalde, decided to abandon the convertibility law. As a result, the exchange rate of the pesos vis-à-vis the U.S. dollar dropped from one to four. During that year, the GDP declined 10.9%.

Having gained the power of printing money again, the central government allowed quasi-monies holders to convert them into the devalued national peso. The short run benefits evaporated soon. The recession along with the depreciation slashed the purchasing power of the working class. At the end of the crisis, the national product was about a quarter lower than its 1998 level, and the rate of unemployment shot up to 24%. It appears that issuing of local money delayed the collapse of the financial system, but it is unclear whether the temporary breath gained by local administrators that issued bonds made the subsequent recession less severe. The case of Argentina suggests, nevertheless, that a major relaxation of the current constraints of regional and municipal entities is not going to help solve how to guarantee the provision of health care service in the long run. Nonetheless, the current policy of cutting basic public services indiscriminately is the least imaginative of the solutions. Alesina and Giavazzi in an open editorial published on Corriere della Sera on Sept 27, suggested that hospitals could charge health care users directly instead of being reimbursed by the regional authorities. By doing so, they argued, not only the quality of the service would improve, but regions would need fewer

resources. Although this is food for thought, in the U.S. such a system generated a colossal profit making machine that contributed to the explosion of the health care costs. Similarly, Fitoussi and Saraceno (2008) argue that the spectacular gain in income of the last three decades in China did not go hand-in-hand with similar gains in life expectancy and quality of health care, because the government opted for a health care system based on out-of-pocket expenses.

The Argentinean experience tells us that local administrators in distressed regions of Europe are going to lobby the government to give more freedom in managing their budget intertemporally – something that is already happening in Spain, and is summarized in the London School of Economics blog by K. Basta . They are also probably going to make more intensive use of 'creative accounting', so as to prolong their serving time in office. But this will not be the solution. A major reassessment of the national government's priorities in combination with a sensible monetary policy at the European level is the only way out. We badly need to free up resources to revitalize the public educational system and to maintain the overall good standard of public health care services.

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Social action, but no end of the crisis

Evaluation of the five-year economic programme (2012-2017)

By Eric Heyer, Mathieu Plane, Xavier Timbeau

The initial decisions of the five-year programme are coming amidst an extremely difficult and very uncertain economic situation. In a recent *OFCE Note* (No. 23 of 26 July 2012), we first analyze the macroeconomic context for François Hollande's five-year programme and the XIVth legislature. This analysis details the likely consequences for the next five years of the strategy currently being implemented in Europe. We evaluate both the cost to the public finances as well as the impact on economic activity, employment and the distribution of income. In part two, we analyze the public policy choices being given priority by the new government, including both those aimed at the young (generation contracts, jobs of the future), at some seniors (revision of the pension reform), and at the middle and lower classes (allowance for the start of school, boost to the minimum wage, Livret A bank accounts, rent control, revised taxation of overtime), as well as those intended to revive certain public expenditures that are deemed essential (public jobs in education, the justice system and the police in the "public finance" section, and public early childhood services).

François Hollande was elected President of the French Republic at a time when France and Europe are going through an unprecedented crisis. Unemployment in metropolitan France has increased by over 2 percentage points since the crisis began and is now (in ILO terms, 9.6% of the workforce in first quarter 2012) approaching the record levels of 1997 (10.5%). Gross domestic product per capita in terms of purchasing power has fallen since 2008 by 3%. If the growth trend for the five

years preceding the crisis had continued at that same rate from 2008 until early 2012, GDP per capita would now be 8% higher than it is. The current account has deteriorated during the crisis by 1.5 GDP points (25.7 billion euros, 10 billion of which is for the oil bill), thus worsening France’s net balance of trade by 7.8 GDP points. The public debt increased by 577 billion (nearly 30 GDP points), and at the beginning of 2012 represented almost 90% of GDP. Industry has paid a heavy price for the crisis (almost 300,000 jobs lost), with all signs indicating that the job losses and closures of industrial sites might be irreversible.

Yet this dire situation, which can be chalked up to the crisis that began in 2008, is not over. Due to the impact of austerity policies implemented at a time of panic at seeing financing of the public debt dry up, the sovereign debt crisis is threatening the euro zone with a prolonged recession in 2012 and 2013. And the even worse scenario looming on the horizon – the disintegration of the euro zone – would transform the threats of recession into the risk of a major depression.

Assessments of the situation differ depending on the elements available. Some measures have been implemented by decree, while others are being discussed by the legislature, but the proposed bills do permit a quantitative analysis. Others are in the planning stage, with the main trade-offs still to be made, so our assessment tries to explore the main points.

Our assessment of the economic strategy for the five-year programme does not stop there. The outlines of the premises for a strategy to end the crisis can now be seen. The deficit reduction commitments and the initial steps taken in this direction in the budget packages in July 2012, such as those announced during the budget orientation debate of June 2012, point to a strategy whose first step is the achievement of a reduction in the public deficit to 3% of GDP by the end of 2013, regardless of the cost. Based on this fiscal virtue,

this amounts to a strategy to end the crisis by stabilizing the state of the public accounts, thereby reassuring the financial markets and other economic agents and establishing the conditions for a strong future recovery. This strategy is based on cutting public expenditures and raising taxes (see the “public finance” section, government tax proposals and the taxation of the oil companies).

This strategy for ending the crisis is risky, to say the least, because it does not take full account of the crisis facing Europe today. It might be justified if we were already on course to end the crisis and if the point were simply to set priorities. But Europe remains in a situation of extreme uncertainty, living in the expectation of a massive failure of one or another Member State in the euro zone, fearing the collapse of this or that financial institution, and suffering the consequences of a spiral of austerity that is being fueled by rising sovereign interest rates. In this situation, everything is coming together to strengthen the existence of a liquidity trap and to generate high fiscal multipliers. Given this, *ex ante* reductions in the deficit through tax hikes and spending cuts is weighing heavily on activity, and thus limiting or even cancelling out any actual deficit reductions. The factors pushing up the public debt are not being reversed, and the reduction in activity is heightening the risk that the unsustainable private debt will be socialized. The increase in sovereign interest rates is being fueled by an inability to meet deficit reduction targets and by rising public debt, and is thus pushing public deficits higher, forcing even more austerity.

One response to this dynamic that is bringing about the collapse of the euro would be one form or another of pooling public debts in Europe. This would require relatively complete control of the budgets of member countries by a federal body with strong democratic legitimacy. A response like this would therefore mean “more Europe”, and would make it possible to

define “more moderate” austerity policies for France as well as its major trading partners. It would make putting an end to involuntary mass unemployment and the liquidity trap prerequisites to an improvement in the public finances. It would also make it possible to ensure the sustainability of public finances without leading to the lost decades that are now gestating.

In the first part of the Note, we analyze the macroeconomic context for François Hollande’s five-year programme and the XIVth legislature. This analysis details the likely consequences for the next five years of the strategy currently being implemented in Europe. The value of the fiscal multiplier is a critical parameter, and we show that the current strategy is valid only if the multipliers are low (*i.e.* on the order of 0.5). However, a slew of empirical evidence indicates that, in the exceptional situation we are experiencing today, the budget and fiscal multipliers may be larger than 0.5 (between 1 and 1.5, see the Note). We detail in a second part the measures taken in the Supplementary Budget Act of July 2012 (for 2012) and the elements outlined in the budget orientation debate in preparation for the Budget Act for 2013 and for the period 2012-2017. To succeed in reducing the public deficit to 3%, it seems that there must be over 10 billion euros in additional tax revenue or in savings on expenditure, *ex ante*.

We then present an evaluation of eleven measures. Guillaume Allègre, Marion Cochard and Mathieu Plane have estimated that the implementation of the *contrat de génération* [“generation contract”] could create between 50,000 and 100,000 jobs, at the cost of a strong deadweight effect. Eric Heyer and Mathieu Plane point out that in the short term, subsidized *emplois avenir* [“jobs for the future”]-type contracts can help to reduce unemployment. Eric Heyer shows that the revision of taxation on overtime will help to cut the public deficit by 4 billion euros, without hurting the labour market. Guillaume

Allègre discusses the consequences of increasing the *Allocation de rentrée scolaire* [allowance for the start of school] and shows that it mainly benefits the lowest five deciles in terms of standard of living. Henri Sterdyniak analyzes the possibilities for fiscal reform. The point is not to evaluate the government's proposals for fiscal reform, but to provide a comprehensive overview of the current system's margin for change and its inconsistencies. Henri Sterdyniak and Gérard Cornilleau evaluate the increased opportunities for retiring at age 60 and analyze the possible paths to a more large-scale reform of the pension system. Hélène Périvier evaluates the possibilities for an early childhood public service, the eventual cost of which could be covered in part by an increase in activity that would generate more than 4 billion euros. Eric Heyer and Mathieu Plane analyze the impact of a boost in the minimum wage (SMIC) and conclude that, given the small spillover of increases in the SMIC onto the rest of the wage structure, the impact on the cost of labour is limited by the greater reduction in social charges on low wages. While the effect on employment is small, it would cost the public purse 240 million euros. Sabine Le Bayon, Pierre Madec and Christine Rifflart evaluate rent control. Hervé Péléraux discusses the compensation of Livret A bank accounts and the impact of doubling their ceiling. Céline Antonin and Evens Salies evaluate the new taxes on the oil companies, which could provide 550 million euros in tax revenue in 2012, at the risk that this tax might ultimately be passed on to the end consumer.

Japan's reconstruction:

constrained by the deterioration in public finances

By Bruno Ducoudré

Following the earthquake that hit Japan in March 2011, the government estimated the cost of the loss at 16.9 trillion yen (3.6 points of GDP). The response in terms of the structural deficit needed to deal with this exogenous shock conflicts with the government's desire to implement an austerity policy to reduce the deficit. The additional financing requirements are thus coming at the worst possible time, amidst the economic crisis that began in 2008, which has been accompanied by a sharp deterioration in public finances due to the need to prop up the economy.

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

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

three-quarters of which is to be funded by debt (Table).

Contrary to expectations, the series of plans passed in 2011 have not resulted in a rapid surge in public spending: public consumption grew by 2.1% in 2011, unchanged from 2010 and less than in 2009, and public investment fell by 3.1% in 2011. Reconstruction costs were partly substituted for other expenses. Also, part of the budget adopted was set aside and so is just beginning to be spent. Public orders for construction work rose by 20% in Q4 of 2011 yoy, and public works in progress rose sharply at year end. Thus, the additional expenses related to the reconstruction costs already approved will be spread in part over the coming quarters, and even beyond fiscal year 2012.

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

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

of GDP in 2012, and will worsen to 9.8% of GDP in 2013.

Provisional budgets for 2011-2012 for reconstruction
Central government

In % GDP

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

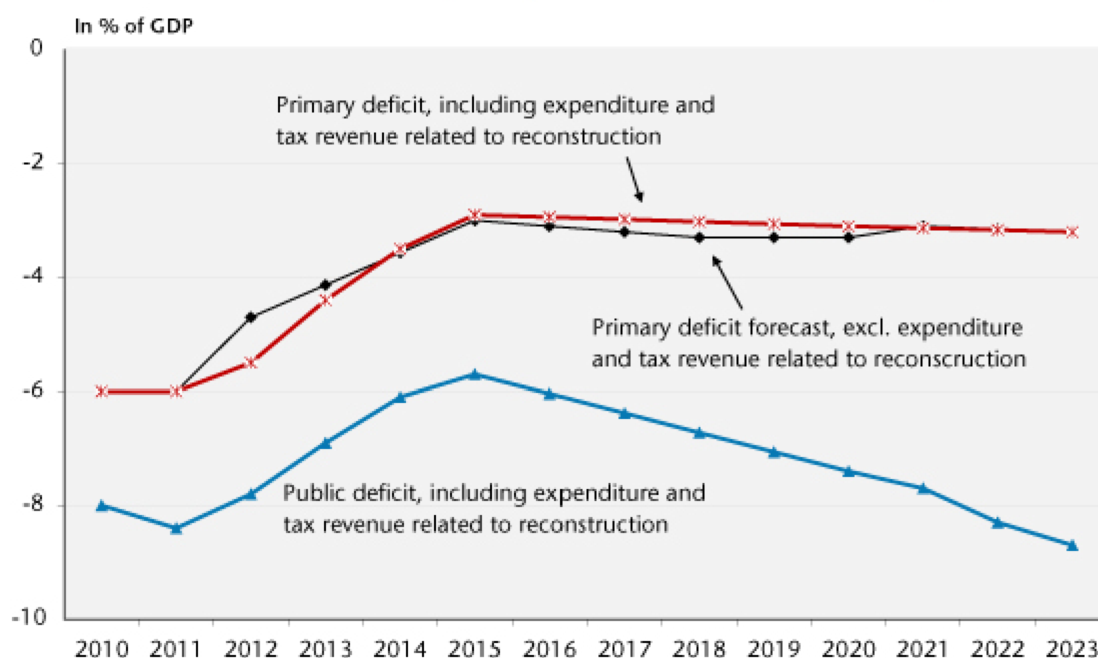
Sources: Cabinet Office, Ministry of Finance, OFCE calculations.

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

have not been clarified, and the government has not indicated how the debt built up to finance reconstruction would be repaid. Finally, given the continuing growth of the public debt, the interest burden, which currently is low (1.8 GDP points in 2011), will place an increasing burden on state finances in the future. This will exacerbate the government’s difficulties in implementing any budgetary changes aimed at stabilizing the debt-to-GDP ratio by 2020, and then to bring it down even further.

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

Government forecasts of the primary deficit over the reconstruction period



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

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

Underlying deflation

Christophe Blot, Marion Cochard, Bruno Ducoudré and Eric Heyer

A look at the latest statistics on price trends indicates that the risk of deflation seems to have given way to renewed inflation in the major developed countries. So do we really need to fear the return of inflation, or are these economies still structurally deflationary?

First, note that the nature and scale of the economic crisis we have been living through since 2008 are reminiscent of what led to past periods of deflation (the crisis of 1929, the Japanese crisis of the 1990s, etc.). The recessionary pattern that began in 2008 has followed the same path: the shock to activity led to a slowdown in inflation – and sometimes lower prices or wages – in most of the developed countries. However, a fall in prices is not necessarily synonymous with deflation: this has to be long term and, above all, it must be anchored in expectations and a vicious cycle of debt deflation. But this deflationary scenario did not materialize. Far from sitting by idly, at the end of 2008 governments and central banks took fiscal and monetary measures to stabilize activity and limit the rise in unemployment. Moreover, independently of the response by economic policy, price trends were strongly influenced by changes in commodity prices. While the collapse in oil prices in the second half of 2008 accelerated the deflationary process, the rise in prices since 2009 has fuelled more general price rises and held off the risk of

deflation. Moreover, business has partially cushioned the impact of the crisis by accepting cuts in margins, which has helped to mitigate rising unemployment, a key factor in the deflationary process.

In a study by the OFCE published in its journal of forecasts (Prévisions de la Revue de l'OFCE), we start from a wage-price model to develop a method for assessing the way that oil price dynamics and labour market adjustments affect changes in inflation. We show that if oil prices had continued their upward trend after they peaked in the summer of 2008, and if the adjustment on the labour market had been, in all countries, the same as in the US, then the year-on-year change in inflation in second quarter 2011 would have been lower, by 0.7 points in France to 3.4 points in the UK (Table 1). This confirms that these economies are still structurally deflationary.

Despite the central banks' repeated efforts at quantitative easing, they need not fear the return of inflation. The macroeconomic environment is still characterized by a risk of deflation, and therefore by the need for an accommodative monetary policy.

Impact of shocks on consumer prices

Year-on-year change

	Impact on the inflation rate…	2010 Q1	2010 Q2	2010 Q3	2010 T4	2011 Q1	2011 Q2
Germay	… of the speed of productivity adjustment	0.3	0.5	0.6	0.8	0.8	0.8
	… of the change in oil prices	0.0	0.2	0.2	0.3	0.4	0.4
	Total impact	0.3	0.7	0.8	1.0	1.2	1.3
France	… of the speed of productivity adjustment	0.0	0.0	0.0	0.1	0.1	0.1
	… of the change in oil prices	0.2	0.4	0.2	0.3	0.5	0.6
	Total impact	0.2	0.4	0.2	0.4	0.6	0.7
Italy	… of the speed of productivity adjustment	0.3	0.3	0.3	0.3	0.2	0.1
	… of the change in oil prices	0.6	0.8	0.6	0.5	0.6	0.6
	Total impact	0.8	1.2	1.0	0.8	0.8	0.8
Spain	… of the speed of productivity adjustment	0.0	-0.1	-0.2	-0.2	-0.3	-0.4
	… of the change in oil prices	0.0	0.3	0.3	0.3	0.4	0.5
	Total impact	0.0	0.2	0.1	0.0	0.1	0.1
UK	… of the speed of productivity adjustment	0.7	1.3	1.8	2.2	2.8	3.1
	… of the change in oil prices	0.1	0.1	-0.1	-0.1	0.1	0.3
	Total impact	0.8	1.4	1.7	2.2	2.9	3.4
USA	… of the speed of productivity adjustment	0.0	0.0	0.0	0.0	0.0	0.0
	… of the change in oil prices	0.5	0.4	0.1	0.0	0.2	0.4
	Total impact	0.5	0.4	0.1	0.0	0.2	0.4
Japan	… of the speed of productivity adjustment	0.6	0.8	0.9	1.0	1.1	1.2
	… of the change in oil prices	0.0	0.2	0.2	0.2	0.3	0.4
	Total impact	0.6	1.0	1.1	1.2	1.3	1.6

Source : National data, OFCE calculations.

The misfortunes of virtue*

By Christophe Blot

** This text summarizes the outlook produced by the Department of Analysis and Forecasting for the euro zone economy in 2012-2013, which is available in French on the OFCE web site*

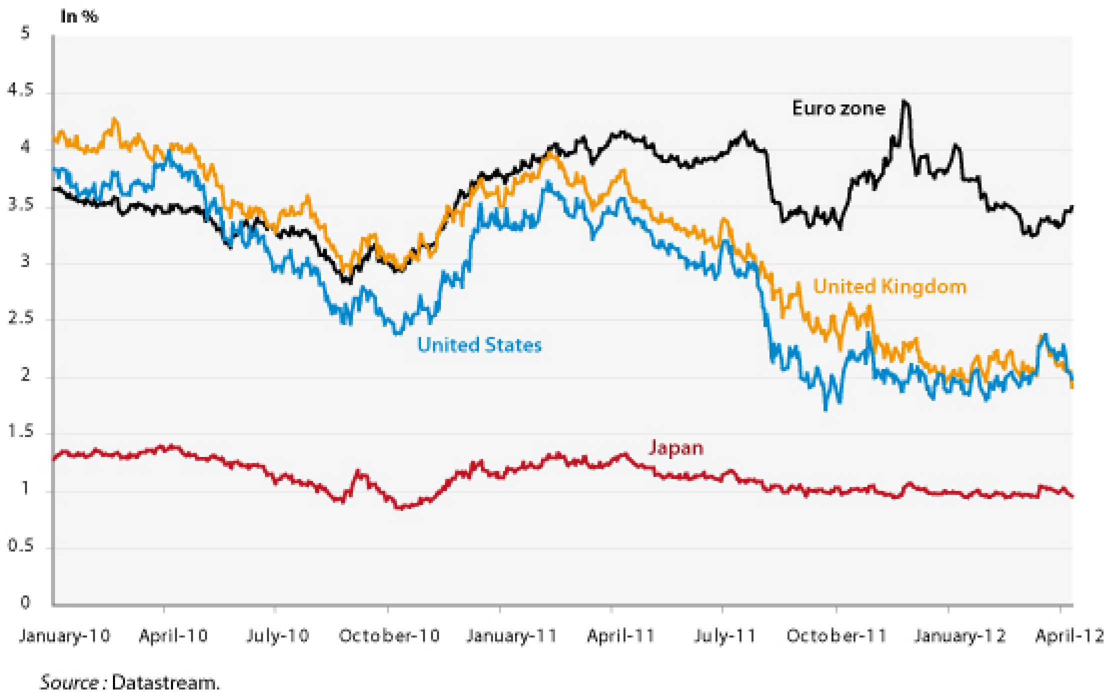
The euro zone is still in crisis: an economic crisis, a social crisis and a fiscal crisis. The 0.3% decline in GDP in the fourth quarter of 2011 is a reminder that the recovery that

began after the great drop of 2008-2009 is fragile and that the euro zone has taken the first step into recession, which will be confirmed in early 2012.

The fall in the average long-term government interest rate in the euro zone seen since the beginning of the year has come to a halt. After reaching 3.25% on 9 March, it rose again due to new pressures that emerged on Italian and Spanish rates. Indeed, despite the agreement to avoid a default by Greece, Spain was the source of new worries after the announcement that its budget deficit had reached 8.5% in 2011 – 2.5 points above the original target – and the declaration that it would not meet its commitments for 2012, which has reinforced doubts about the sustainability of its debt. The Spanish situation illustrates the close link between the macroeconomic crisis and the sovereign debt crisis that has hit the entire euro zone. The implementation of fiscal adjustment plans in Europe, whose impact is being amplified by strong economic interdependence, is causing a slowdown or even a recession in various euro zone countries. The impact of synchronized restrictions is still being underestimated, to such an extent that governments are often being assigned targets that are difficult to achieve, except by accepting an even sharper recession. So long as the euro zone continues to be locked in a strategy of synchronized austerity that condemns in advance any resumption of activity or reduction in unemployment, the pressure will not fail to mount once again in 2012. Long-term public interest rates in the euro zone will remain above those of the United States and the United Kingdom (see the figure), even though the average budget deficit was considerably lower in 2011 in the euro zone than in these two countries: 3.6% against 9.7% in the US and 8.3% in the UK.

To pull out of this recessionary spiral, the euro zone countries need to recognize that austerity is not the only way to reduce budget deficits. Growth and the level of interest rates are two other factors that are equally important for

ensuring the sustainability of the public debt. It is therefore urgent to set out a different strategy, one that is less costly in terms of growth and employment, which is the only way to guarantee against the risk that the euro zone could fall apart. First, generalized austerity should be abandoned. The main problem with the euro zone is not debt but growth and unemployment. Solidarity must be strengthened to curb speculation on the debt of the weaker countries. The fiscal policies of the Member states also need to be better coordinated in order to mitigate the indirect effects of cutbacks by some on the growth of others [1]. It is necessary to stagger fiscal consolidation over time whenever the latter is needed to ensure debt sustainability. At the same time, countries with room for fiscal manoeuvre should develop more expansionary fiscal policies. Finally, the activities of the European Central Bank should be strengthened and coordinated with those of the euro zone governments. The ECB alone has the means to anchor short-term and long-term interest rates at a sufficiently low level to make it possible both to support growth and to facilitate the refinancing of budget deficits. In two exceptional refinancing operations, the ECB has provided more than 1,000 billion euros for refinancing the euro zone banks. This infusion of liquidity was essential to meet the banks' difficulties in finding financing on the market. It also demonstrates the capacity for action by the monetary authorities. The portfolio of government debt securities held by the ECB at end March 2012 came to 214 billion euros, or 2.3% of euro zone GDP. In comparison, in the United States and the United Kingdom, the portfolio of government securities held by the central banks represents more than 10% of their GDP. The ECB therefore has significant room for manoeuvre to reduce the risk premium on euro zone interest rates by buying government securities in the secondary markets. Such measures would make it possible to lower the cost of ensuring the sustainability of the long-term debt.



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[1] See "He who sows austerity reaps recession", *OFCE note no. 16*, March 2012.

He who sows austerity reaps recession

By the Department of Analysis and Forecasting, headed by X. Timbeau

This article summarizes OFCE note no.16 that gives the outlook on the global economy for 2012-2013.

The sovereign debt crisis has passed its peak. Greece's public debt has been restructured and, at the cost of a default, will fall from 160% of GDP to 120%. This restructuring has permitted the release of financial support from the Troika to

Greece, which for the time being solves the problem of financing the renewal of the country’s public debt. The contagion that hit most euro zone countries, and which was reflected in higher sovereign rates, has been stopped. Tension has eased considerably since the beginning of 2012, and the risk that the euro zone will break up has been greatly reduced, at least in the short term. Nevertheless, the process of the Great Recession that began in 2008 being transformed into a very Great Recession has not been interrupted by the temporary relief of the Greek crisis.

First, the global economy, and especially the euro zone, remains a high-risk zone where a systemic crisis is looming once again. Second, the strategy adopted by Europe, namely the rapid reduction of public debt (which involves cutting public deficits and maintaining them below the level needed to stabilize debt), is jeopardizing the stated objective. However, since the credibility of this strategy is perceived, rightly or wrongly, as a necessary step in the euro zone to reassure the financial markets and make it possible to finance the public debt at acceptable rates (between 10% and 20% of this debt is refinanced each year), the difficulty of reaching the goal is demanding ever greater rigor. The euro zone seems to be pursuing a strategy for which it does not hold the reins, which can only fuel speculation and uncertainty.

Our forecast for the euro zone points to a recession of 0.4 percentage point in 2012 and growth of 0.3 point in 2013 (Table 1). GDP per capita in the euro zone should decline in 2012 and stabilize in 2013. The UK will escape recession in 2012, but in 2012 and 2013 annual GDP growth will remain below 1%. In the US, GDP growth will accelerate from 1.7% per year in 2011 to 2.3% in 2012. Although this growth rate is higher than in the euro zone, it is barely enough to trigger an increase in GDP per capita and will not lead to any significant fall in unemployment.

The epicenter of the crisis is thus shifting to the Old Continent and undermining the recovery in the developed countries. The United States and United Kingdom, which are

faced even more than the euro zone with deteriorating fiscal positions, and thus mounting debt, are worried about the sustainability of their public debts. But because growth is just as important for the stability of the debt, the budget cuts in the euro zone that are weighing on their activity are only adding to difficulties of the US and UK.

By emphasizing the rapid reduction of deficits and public debt, euro zone policymakers are showing that they are anticipating a worst case scenario for the future. Relying on so-called market discipline to rein in countries whose public finances have deteriorated only aggravates the problem of sustainability by pushing interest rates up. Through the interplay of the fiscal multiplier, which is always underestimated in the development of strategies and forecasts, fiscal adjustment policies are leading to a reduction in activity, which validates the resignation to a worse “new normal”. Ultimately, this is simply a self-fulfilling process.

Outlook for global growth

Annual growth rate (%)

	Weight in the total (1)	GDP in volume 2011	2012	2013
DEU	4,2	3,1	0,1	0,8
FRA	3,1	1,7	0,2	0,7
ITA	2,6	0,6	-1,7	-0,9
ESP	2,0	0,7	-1,3	-0,6
NLD	1,0	1,5	-1,1	0,5
BEL	0,6	1,9	0,1	0,9
AUT	0,5	3,1	0,4	0,8
FIN	0,5	2,7	0,7	1,1
PRT	0,3	-1,3	-2,9	0,2
GRE	0,3	-6,3	-5,3	-0,5
IRL	0,3	0,8	-0,6	0,9
EUZ	15,5	1,5	-0,4	0,3
GBR	3,2	0,9	0,7	0,9
SWE	0,5	4,0	0,8	1,6
DNK	0,3	1,1	0,6	1,1
EU-15	19,4	1,5	-0,2	0,4
12 new member states	2,7	3,1	1,1	2,1
EU-27	22,0	1,7	-0,1	0,6
CHE	0,5	1,9	0,3	1,0
NOR	0,4	2,5	3,1	2,0
Europe	22,9	1,8	0,0	0,6
USA	20,8	1,7	2,1	2,4
JPN	6,3	-0,6	1,9	1,5
CAN	1,9	2,5	2,0	2,3
Industrialized countries	50,5	1,4	1,2	1,5
EU candidate countries (2)	1,5	7,6	1,7	4,3
RUS	3,3	4,5	3,3	3,8
Other CIS (3)	1,3	3,9	3,7	4,2
CHN	11,3	9,2	8,1	8,1
Other Asian countries	13,2	5,6	5,8	6,3
Latin America	8,7	4,3	3,1	3,5
Sub-Saharan Africa	2,3	4,9	5,4	5,3
Middle East and North Africa	4,8	3,1	3,2	3,6
World	100	3,5	3,1	3,4

1) Weighted according to GDP and 2008 PPPs estimated by the IMF.
2) Croatia, Republic of Macedonia and Turkey.
3) Commonwealth of Independent States.
Sources: IMF, OECD, national sources, [illegible] calculations and forecasts.

Yes, the national accounts will be revised after the election

By Hervé Péléraux and Lionel Persyn[1]

In a Europe that is heading more and more clearly towards a recession, in mid-February the INSEE reported a 0.2% rise in France's GDP. This fourth-quarter performance was surprising, as it contrasts sharply with the deterioration in the economic climate since summer 2011, which indicated that GDP growth would be less favourable than that announced.

The current figures from the national accounts are, however, not set in stone. A note from the OFCE describes the procedure since the release of the provisional results that marks the starting point in the process of revising the accounts. This revision is spread over several years, first involving the tuning of the quarterly accounts with the annual accounts, then the revision of the annual accounts (the final version for 2011 will be announced in May 2014). The final changes are to the database for the national accounts, which will provide an opportunity to introduce methodological innovations that aim at greater accuracy on past estimates.

The enigma of the fourth quarter of 2011 may be resolved in the future as the revisions are worked out. It is useful to refer to past experience to try to identify the profile of the coming adjustments and to draw the likely implications for the current period. Since 1987, the revisions to the accounts seem to have been pro-cyclical, that is to say, the preliminary figures are mostly revised upwards in periods of recovery or rapid growth, and downwards in periods of downswings in the economic cycle. In some major cyclical episodes, the average revisions are significant and could affect the economic

diagnosis.

This was what happened in 2008. After the INSEE announced a negative result for the second quarter of -0.3%, the initial estimate for the third quarter was a positive 0.1%, which for a while put off the prospect that the French economy was entering a recession. The subsequent assessments gave a more dramatic turn to the GDP’s trajectory, with the current respective estimates for the two quarters being -0.7% and -0.3%. Had these been known at the time, this would probably have pushed forecasts downwards by fully revealing the severity of the impact of the financial crisis on the real economy.

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[1] At the time this note was written, Lionel Persyn was an intern at OFCE and a doctoral candidate at the University of Nice at Sophia Antipolis.

The irresistible attraction to recession

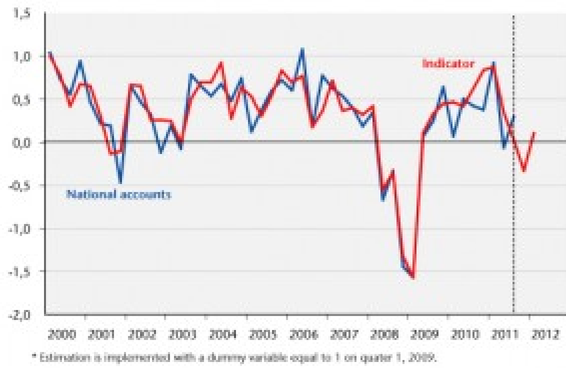
By Hervé Péléraux

Here is the leading indicator for the French economy, updated to 30 January 2011.

The February forecasts of the leading indicator significantly worsened the outlook for the French economy at the turn of 2011 and 2012.

On the one hand, GDP is expected to have fallen more than expected in the fourth quarter of 2011, by -0.3% instead of the -0.2% estimated last month. On the other hand, the pick-up in growth in the first quarter of 2012 observed in January is fast disappearing, with GDP rising by 0.1% and not 0.3% as in the previous estimates. In total, GDP will contract by 0.2% over the two quarters. The uncertainty hanging over a forecast of GDP over two quarters, which we have pointed out earlier, is gradually being lifted in an unfavourable sense as the negative information builds up. In particular, the climate in industry continued to worsen in January at a higher rate than expected last month.

The deteriorating business environment is taking precedence over the more positive elements that up to now blunted the impact of the sovereign debt crisis on growth, namely, the decline in the euro against the dollar in the third quarter of 2011 and the interruption of the dive by the CAC40 stock market index in the fourth quarter. If this same dynamic repeats in February and March, France would be unlikely to escape a recession in the usually accepted meaning of the term, *i.e.* the occurrence of two consecutive quarters of falling GDP.



* Estimation is implemented with a dummy variable equal to 1 on quater 1, 2009.

In %, Q/Q -1, chained index, 2005 base

	2010	2011				2012
	Q4	Q1	Q2	Q3	Q4	Q1
Nationale accounts	0,4	0,9	-0,1	0,3	-	-
Indicator	0,8	0,9	0,4	0,0	-0,3	0,1

Sources : INSEE, OFCE forecasts and calculations.

Next update on 29 February 2012