

Dispersion of company markups internationally

[Stéphane Auray](#) and [Aurélien Eyquem](#)

The strong globalization of economies has increased interest in the importance of markups for companies with an international orientation. A markup is defined as the difference between the marginal cost of production and the selling price. Empirical evidence is accumulating to show that these markups have increased significantly in recent years (Autor, Dorn, Katz, Patterson, and Reenen, 2017; Loecker, Eeckhout, and Unger, 2020) and that large corporations account for a growing share of the aggregate fluctuations (Gabaix, 2011). Moreover, the dispersion of markups is considered in the literature as a potential source of a misallocation of resources – capital and labour – in both economies considered to be closed to international trade (see Restuccia and Rogerson, 2008, or Baqaee and Farhi, 2020) and economies considered to be open to trade (Holmes, Hsu and Lee, 2014, or Edmond, Midrigan and Xu, 2015). Finally, it has recently been shown by Gaubert and Itskhoki (2020) that these markups are a key determinant of the granular origin – i.e. linked to the activity of big exporters – of comparative advantages, or in other words, they may be a

determinant of trade competitiveness.

In a recent paper (Auray and Eyquem, 2021), we introduce a dispersion of profit margins by assuming strategic pricing via Bertrand-type competition in a two-country model with endogenous variety effects and international trade along the lines of Ghironi and Melitz (2005). Our aim is to understand the interaction between these margins, firm productivity and entry-and-exit phenomena in domestic and foreign markets. If there are distortions in the allocation of resources, as is usually the case in these models, our corollary objective is to study the implementation of optimal fiscal policy.

In models with heterogeneous firms such as Ghironi and Melitz (2005), firms are assumed to be heterogeneous in terms of individual productivity. The most productive firms are more likely to enter markets, because they are better able to pay fixed entry costs, whether in local or export markets. Moreover, because these firms are more efficient, their production costs are lower, which allows them to capture larger market shares. These effects, which seem relatively intuitive, have already been widely validated empirically.

In general, the introduction of strategic pricing behaviour allows firms with larger market shares to benefit from greater price-setting power, which leads them to charge higher markups – it being understood that the resulting selling prices may be lower than those of their competitors. A growing literature on international trade emphasises the importance of this kind of strategic behaviour and the resulting dispersion of markups for determining patterns of trade openness and their sectoral composition (see, for example, Bernard, Eaton, Jensen and Kortum, 2003; Melitz and Ottaviano, 2008; Atkeson and Burstein, 2008) but also for the magnitude of the welfare gains associated with trade (Edmond, Midrigan and Xu, 2015). Indeed, in addition to the usual impact of openness to trade, it could also reduce the adverse effects of the dispersion of markups through the resulting increase in competition, thereby boosting its positive effects.

First, as expected, when fiscal policy is passive, Bertrand competition generates a distribution of markups such that firms that are larger – hence the more productive firms – offer lower prices, attract larger market shares and obtain higher profit margins. Moreover, the mechanism for the selection of exporting firms described by Melitz (2003) implies that these firms are

more productive and therefore charge higher markups. These results are intuitive and consistent with the observed distribution of markups (see Holmes, Hsu, and Lee, 2014).

Second, we characterize the optimal allocation of resources and show how it can be implemented. The best possible equilibrium fully corrects for price distortions and implies a zero dispersion of markups and a near zero level of markups. It is implemented, as is often the case in this literature, by generous subsidies that cancel out markups while preserving the incentive for firms to enter domestic and export markets, i.e. by allowing them to cover the fixed costs of entry. This first-order equilibrium can be achieved using a combination of subsidies for a firm's specific sales, a tax scheme on profits that differentiates between non-exporting and exporting firms, and a specific labour tax.

In a similar model where markups are assumed to be the same for all firms, the best equilibrium is the same but, in contrast, much easier to implement through a single policy instrument: a uniform and time-varying subsidy for all firms.

In both cases, the gains associated with such policies are very large compared to the laissez-faire case, representing a potential increase in household consumption

of around 15%. However, given the complexity of implementing a scheme with heterogeneous markups and a cost to the public purse of over 20% of GDP – implementation requires large amounts of subsidies, whether the markups are heterogeneous or homogeneous – we consider second-order alternative policies, where the number of policy instruments is limited and the government budget must be balanced. We find that these restrictions significantly reduce the ability of policy makers to cut the welfare losses associated with the laissez-faire equilibrium, and that only one-third of the potential welfare gains can be implemented in this case.

Third, while the first-order allocations are independent of the degree of pricing behaviour, we find that the welfare losses observed in the laissez-faire equilibrium are lower when markups are heterogeneous and higher on average than the markups observed in the absence of strategic pricing. While this may seem surprising, the result can be rationalized by considering the effects of markup dispersion on both the intensive markup – the quantity produced per firm – and the extensive markup – the number of firms in the markets. Indeed, Bertrand competition implies that the dispersion and the average level of markups are positively related. Markup dispersion thus increases the level of markups with two effects. On the one

hand, all other things being equal, higher markups reduce the quantity produced by each firm – the intensive markup – and induce a misallocation of resources that generates welfare losses. On the other hand, higher markups imply higher expected profits for potential entrants, which stimulates entry and thus increases the number of existing firms – the extensive markup. According to our model, the welfare gains associated with the second effect dominate the welfare losses associated with the first effect. The result therefore implies that the dispersion of markups can generate welfare gains, at least when no other tax or industrial policy is pursued.

Fourth, while the previous results mainly focus on the implications of our model and the associated optimal policies on average over time, we also study their dynamic properties. Within the framework of passive (*laissez-faire*) fiscal policies, when the economy experiences aggregate productivity shocks – technological, for instance – the model behaves broadly like the Ghironi and Melitz (2005) model. An original prediction of our model is that markups are globally countercyclical while export markups are procyclical. The optimal policy involves adjustments in tax rates in order to reverse this trend, to align all markups over the business cycle and to make all markups procyclical.

These results are consistent with the findings of studies that focus on the optimal cyclical behaviour of markups with heterogeneous firms in closed (Bilbiie, Ghironi and Melitz, 2019) and open (Cacciatore and Ghironi, 2020) economy models. However, conditionally on aggregate productivity shocks, the dispersion of markups has little effect quantitatively compared to a similar model with homogeneous markups.

Finally, in the spirit of Edmond, Midrigan and Xu (2015), we conducted a trade liberalization experiment whereby the costs of trade gradually and permanently decline to almost zero. We find that the long-run welfare gains are much larger when the policy implemented is optimal. On the other hand, the laissez-faire equilibrium indicates that short-run welfare gains are affected by markup dispersion. Indeed, markup dispersion affects the dynamics of business creation resulting from trade liberalization in a critical way. As in Edmond, Midrigan and Xu (2015), markup dispersion reduces the long-run welfare gains from trade, but for a different reason: it affects the dynamism of business creation and reduces the number of firms in the long run. However, since in this case fewer resources are invested in the short run to create new companies, consumption increases more at the intensive markup in the short and medium run – less than

10 years. While the long-run welfare gains from trade integration vary from 12% to 14.5%, depending on the calibration, the short-run welfare gains with heterogeneous markups can be up to 3% larger than with homogeneous markups.

The conclusions of this study lead to an approach to corporate profit margins that is more nuanced than that usually found in the literature. Indeed, while the markups and their dispersion do have negative effects on the economy, they also have an important role to play in the phenomena of business entry and participation in international markets. Our work is a complement to a strictly microeconomic approach to industrial policy issues, which would conclude unequivocally that the market power at the origin of these markups is harmful. As such, in the manner of Schumpeter, this calls for a more balanced view of the role of company markups in modern economies, which would show a tension between distortions of competition and incentives to business creation.

Bibliographic references

Auray Stéphane and Aurélien Eyquem, 2021, "The dispersion of Mark-ups in an Open Economy".

Autor David, David Dorn, Lawrence F. Katz, Christina Patterson and John Van Reenen, 2017, "Concentrating on the Fall of the Labor Share", *American Economic Review*, 107 (5):180-185.

Baqae David Rezza and Emmanuel Farhi, 2020, "Productivity and Misallocation in General Equilibrium", *The Quarterly Journal of Economics*, 135 (1):105-163.

Berman N., P. Martin and T. Mayer, 2012, "How do Different Exporters React to Exchange Rate Changes?", *Quarterly Journal of Economics*, 127 (1):437-492.

Bernard Andrew B., Jonathan Eaton, J. Bradford Jensen and Samuel Kortum, 2003, "Plants and Productivity in International Trade", *American Economic Review*, 93 (4):1268-1290.

Bilbiie Florin O., Fabio Ghironi and Marc J. Melitz, 2008, "Monetary Policy and Business Cycles with Endogenous Entry and Product Variety", In *NBER Macroeconomics Annual 2007*, Volume 22, NBER Chapters. National Bureau of Economic Research, Inc, 299-353.

Bilbiie Florin O., Fabio Ghironi and Marc J. Melitz, 2019, "Monopoly Power and Endogenous Product Variety: Distortions and Remedies", *American Economic Journal: Macroeconomics*, 11 (4):140-174.

Cacciatore Matteo, Giuseppe Fiori and Fabio Ghironi, 2016, "Market Deregulation and Optimal Monetary Policy in a Monetary Union", *Journal of International Economics*, 99 (C):120-137.

Cacciatore Matteo and Fabio Ghironi, 2020, "Trade, Unemployment, and Monetary Policy", *NBER Working Paper*, 27474.

Edmond Chris, Virgiliu Midrigan and Daniel Yi Xu, 2015, "Competition, Markups, and the Gains from International Trade", *American Economic Review*, 105(10):3183-3221.

Etro Federico and Andrea Colciago, 2010, "Endogenous Market Structure and the Business Cycle", *Economic Journal*, 120(549):1201-1233.

Gabaix Xavier, 2011, "The Granular Origins of Aggregate Fluctuations", *Econometrica*, 79(3):733-772.

Gaubert Cecile and Oleg Itskhoki, 2020, "Granular Comparative Advantage", *Journal of Political Economy* (forthcoming).

Ghironi F. and M. J. Melitz, 2005, "International Trade and Macroeconomic Dynamics with Heterogeneous Firms", *Quarterly Journal of Economics*, 120(3):865-915.

Holmes Thomas J., Wen-Tai Hsu and Sanghoon Lee, 2014, "Allocative Efficiency, Mark-ups, and the Welfare Gains from Trade", *Journal of International Economics*, 94(2):195-206.

Loecker Jan De, Jan Eeckhout and Gabriel Unger, 2020, "The Rise of Market Power and the Macroeconomic Implications ["Econometric Tools for Analyzing Market Outcomes"]", *The Quarterly Journal of Economics*, 135(2):561-644.

Melitz Marc J., 2003, "The Impact of Trade on Intra-Industry Reallocations and Aggregate Industry Productivity", *Econometrica*, 71(6):1695-1725.

Melitz Marc J. and Gianmarco I. P. Ottaviano, 2008, "Market Size, Trade, and Productivity", *Review of Economic Studies*, 75(1):295-316.

Restuccia Diego and Richard Rogerson, 2008, "Policy Distortions and Aggregate Productivity with Heterogeneous

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].

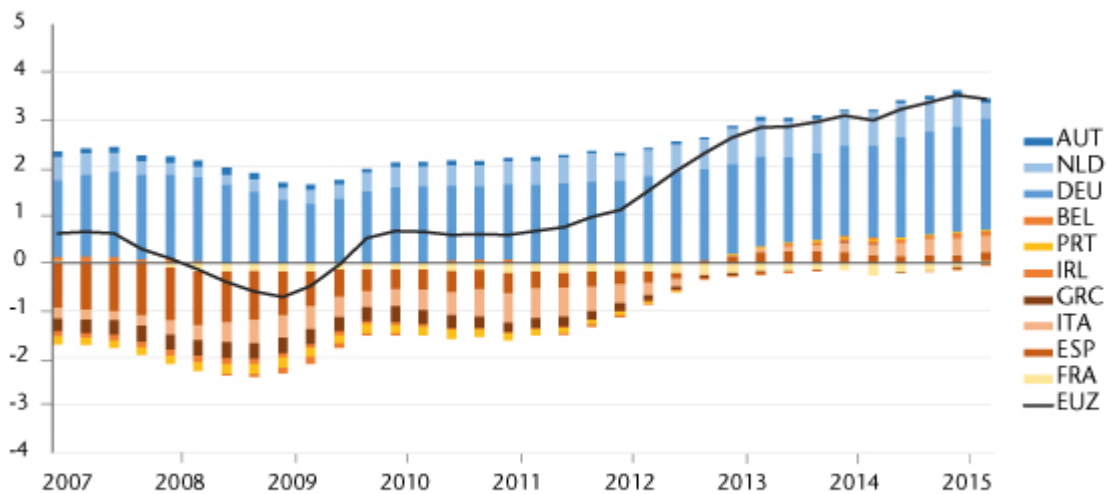
What strategy for internally rebalancing the euro zone?

By [Sébastien Villemot](#) and [Bruno Ducoudré](#)

The euro zone has made significant efforts to reduce its trade imbalances since the outbreak of the financial crisis. In 2009, only Germany, the Netherlands and Austria had a current account surplus, while all the other countries, in particular France, Italy and Spain, ran current account deficits, resulting in a deficit for the zone as a whole (-0.7% of GDP). Five years later, in 2014, the situation had changed radically. The euro zone had a large current account surplus

-3.4% of GDP – with almost all the countries running a surplus (figure).

Figure. Current account in % of euro area GDP



Note: The upward shift in the current account is the result of lower prices for raw materials, low internal demand, and unconventional monetary policy.

Source: National accounts, ECB, iAGS 2016 calculations. The current account is cumulated over 4 quarters.

It should nevertheless not be concluded that the euro zone has corrected its trade imbalances, as there are still several reasons for concern. Firstly, some of the current account surplus is cyclical, particularly in southern Europe, due to depressed domestic demand. Secondly, the magnitude of the euro zone's current account surplus comes with deflationary risks: while for the moment the ECB's expansionary monetary policy is helping to contain upward pressure on the euro, this pressure will eventually materialize once the monetary cycle enters a phase of normalization, leading to imported deflation and losses in competitiveness vis-à-vis the rest of the world.

More importantly, the reversal of the euro zone's current account position vis-à-vis the rest of the world does not mean that the zone's internal imbalances have been corrected. The analysis that we made in the [2016 iAGS report](#) shows that there are still significant imbalances, although they have diminished since the start of the crisis.

Based on a model to simulate changes in the current accounts of the euro zone countries in terms of price competitiveness differentials [1], we calculated the nominal adjustments

within the euro zone needed to achieve balanced current accounts for all the countries. A balanced position is defined here as stabilization of the net external position, at a level compatible with EU procedures (i.e. greater than -35% of GDP), and with the output gaps closed in all the countries.

The table below shows the results of these simulations and helps to take stock of the adjustments made since the beginning of the crisis as well as the adjustments still needed relative to Germany, which is used as a reference point.

Table. Nominal adjustments needed to achieve balanced current accounts relative to Germany

| | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 |
|-------------|-------|-------|-------|-------|-------|-------|-------|
| Germany | 0,0 | 0,0 | 0,0 | 0,0 | 0,0 | 0,0 | 0,0 |
| Austria | 20,2 | 15,9 | 13,3 | 1,0 | 2,8 | 6,5 | 1,4 |
| Belgium | -32,9 | -29,9 | -15,7 | -30,7 | -23,8 | -22,2 | -23,2 |
| Spain | -46,8 | -32,8 | -30,6 | -29,9 | -21,9 | -15,3 | -18,5 |
| Finland | 4,8 | -1,2 | -7,9 | -29,0 | -30,7 | 28,4 | -24,7 |
| France | -18,9 | -16,1 | -16,6 | -19,1 | -19,8 | -15,2 | -19,1 |
| Greece | -89,1 | -87,9 | -80,8 | -73,0 | -48,5 | -39,7 | -39,8 |
| Ireland | -26,8 | -28,7 | -25,6 | -26,9 | -28,7 | -19,8 | -14,9 |
| Italy | -29,2 | -25,2 | -32,7 | -31,9 | -19,9 | -12,0 | -9,9 |
| Netherlands | -4,5 | 6,1 | 6,2 | 4,4 | 5,1 | 6,8 | 0,8 |
| Portugal | -68,5 | -65,3 | -59,2 | -43,1 | -30,9 | -17,1 | -21,4 |

Source: Authors' calculations.

There were still significant nominal misalignments in the euro zone in 2014. Several groupings of countries can be identified. Austria and the Netherlands are on level footing with Germany. In contrast, Greece must undergo a nearly 40% depreciation compared to Germany, despite its previous sacrifices; even if the Greek current account is close to balanced today, this is due to the output gap that has widened considerably (-12.6% in 2014 according to the OECD) and artificially improved the external trade balance by shrinking domestic demand. Between these two extremes lies a group of countries, including France, Spain, Portugal, Belgium and Finland, which need a depreciation of about 20% relative to Germany. Italy meanwhile is in a somewhat better position, with a relative depreciation of about 10% required, thanks to its current account surplus (1.9% of GDP in 2014) and a

relatively favourable net international investment position (-27.9% of GDP).

These nominal imbalances cannot be solved by changes in exchange rates, since the countries all share the same currency. The adjustment thus has to be made through relative price movements, i.e. by differentials in inflation rates between countries. Thus, inflation in Germany (and the Netherlands and Austria) needs to stay higher for a while than in the intermediate group, which itself needs to be higher than in Greece. And, given the importance of wages in determining the price of value added, this outcome will be achieved mainly by differential changes in nominal unit labour costs.

There are several possible ways to achieve this goal. The one that has been followed so far has been to make the reduction of labour costs the norm, based on a non-cooperative race for competitiveness. With Germany making extensive efforts to hold down its prices and wages, other countries could adjust only by cutting their own costs, whether through wage cuts (as in Greece and Spain) or by lowering corporate tax (as in France). While these strategies have indeed helped to reduce imbalances in the zone since 2008, as our table shows, the adjustment is still far from complete, and the economic cost has been high. Lowering wages in the southern European countries undermined demand, and therefore business, while deflationary pressures were strengthened and are still threatening, despite the ECB's energetic policies.

Another approach would be to coordinate wage developments in the euro zone countries in order to allow the ECB to meet its inflation target of 2%, while making nominal readjustments. Each country would set a target for changes in its unit labour costs. Countries that are currently undervalued (Germany, Netherlands, Austria) would set a target of over 2%, while overvalued countries would set a target that was positive, but below 2%. Once the imbalances were absorbed, which would

require a number of years, the targets could be harmonized to 2%.

The relative adjustment of unit labour costs could also be made through differential gains in productivity. This point highlights the importance of investment stimulus policies in the euro zone, so as to improve the productivity and competitiveness of countries that need to make significant nominal adjustments. Using this approach to adjust unit labour costs would release some of the downward pressure on wages and domestic demand in the euro zone.

A policy like this would represent a profound change in the economic governance of the euro zone, and would call for enhanced cooperation. This is, however, the price for maintaining the cohesion of the monetary union.

[\[1\]](#) Although non-price competitiveness also plays a role in trade dynamics, we have ignored it due to lack of an adequate quantitative measure.

Should Germany's surpluses be punished?

By [Henri Sterdyniak](#)

On the procedure for macroeconomic imbalances

Since 2012, every year the European Commission analyses the macroeconomic imbalances in Europe: in November, an alert mechanism sets out any imbalances, country by country. Countries with imbalances are then subjected to an in-depth review, leading to recommendations by the European Council

based on Commission proposals. With respect to the euro zone countries, if the imbalances are considered excessive, the Member state is subject to a macroeconomic imbalance procedure (MIP) and must submit a plan for corrective action, which must be approved by the Council.

The alert mechanism is based on a scoreboard with five indicators of external imbalances [\[1\]](#) (current account balance, net international investment position, change in the real effective exchange rate, change in export market shares, change in nominal unit labour costs) and six indicators of internal imbalances (unemployment rate, change in housing prices, public debt, private debt, change in financial sector liabilities, credit flows to the private sector). An alert is issued when an indicator exceeds a certain threshold, e.g. 60% of GDP for public debt, 10% for the unemployment rate, -4% (+6% respectively) for a current account deficit (respectively surplus).

On the one hand, this process draws lessons from the rise in imbalances recorded before the crisis. At the time of the Maastricht Treaty, the negotiators were convinced that economic imbalances could only come from the way the State behaved; it therefore sufficed to set limits on government deficits and debt. However, between 1999 and 2007, the euro zone saw a steep rise in imbalances due mainly to private behaviour: financial exuberance, securities and property bubbles, swollen foreign deficits in southern Europe, and a frantic search for competitiveness in Germany. These imbalances became intolerable after the financial crisis, requiring painful adjustments. The MIP is thus designed to prevent such mistakes from happening again.

On the other hand, the analysis and the recommendations are made on a purely national basis. The Commission does not propose a European strategy that would enable the countries to move towards full employment while reabsorbing intra-zone imbalances. It does not take into account inter-country

interactions when it demands that each country improve its competitiveness while cutting its deficit. The Commission's recommendations are a bit like the buzzing of a gadfly when it proclaims that Spain should reduce its unemployment, France should improve its competitiveness, etc. Its proposals are based on a myth: it is possible to implement policies on public deficit and debt reduction, on wage austerity and on private debt reduction, while offsetting their depressive impact on growth and employment through structural reforms, which are the *deus ex machina* of the fable. This year there is also, fortunately, the European Fund for strategic investments (the 315 billion euros of the Juncker plan), meaning that the Commission can claim to be giving "a coordinated boost to investment", but this plan represents at most only 0.6% of GDP over 3 years; its actual magnitude is thus problematic.

For 2015, all the countries in the European Union have at least one imbalance according to the scoreboard [\[2\]](#) ([see here](#)). France has lost too much of its export market share and has an excessive public debt and private debt. Germany, too, has lost too much of its export market share, its public debt is excessive and above all its current account surplus is too high. Of the 19 countries in the euro zone, seven, however, have been absolved by the Commission and 12 are subject to an in-depth review, to be published in late February. Let's take a closer look at the German case.

On Germany's surplus

A single currency means that the economic situation and policies of each country can have consequences for its partners. A country that has excessive demand (due to its fiscal policy or to financial exuberance that leads to an excess of private credit) and is experiencing inflation (which can lead to a rise in the ECB's interest rate), thereby widening the euro zone's deficit (which may contribute to a fall in the euro), requires its partners to refinance it more or less automatically (in particular via TARGET2, the system

of automatic transfers between the central banks of the euro zone); its debt can thus become a problem.

This leads to two observations:

1. Larger countries can have a more harmful impact on the zone as a whole, but they are also better able to withstand the pressures of the Commission and its partners.

2. The harm has to be real. Thus, a country that has a large public deficit will not harm its partners, on the contrary, if the deficit makes up for a shortfall in its private demand.

Imagine that a euro zone country (say, Germany) set out to boost its competitiveness by freezing its wages or ensuring that they rise much more slowly than labour productivity; it would gain market share, enabling it to boost its growth through its trade balance while reining in domestic demand, to the detriment of its euro zone partners. The partners would see their competitiveness deteriorate, their external deficits widen, and their GDP shrink. They would then have to choose between two strategies: either to imitate Germany, which would plunge Europe into a depression through a lack of demand; or to prop up demand, which would lead to a large external deficit. The more a country manages to hold down its wages, the more it would seem to be a winner. Thus, a country running a surplus could brag about its good economic performance in terms of employment and its public account and trade balances. As it is lending to other member countries, it is in a strong position to impose its choices on Europe. A country that is building up deficits would sooner or later come up against the mistrust of the financial markets, which would impose high interest rates on it; its partners may refuse to lend to it. But there is nothing stopping a country that is accumulating surpluses. With a single currency, it doesn't have to worry about its currency appreciating; this corrective mechanism is blocked.

Germany can therefore play a dominant role in Europe without having an economic policy that befits this role. The United States played a hegemonic role at the global level while running a large current account deficit that made up for the deficits of the oil-exporting countries and the fast-growing Asian countries, in particular China; it balanced global growth by acting as a “consumer of last resort”. Germany is doing the opposite, which is destabilizing the euro zone. It has automatically become the “lender of last resort”. The fact is that Germany’s build-up of a surplus must also be translated into the build-up of debt; it is therefore unsustainable.

Worse, Germany wants to continue to run a surplus while demanding that the Southern European countries repay their debts. This is a logical impossibility. The countries of Southern Europe cannot repay their debts unless they run a surplus, unless Germany agrees to be repaid by running a deficit, which it is currently refusing to do. This is why it is legitimate for Germany to be subject to an MIP – an MIP that must be binding.

The current situation

In 2014, Germany’s current account surplus represented 7.7% of GDP (or 295 billion euros, Table 1); for the Netherlands the figure was 8.5% of GDP. These countries represent an exception by continuing to run a strong external surplus, while most countries have come much closer to equilibrium compared with the situation in 2007. This is in particular the case of China and Japan. Germany now has the highest current account surplus of any country in the world. Its surplus would be even 1.5 GDP points higher if the euro zone countries (particularly those in Southern Europe) were closer to their potential output. Thanks to Germany and the Netherlands, the euro zone, though facing depression and high unemployment, has run a surplus of 373 billion dollars compared with a deficit of 438 billion for the United States: logically, Europe should be seeking to

boost growth not by a depreciation of the euro against the dollar, which would further widen the disparity in trade balances between the euro zone and the United States, but by a strong recovery in domestic demand. If Germany owes its surplus to its competitiveness policy, it is also benefitting from the existence of the single currency, which is allowing it to avoid a surge in its currency or a depreciation in the currency of its European partners. The counterpart of this situation is that Germany has to pay its European partners so that they remain in the euro.

Table 1. Current account balance as % of GDP

| | 2007 | 2014 |
|----------------|-------|------|
| Netherlands | 6,7 | 8,5 |
| Germany | 7,5 | 7,7 |
| Austria | 3,5 | 2,5 |
| Italy | -2,4 | 1,8 |
| Belgium | 1,9 | -0,1 |
| Spain | -10,0 | -0,1 |
| Portugal | -10,1 | -0,2 |
| Finland | 4,1 | -1,4 |
| France | -1,0 | -1,8 |
| Greece | -14,6 | -2,0 |
| Euro zone | 0,2 | 2,8 |
| United Kingdom | -2,2 | -4,1 |
| Denmark | 1,4 | 6,5 |
| Sweden | 9,3 | 5,9 |
| United States | -5,0 | -2,2 |
| Japan | 4,9 | 0,1 |
| China | 10,7 | 3,3 |

Source : European economy.

There are three possible viewpoints. For optimists, Germany's surplus is not a problem; as the country's population ages, Germans are planning for retirement by accumulating foreign assets, which will be used to fund their retirements. The

Germans prefer investing abroad rather than in Germany, which they feel is less profitable. These investments have fuelled international financial speculation (many German financial institutions suffered significant losses during the financial crisis due to adventurous investments on the US markets or the Spanish property market); now they are fuelling European debt. Thus, through the TARGET2 system, Germany's banks have indirectly lent 515 billion euros to other European banks at a virtually zero interest rate. Out of its 300 billion surplus, Germany spends a net balance of only 30 billion on direct investment. Germany needs a more coherent policy, using its current account surpluses to make productive investments in Germany, Europe and worldwide.

Another optimistic view is that the German surplus will decline automatically. The ensuing fall in unemployment would create tensions on the labour market, leading to wage increases that would also be encouraged by the establishment of the minimum wage in January 2015. It is true that in recent years, German growth has been driven more by domestic demand and less by the external balance than prior to the crisis (Table 2): in 2014, GDP grew by 1.2% in Germany (against 0.7% in France and 0.8% for the euro zone), but this pace is insufficient for a solid recovery. The introduction of the minimum wage, despite its limitations (see [A minimum wage in Germany: a small step for Europe, a big one for Germany](#)), will lead to a 3% increase in payroll in Germany and for some sectors will reduce the competitiveness gains associated with the use of workers from Eastern Europe. Even so, by 2007 (relative to 1997), Germany had gained 16.3% in competitiveness compared to France (26.1% compared to Spain, Table 3); in 2014, the gain was still 13.5% relative to France (14.7% relative to Spain). A rebalancing is taking place very slowly. And in the medium term, for demographic reasons, the need for growth in Germany is about 0.9 points lower than the need in France.

Table 2. Contributions to GDP by domestic demand and the external balance

| | GDP | | Domestic demand | | External balance | |
|-----------|-----------|-----------|-----------------|-----------|------------------|-----------|
| | 1998-2007 | 2007-2014 | 1998-2007 | 2007-2014 | 1998-2007 | 2007-2014 |
| Germany | 1,60 | 0,70 | 0,85 | 0,70 | 0,75 | 0,00 |
| France | 2,25 | 0,30 | 2,60 | 0,35 | -0,35 | -0,05 |
| Spain | 3,85 | -0,70 | 4,60 | -2,10 | -0,75 | 1,40 |
| Italy | 1,50 | -1,30 | 1,65 | -2,80 | -0,15 | 1,50 |
| Euro zone | 2,30 | -0,10 | 2,20 | -0,55 | 0,10 | 0,45 |

Table 3. Indicator of relative unit labour costs

Base 100 = 1997

| | 2007 | 2013 |
|--------------------------|-------|-------|
| Euro zone | 99,0 | 105,2 |
| Germany | 86,2 | 90,4 |
| Austria | 94,2 | 98,1 |
| Finland | 98,9 | 109,3 |
| France | 103,0 | 104,5 |
| Belgium | 103,2 | 107,8 |
| Italy | 107,9 | 111,9 |
| Portugal | 110,3 | 101,8 |
| Netherlands | 108,2 | 111,9 |
| Greece | 110,5 | 98,3 |
| Spain | 116,6 | 106,0 |
| Ireland | 124,1 | 106,1 |
| <i>Outside euro zone</i> | | |
| United Kingdom | 122,2 | 104,1 |
| Sweden | 92,4 | 98,6 |

Source : European economy.

Furthermore, a more pessimistic view argues that Germany should be subject to a macroeconomic imbalance procedure to get it to carry out a macroeconomic policy that is more favourable to its partners. The German people should benefit more from its excellent productivity. Four points need to be emphasised:

1. In 2014, Germany recorded a public surplus of 0.6 percent of GDP, which corresponds, according to the Commission's

estimates, to a structural surplus of about 1 GDP point, *i.e.* 1.5 points more than the target set by the Fiscal Compact. At the same time, spending on public investment was only 2.2 GDP points (against 2.8 points in the euro zone and 3.9 points in France). The country's public infrastructure is in poor condition. Germany should increase its investment by 1.5 to 2 additional GDP points.

2. Germany has undertaken a programme to reduce public pensions, which has encouraged households to increase their retirement savings. The poverty rate has increased significantly in recent years, reaching 16.1% in 2014 (against 13.7% in France). A programme to revive social protection and improve the prospects for retirement [\[3\]](#) would boost consumption and reduce the savings rate.

3. Germany should restore a growth rate for wages that is in line with growth in labour productivity, and even consider some catch-up. This is not easy to implement in a country where wage developments depend mainly on decentralized collective bargaining. This cannot be based solely on raising the minimum wage, which would distort the wage structure too much.

4. Finally, Germany needs to review its investment policy [\[4\]](#): Germany should invest in Germany (public and private investment); it should invest in direct productive investment in Europe and significantly reduce its financial investments. This will automatically reduce its unproductive investments that go through TARGET2.

Germany currently has a relatively low rate of investment (19.7% of GDP against 22.1% for France) and a high private sector savings rate (23.4% against 19.5% for France). This should be corrected by raising wages and lowering the savings rate.

As Germany is relatively close to full employment, a

significant part of its recovery will benefit its European partners, but this is necessary to rebalance Europe. Any policy suggested by the MIP should require a change in Germany's economic strategy, which it considers to be a success. But European integration requires that each country considers its choice of economic policy and the direction of its growth model while taking into account European interdependencies, with the aim of contributing to balanced growth for the euro zone as a whole. An approach like this would not only benefit the rest of Europe, it would also be beneficial to Germany, which could then choose to reduce inequality and promote consumption and future growth through a programme of investment.

[1] For more detail, see [European Commission \(2012\) : "Scoreboard for the surveillance of macroeconomic imbalances", *European Economy Occasional Papers* 92.](#)

[2] This partly reflects the fact that some of these indicators are not relevant: almost all European countries are losing market share at the global level; changes in the real effective exchange rate depend on trends in the euro, which the countries do not control; the public and private debt thresholds were set at very low levels; etc.

[3] The ruling coalition has already raised the pensions of mothers and allowed retirement at age 63 for people with lengthy careers, but this is timid compared with previous reforms.

[4] The lack of public and private investment in Germany has been denounced in particular by the economists of the DIW, see for example: "Germany must invest more for future", *DIW Economic Bulletin* 8.2013 and *Die Deutschland Illusion*, Marcel Fratzscher, October 2014.

Inequality and Global Imbalances: reconsidering old ideas to address new problems

by [Jean-Luc Gaffard](#) and [Francesco Vona](#)

The main challenge of the Bretton Woods agreements was to reconcile social justice and full employment to be achieved through domestic policies with an international discipline and progress toward trade liberalization (Rodrick 2011). After more than six decades, such division of objectives between international and domestic policies has been questioned by the current economic crisis, characterized by high debt levels, remarkable global imbalances and low global demand. It can hence be useful to reopen an old debate by reconsidering ideas that were discarded in the past, such as the proposal of Keynes to create global demand stabilizers. Our suggestion is that a global stabilizer that prescribes surplus countries to gradually increase their wages can have both a direct positive effect on global demand, without increasing public debts, and an indirect one by favouring a reduction in income disparities.

The structural lack of global demand represents unquestionably the key constraint to exit from the great recession. Worldwide, sluggish demand appears as the resultant of two quite independent factors, a *constraint* and a *political choice*. The choice is of those countries, especially emerging ones plus Germany, that build up their wealth on export-lead growth using a mix of wage moderation and clever firms' industrial strategies. The public debt constraint, instead, impacts upon the possibility to expand demand of the majority

of developed countries. As these countries should enforce restrictive fiscal policies to prevent default, their only chance to expand demand impinges on redistribution in favour of poorer households who consume a larger fraction of their incomes.

The current debate on this matter is misleadingly at best, oscillating between the usual Scylla and Charybdis of more or less state intervention. From a standard Keynesian viewpoint, the bottleneck in global demand is the consequence of neo-liberal policies, which in Europe are worsened by the opposition of Nordic countries against large scale public funded EU programs, possibly financed with EU bonds. From an orthodox viewpoint, which relies upon the belief in a trickle-down mechanism (increase the wealth of the rich eventually benefit all), the crisis represents an opportunity to remove the last barriers to a full liberalization of labor and goods markets. These barriers would prevent EU economies to raise their competitiveness with respect to their new emerging competitors, the BRICS (Brazil- Russia- India-China- South Africa). While Keynesians are overoptimistic in their belief that more public expenditures will succeed in ensuring a fresh start to our feeble economies, orthodox economics neglects by assumption the problem of global demand. In particular, it ignores that a race for competitiveness based on further wage moderation and welfare state cuts would only amplify the global demand constraint.

It is well documented that, in last thirty years, living conditions and real wages of both low and middle skilled workers decreased substantially while profits and, in general, earnings of top 1% earners increased impressively, especially since the 2000s (Piketty and Saez 2006, Eckstein and Nagypál 2004, OECD 2011). The widening in incomes has been especially large in the US and Anglo-Saxon countries where deregulated labour markets allow wage to adjust downward, but also affected European economies in other forms such as

structurally higher unemployment rates and higher profit shares (Krugman 1994). The excessive decrease of the median wage with respect to the average productivity created a fundamental wedge between demand, which is more sensible to wage changes than to changes in profit opportunities, and supply, for which the opposite holds. Globalization plays a key role in increasing inequality between profits and wages as increases in capital mobility were not accompanied in parallel increases in international labour mobility (Stiglitz 2012). Only the joint working of increasing debt (both private and public) and of productivity improvements related to new information & communication technologies prevented the demand deficit to emerge earlier together with the dysfunctional role of excessive inequality (see Stiglitz 2012, Fitoussi and Saraceno 2011, and on the role of technical change Patriarca and Vona 2013). Global imbalances played a key role in maintaining high the level of global demand as long as savings of countries with commercial surpluses (e.g. China) were borrowed to households and governments in countries with commercial deficits (e.g. the US). By mitigating the consequence of on excessive inequality, they keep also under control the political pressure for redistribution. But, as we have seen, they are a source of macroeconomic instability. In fact, the saving glut in export-led economies creates a mass of liquidity in search of investment opportunities that increases the likelihood of asset price bubbles, especially in presence of an inadequate and oversized financial sector (Corden 2011).

Leaving ethical considerations aside, the concern for rising inequality in western economies would have been irrelevant for overall growth provided the lower demand there was compensated by a growing demand in emerging and export-led countries, such as China. Unfortunately, the compensation did not and is not expected to take place soon for at least two reasons.

First, oligarchies in emerging economies (especially China)

found it convenient to sustain global demand indirectly, rather than through wage increases proportional to productivity, by investing large current-account surpluses in the US financial market and so financing US consumers. The indirect empirical support for this argument is that inequality increased in China too since the market friendly reform started. Especially inequality in factor shares, i.e. between profits and wages, increased substantially since the 1995 with the labour share falling by between 7.2% and 12.5% depending on the accounting definitions used (Bai and Qian 2010).

Secondly, a historical comparison of catching-up episodes can help shed light on the origin of the global demand glut. Between the second half of the 19th century and the beginning of the 20th century, the economic catching-up of both Germany and the US with the UK was soon followed by convergence in living standards and wages (Williamson 1998). Nowadays, the economic catching-up of China is much slower in terms of convergence of wages and living conditions. By way of example, China's GDP per capita increased from 5.7% to 17.2% of US GDP per capita from 1995 to 2010 (source: World Penn Tables), while the hourly labour compensation cost is also increasing but reached only 4.2% of the US labour compensation cost in 2008 (source: Bureau of Labor Statistics Data). This gap between GDP per capita and unit labour cost in China clearly shows that the catching-up in terms of workers' living conditions is far slower than the economic catching-up.

The reasons for this slow wage convergence deserve further investigations and have probably to do with factors affecting institutional changes that support redistribution from profits to wages, including culture and tax progressivity (Piketty and Qian 2009), in the catching up country. Certainly, the size of Chinese population relative to the world population did not help in fastening these institutional changes. By simple assumptions of standard bargaining theory, bargaining power

depends on the outside option that, for workers, is limited by existence of a large 'reserve army' willing to work for extremely low wages. One can then argue that the larger the reserve army, the longer it takes to reduce the downward pressure on the workers' wages in the advanced part of the economy. De facto, the wage convergence has been much faster in previous catching-up episodes since the labour constraint becomes stringent sooner due to the smaller size of the population, allowing workers to fight for better conditions and higher wages. In a nutshell, an excessively large reserve army in the countryside prevents both wages to increase and democratic reforms to take off in China, thus creating a wedge between the timing of economic growth and the one of political reforms, required to rebalance demand and supply.

Not only the slow wage convergence of catching-up country causes persistent global imbalances between demand and supply, it is also the essential reason of the obstacles faced to reduce inequality in western countries. First, implementing redistributive policies and increases in real wages are likely to further reduce competitiveness and to bring about a substantial investment outflows. Second, the trend of delocalizing production abroad can have forced workers to accept lower wages; an effect that is difficult to correlate empirically with observable proxies of globalization such as trade or investment outflows.. While empirical analyses looking at the last 30 years of the 20st century concur that globalization was not the main driver of inequality increases, recent evidence shows that: (i) Outsourcing had a negative impact on middle and low skill wages and employment levels in developed countries, especially in the last decade (Firpo, Fortin and Lemieux 2011); (ii) The effect of trade on inequality can be underestimated due to production fragmentation (Krugman 2008).

Global imbalances are also likely to create political obstacles to policies aimed at reducing inequality. An overs-

sized financial sector contributed to increase earnings of the top 1% of the population and so their lobbying power. This allowed these super-rich to heavily influence political decisions making their rents higher, especially through a massive reduction of tax progressivity (Fitoussi and Saraceno 2012) and other opaque channels (e.g. fiscal loopholes, Stiglitz 2012). Now, this lobby of super-rich makes it exceedingly difficult to limit the power of finance and restore fairer tax rates for financial rents and top incomes.

How to avoid the stalemate generated by global imbalances and global pressure for wage moderation? Are there in the system as it is endogenous forces that will eventually reduce global imbalances and inequality?

The first option is to wait for reforms in China. Politicians in western countries can hope in a speeding up of this process that will lead to a parallel increase in real wages and hence global demand. This will be the ideal market solution, but it is unlikely to occur in the short- and medium-run. A second possibility will consist in a large scale devaluation of western economies' currencies: Dollar, Euro and Yen. However, such a policy is likely to create a devaluation spiral, also increasing investment uncertainty. Moral suasion is unlikely to convince Chinese politicians to not devalue the Yuan as their assets in dollars and euro will depreciate substantially. A third protectionist solution is not convincing at all as it is likely to trigger a retaliation spiral paving the way for global wars. Indirect and global political interactions are an issue at stake here: nationalistic political parties and the associated protectionist policies are more likely to become popular if the timing of Chinese reforms is too slow and so the adjustment process too painful in the medium-run. A fourth solution is to resort to an old idea of John Maynard Keynes on 'global automatic stabilizers'. In the post-WWII context, Keynes proposed an international institution, the so-called

International Clearing Union' (ICU), to reabsorb both commercial surpluses and deficit, seen as equally worrisome (see also the article in Italian of A. Bramucci 2012). In particular, persistent commercial surpluses were seen as a potential source of long-term shortages of global demand. The main idea was to coordinate thorough the ICU both re-evaluations and demand expansions for the countries in surplus, and de-evaluation and control of capital movements for countries in deficit. Such an institution would go in the right direction to help reabsorbing global imbalances, but lack enforcement power to ensure that the necessary adjustments are effectively put in place.

Combining a global rule for wage adjustment with WTO sanctions can represent a more clever and reliable way to revive global demand. The first part of the proposal would consist in linking real wage growth not only to productivity growth, as proposed by A. Watt (2011), but also to commercial surplus. Conditioned to the country's level of development (so the prescribed adjustments should take into account of initial level of GDP per capita and obviously adjusted for PPPs), countries experiencing medium-term growths both in productivity and in the commercial surplus have to increase real wages. Otherwise, other countries could raise tariffs on the products exported by the country that does not follow the rule. The effective capacity to implement of the rule can be reinforced by giving to Unions, either global or local, and NGOs the power to control for specific situations where the rule is not respected, i.e. special export-oriented zone in China where labour standards are particularly low. In the case of commercial deficits, the country could be asked to follow (real) wage moderation and to put under control public deficit. In such a context, these restrictive policies would have limited harmful effects on growth for the increase in external demand that follows the wage increase in the export-oriented countries. The proposal would have also positive effect in reducing the overall level of functional inequality

worldwide, restoring a more balanced distribution between wages and profits.

Overall, the coordination of global demand and supply would be restored using a simple automatic stabilizer that will neutralize the protectionist treat and, at the same time, will relax the constraints that prevent inequality-reducing policies to be approved in western countries.

Readings:

- Bai, C., Qian, Z., 2010, "The factor income distribution in China: 1978-2007", *China Economic Review*, vol. 21(4), 650-670.
- Bramucci, A., 2012, "Gli Squilibri Europei e la Lezione di Keynes", sbilanciamoci.info.
- Corden, W., 2011, "Global Imbalances and the Paradox of Thrift", *Policy Insight No.54*, Centre for Economic Policy Research (CEPR).
- Eckstein, Z., Nagypál, É., 2004. "[The evolution of U.S. earnings inequality: 1961-2002](#)", *Quarterly Review*, Federal Reserve Bank of Minneapolis, issue Dec, 10-29.
- Firpo, S., Fortin, N., Lemieux, T., 2011, "[Occupational Tasks and Changes in the Wage Structure](#)," *IZA Discussion Papers* 5542, Institute for the Study of Labor (IZA).
- Fitoussi, J.-P., Saraceno, F., 2011, "[Inequality, the Crisis and After](#)," *Rivista di Politica Economica*, issue 1, pages 9-27.
- Krugman, P., 1994, "Past and prospective causes of high unemployment," *Proceedings*, Federal Reserve Bank of Kansas City, issue Jan, 49-98.
- Krugman, P., 2008, "Trade and Wages, Reconsidered", *Brookings Papers on Economic Activity*, vol. 39(1), 103-154.
- OECD (2011), *Divided We Stand: Why Inequality Keeps Rising* www.oecd.org/els/social/inequality.
- Ottaviano, G., Peri, G., Wright, G., 2010, "[Immigration, Offshoring and American Jobs](#)", CEPR Discussion Paper

N8078.

- Patriarca, F., Vona, F., 2013, "Structural Change and the Income Distribution: an inverted-U relationship", *Journal of Economic Dynamics and Control* forthcoming.
- Piketty, T., Qian, N., 2009, "[Income Inequality and Progressive Income Taxation in China and India, 1986-2015](#)", *American Economic Journal: Applied Economics*, vol. 1(2), 53-63.
- Piketty, T., Saez, E., 2006, "[The Evolution of Top Incomes: A Historical and International Perspective](#)", *American Economic Review*, vol. 96(2), 200-205.
- Rodrik, D., 2011, *The Paradox of Productivity*, New York: Norton & Cie.
- Stiglitz, J., 2012, *The Price of Inequality: How Today's Divided Society Endangers Our Future*, [W.W. Norton & Company](#).
- Watt, A., 2012, *La crisi europea e la dinamica dei salari. La rotta d'Europa, 1. L'economia. Sbilanciamoci!*, sbilibri, 2.
- Williamson, J. 1998. *Globalization and the Labour Market: Using history to inform policy*. in: Aghion, P., Williamson, J. 'Growth inequality and Globalization: Theory, History and Policy', Cambridge University Press.

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

By [Eric Heyer](#)

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

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

Four years after the onset of the crisis, the French economy has real potential for a rebound: this should lead to spontaneous average growth of about 3.0% per year in 2012 and 2013, making up some of the output gap built up since the start of the crisis. But this spontaneous recovery is being hampered, mainly by the establishment of budgetary savings plans in France and throughout Europe. The fiscal consolidation strategy imposed by the European Commission is likely to slice nearly 6 percentage points off GDP in France during 2012 and 2013.

Table 1. The brakes on growth in France

En points of GDP

| Rythm | ... quaterly | | ... annually | |
|-----------------------------|--------------|------|--------------|------|
| | 2012 | 2013 | 2012 | 2013 |
| <i>Spontaneous recovery</i> | 0,8 | 0,8 | 2,1 | 3,1 |
| <i>Budget impact</i> | -0,4 | -0,4 | -1,6 | -1,7 |
| <i>Oil shock</i> | -0,05 | 0,0 | -0,2 | 0,0 |
| <i>External environment</i> | -0,4 | -0,3 | -1,4 | -1,2 |
| <i>Achievement</i> | | | -1,0 | -0,2 |
| Growth forecasts | -0,04 | 0,04 | 0,1 | 0,0 |

Sources : INSEE, OFCE calculations.

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

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

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

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

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

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

A darker scenario is also possible: according to our forecasts, and taking into account the draft budget bills known and approved, no major European country would meet its deficit reduction commitments in 2013. By underestimating the difficulty of reaching inaccessible targets, there is a high risk of seeing the euro zone countries locked into a spiral where the nervousness of the financial markets would become the engine driving ever greater austerity. To illustrate this risk, we simulated a scenario in which the major euro zone

countries (Germany, France, Italy and Spain) implement new austerity measures to meet their deficit targets in 2013. Adopting such a strategy would result in a strong negative shock to economic activity in these countries. For the French economy, it would lead to additional austerity that either at the national level or coming from its euro zone partner countries would cause a severe recession in 2013. French GDP would fall by more than 4.0%, resulting in a further increase in the unemployment rate, which would approach 14%.

Table 2. Illustrative scenarios of risks to French growth

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

* OFCE forecast October 2012

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

How France can improve its trade balance*

By [Eric Heyer](#)

Prime Minister Jean-Marc Ayrault has made a commitment to restoring France's balance of trade, excluding energy, by the end of his five-year term. Without addressing the curious anomaly of leaving the energy deficit out of the analysis of the country's trade position, as if it did not count in France's dependence on the rest of the world, we will examine the various solutions that the government could use to achieve this goal.

The first solution is to do nothing and to wait until the austerity policy that has been implemented in France through public spending cuts and higher taxes reduces consumer spending. In the face of higher unemployment and the resulting increase in household precautionary savings, the French will cut back on consumption. However, since some of this comes from outside France, this will limit imports into France from abroad and, everything else being equal, improve the country's trade balance.

This solution, it is clear, not only is not virtuous, as it relies on a reduction in employee purchasing power and rising unemployment, but it also has little chance of success, because it assumes that French exports will not follow the same path as imports and will continue to grow. However, since our partner countries are following this same strategy of a rapid return to balanced public finances, their austerity policies will result in the same dynamics as described above for France, thereby reducing their own domestic demand and hence their imports, some of which are our exports.

As a result, and since the austerity programmes of our

partners are more drastic than ours, it is very likely that our exports will decline faster than our imports, thus exacerbating our trade deficit.

The second solution is to increase our exports. In a context where our European partners, who represent 60% of our trade, are experiencing low or even negative growth, this can be achieved only through gains in market share. Lowering the cost of labour seems to be the fastest way to do this. But in the midst of an effort to re-establish a fiscal balance, the only way to lower the charges on labour is to transfer these to another tax: this was the logic of the "social VAT" set up by the previous government, but repealed by the new one, which seems to lean more towards transferring these to the CSG tax, which has the advantage of having a larger tax base, affecting all income, including capital income.

But in addition to the fact that this strategy is not "cooperative", since it resembles a competitive devaluation and thus is essentially aimed at gaining market share from our euro zone partners, there is no indication that it would be sufficient. Indeed, there is nothing to prevent our partners from adopting the same approach, particularly since their economic situation is worse than ours, and this would cancel all or part of any potential gains in our competitiveness.

The last solution consists of making the country more competitive by raising the productivity of our employees and by specialising in high value-added sectors that are not subject to competition from the emerging countries with their low costs.

This is a medium-term strategy and requires the establishment of policies to promote innovation, research and development, and training. It also means expanding the range of our traditional products such as automobiles, but also specializing in the industries of the future.

The need for a transition to an ecological mode of production that is more energy-efficient could represent this industry of the future, and therefore be the solution to our trade deficit.

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

Will Germany be caught up in the recession of its European partners?

[Christophe Blot](#) and Sabine Le Bayon

Can Germany avoid the recession that is hitting a growing number of countries in the euro zone? While Germany's economic situation is undoubtedly much more favourable than that of most of its partners, the fact remains that the weight of exports in its GDP (50%, vs 27% for France) is causing a great deal of uncertainty about the country's future growth.

Thus, in the last quarter of 2011, the downturn in the German economy (-0.2%) due to the state of consumption and exports has upset hopes that the country would be spared the crisis and that it could in turn spur growth in the euro zone based

on the strength of its domestic demand and wage increases. Exports of goods fell 1.2% in value in late 2011 over the previous quarter, with a contribution of -1.5 points for the euro zone and -0.4 points for the rest of the European Union. Admittedly, the beginning of 2012 saw renewed growth, with GDP rising by 0.5% ([versus 0% in the euro zone](#)). Once again this was driven by exports, in particular to countries outside the euro zone. The prospects of a recession across the Rhine in 2012 thus appear to be receding, but there is still great uncertainty about how foreign trade will be affected in the coming months and about the extent of the slowdown "imported" into Germany. The question is whether the improvement in the first quarter of 2012 is temporary. The decline in manufacturing orders from euro zone firms to Germany (-7.5% in the first quarter of 2012, after -4.8% in the last quarter of 2011) could spell the end of German's persistent growth, especially if the recession in the euro zone continues or worsens.

With GDP per capita above the pre-crisis level, Germany has been an exception in a euro zone that is still profoundly marked by the crisis. The country's public deficit is under control, and it already meets the 3% threshold set by the Stability and Growth Pact. Germany is still running a foreign trade [1] surplus, which came to 156 billion euros (6.1% of GDP) in 2011, whereas at this same time France ran a deficit of 70 billion euros (3.5% of GDP). Despite Germany's favourable foreign trade performance, the crisis has left scars, which today are being aggravated by the energy bill. For instance, before the crisis the trade surplus was 197 billion euros, with over 58% from trade with partners in the euro zone. With the crisis, activity slowed sharply in the euro zone – the zone's GDP in the first quarter of 2012 was still 1.4% lower than the level in the first quarter of 2008 – which is automatically reflected in demand addressed to Germany. Thus, exports of goods to the euro zone are still below their level of early 2008 (down 2.9% for Germany and

6.3% for France, see Table 1). Germany's trade surpluses vis-à-vis Italy and Spain – two countries that were hit hard by the crisis – have fallen significantly, mainly due to lower demand from the two countries. German exports to these two countries have decreased by 27% and 4% respectively since 2007.

Nevertheless, although Germany is more exposed to foreign trade shocks than France, it is less exposed to the euro zone. The share of euro zone countries in German exports fell from 44.8% in 2003 to 39.7% in 2011 (Table 2a). In France, despite a fall on the same order of magnitude, 47.5% of exports are still directed towards the euro zone. When the European Union as a whole is considered, however, the gap disappears, as the EU represents 59.2% of German exports compared with 59.8% of French exports. The lower level of dependence on the euro zone has been offset by increasing exports to the new member states of the European Union (the NEM), with which German trade reached 11.4% in 2011. Moreover, Germany has maintained its lead over France on the emerging markets: in 2011 Asia represented 15.8% of German exports and China 6.1%, against 11.5% and 3.2% in the French case. By managing to diversify the geographical composition of its exports to areas experiencing vigorous growth, Germany has been able to dampen the shock of the slowdown in the euro zone. This can be seen in recent trade trends: while Germany's exports (like France's) have surpassed their pre-crisis level, this was due to exports to countries outside the euro zone, where Germany has benefited more than France (Table 1). Germany has in fact succeeded in significantly reducing its deficit with Asia, which has helped to offset the poor results with the euro zone and with Central and Eastern Europe. Finally, Germany has advantages in terms of [non-price competitiveness](#) [2], which reflects the dynamism of trade in automobiles and electrical, electronic and computer equipment. The surpluses in these two sectors regained their pre-crisis level in 2011 (respectively, 103 and 110 billion euros in 2011), whereas the balances in

these two sectors have continued to deteriorate in France.

Even if orders from countries outside the euro zone remain buoyant (up 3.6% in early 2012), the weight of the euro zone is still too strong for exports to emerging markets to offset the decline in orders placed by the euro zone to Germany. This will inevitably affect the country's growth. GDP should therefore rise less rapidly in 2012 than in 2011 (0.9% according to the OFCE [3], following 3.1%). Germany might thus avoid a recession, unless the euro zone as a whole experiences even sharper fiscal contraction. Indeed, the slowdown in growth means that the euro zone member states will not be able to [meet their budget commitments in 2012 and 2013](#), which could lead them to decide on further restrictive measures, which would in turn reduce growth throughout the zone, and therefore demand addressed to the zone's partners. In this case Germany would not avoid a recession.

Finally, the role of foreign trade is not limited to growth and employment. It could also have an impact on negotiations between France and Germany about the governance of the euro zone. The relative growth of the two countries will in practice affect the balance of power between them. The expected slowdown in growth in Germany clearly reflects its conflicting interests between, on the one hand, maintaining its market opportunities and, on the other, its fears vis-à-vis the functioning of the euro zone and the cost to public finances of broader support for the countries in greatest difficulty. While up to now the latter consideration has dominated the German position, this could change once its commercial interests come under threat, especially at a time when the German Chancellor is negotiating with the Parliamentary opposition about the ratification of the fiscal pact – an opposition that could demand measures to support growth in Europe, as has the new French president.

Table 1. German and French exports since the crisis, in value

2008 Q1 = 100

| | | 2009 - Q2 | 2012 - Q1 |
|--------------------|---------|-----------|-----------|
| Totale | Germany | 76,5 | 108,4 |
| | France | 77,6 | 101,6 |
| Euro zone | Germany | 76,4 | 97,1 |
| | France | 75,4 | 93,7 |
| Other EU countries | Germany | 71,2 | 103,3 |
| | France | 71,4 | 89,4 |
| Rest of the world | Germany | 79,8 | 123,0 |
| | France | 83,1 | 117,5 |

Sources : Customs, Destatis.

Table 2a. The main partners of Germany and France

%

| | 2003 | | 2011 | |
|-----------------------------|---------|--------|---------|--------|
| | Germany | France | Germany | France |
| European Union | 65,0 | 67,0 | 59,2 | 59,8 |
| Euro zone | 44,8 | 52,2 | 39,7 | 47,5 |
| - <i>France/Germany</i> | 10,4 | 15,8 | 9,6 | 16,3 |
| - <i>Italy</i> | 7,3 | 9,2 | 5,9 | 8,0 |
| - <i>Spain</i> | 4,9 | 10,0 | 3,3 | 7,2 |
| - <i>Netherlands</i> | 6,4 | 3,8 | 6,5 | 4,2 |
| - <i>Belgium/Luxembourg</i> | 5,8 | 8,2 | 5,0 | 7,5 |
| - <i>Austria</i> | 5,4 | 1,0 | 5,4 | 0,9 |
| United Kingdom | 8,4 | 9,5 | 6,2 | 6,5 |
| NEM* | 9,2 | 3,7 | 11,4 | 4,8 |
| United States | 9,3 | 6,7 | 6,9 | 5,5 |
| Asia | 11,4 | 7,3 | 15,8 | 11,5 |
| - <i>China</i> | 2,7 | 1,4 | 6,1 | 3,2 |
| - <i>Japan</i> | 1,8 | 1,6 | 1,4 | 1,5 |

Note : The NEM include Bulgaria, the Czech Republic, Latvia, Lithuania, Hungary, Poland, Romania, Slovenia, Slovakia and Estonia.

Sources : Customs, Destatis.

Table 2b. The main suppliers of Germany and France

%

| | 2003 | | 2011 | |
|-----------------------------|---------|--------|---------|--------|
| | Germany | France | Germany | France |
| European Union | 61,4 | 65,2 | 55,7 | 58,9 |
| Euro zone | 42,4 | 53,6 | 37,7 | 48,2 |
| - <i>France/Germany</i> | 9,3 | 18,9 | 7,6 | 17,3 |
| - <i>Italy</i> | 6,5 | 9,4 | 5,3 | 7,4 |
| - <i>Spain</i> | 3,0 | 7,6 | 2,8 | 6,1 |
| - <i>Netherlands</i> | 7,9 | 4,7 | 8,4 | 4,4 |
| - <i>Belgium/Luxembourg</i> | 5,1 | 7,4 | 4,5 | 8,2 |
| - <i>Austria</i> | 4,1 | 1,0 | 4,1 | 0,9 |
| United Kingdom | 6,4 | 6,7 | 4,8 | 4,4 |
| NEM* | 9,3 | 3,2 | 10,7 | 4,0 |
| United States | 7,8 | 6,5 | 5,6 | 5,7 |
| Asia | 15,5 | 12,5 | 20,4 | 15,7 |
| - <i>China</i> | 4,1 | 4,1 | 9,7 | 8,2 |
| - <i>Japan</i> | 3,8 | 3,2 | 2,8 | 1,9 |

Note : The NEM include Bulgaria, the Czech Republic, Latvia, Lithuania, Hungary, Poland, Romania, Slovenia, Slovakia and Estonia.

Sources : Customs, Destatis.

[1] Measured by the gap between the export and import of goods.

[2] See also J.-C. Bricongne, L. Fontagné and G. Gaulier (2011): "Une analyse détaillée de la concurrence commerciale entre la France et l'Allemagne" [A detailed analysis of commercial competition between France and Germany], Presentation at the Fourgeaud seminar [in French].

[3] This figure corresponds to the update of our forecast of April 2012, which takes into account the publication of the growth figures for Q1 2012.

Competitiveness and industrial demand: The difficulties facing the French-German couple

[Jean-Luc Gaffard](#)

The obsession with competitiveness has returned to centre stage with the election campaign. This reflects the reality that French companies are indeed suffering a loss of competitiveness, which is behind the deterioration in foreign trade for almost a decade. This loss is clear vis-à-vis the emerging markets and explains the trend towards relocating abroad. It is also clear vis-à-vis firms from other developed countries, mainly in the euro zone and in particular German companies. This latter situation is especially serious, as it challenges the coherence of European construction ([cf. OFCE, note 19: Competitiveness and industrial development: a European challenge in French](#)).

The gap in competitiveness that has emerged with Germany is clearly based on non-price competition. One of the reasons for this is Germany's superior business model, which is characterized by the maintenance of a network of local businesses of all sizes that focus on their core business and on the international fragmentation of production. This model is especially suitable for business development that is targeted at global markets, and it largely protects the countries hosting these companies from the risk of deindustrialization.

It would, nevertheless, be a mistake to ignore that this development is also the product of an adverse change in price competitiveness. This reflects labour market reforms in Germany, which lowered the relative cost of labour, as well as

strategies that are based on the segmentation of production and the outsourcing of intermediate segments, which have also contributed to lowering production costs.

Germany has thus managed to virtually stabilize its market share of global exports by increasing their level in the European Union (+1.7% in the 2000s) and even more so in the euro zone (+2.3%), while France has lost market share in these same areas (3.1% and 3.4%, respectively).

Two developments have particularly hurt France's industry. Its network of industrial SMEs has fallen apart. They were hit less by barriers to entry than by barriers to growth. All too often SME managers have been inclined or encouraged to sell the enterprises to large corporations rather than to ensure their growth. This is due both to the lack of genuine partnerships with these corporations and to the difficulties experienced in obtaining permanent financing from the banks and markets. For their part, the large industrial firms, both those operating on a multitude of local markets and those in the international markets, have chosen to focus on acquisitions and on the geographical decentralization of both their operations and their equipment and services suppliers. This strategy has been designed to meet geographical shifts in demand and to deal with the demand for immediate profitability set by volatile shareholders, but this has come in part at the expense of the development of local production networks. This process involved a vast movement of mergers and acquisitions that primarily drew on financial skills. The financial institutions were, in turn, converted to the universal banking model, abandoning some of their traditional role of being lending banks and investment banks. These concomitant developments have proved disastrous for overall competitiveness, particularly as hourly labour costs in industry were rising simultaneously.

There are two requirements for restoring the competitiveness of French companies and thereby encouraging the country's re-

industrialization. The first is to allow immediate control of labour costs and the restoration of profit margins; this could be helped in particular by tax measures that would adjust the financing of a portion of social protection. The second requirement is to promote the reorganization of industry through the creation of a network of stable relationships between all those involved in the industrial process, especially by the use of aid that is conditioned on cooperation between large and small firms in “competitiveness clusters”.

This medium-term effort will nevertheless largely remain ineffective if cooperative policies are not implemented across Europe. These policies need both to stimulate supply through the implementation of technology development programmes and to boost internal demand wherever it is clearly insufficient to satisfy production capacity.

The new European treaty, the euro and sovereignty

By [Christophe Blot](#)

On 2 March 2012, 25 countries in the Economic and Monetary Union (EMU) adopted a new treaty providing for greater fiscal discipline. The treaty became an object of dispute almost before the ink was dry [1], as Francois Hollande announced that, if elected, he would seek to renegotiate it in order to emphasize the need to address growth. There is no doubt that a turnabout like this on a treaty that was so fiercely negotiated would be frowned upon by a number of our European partners. The merit of strengthening fiscal discipline in a

time of crisis is, nevertheless, an issue worth posing.

So how should we look at this new treaty? Jérôme Creel, Paul Hubert and Francesco Saraceno have already demonstrated [the potential recessionary impact of the rules it introduces](#). In addition to these macroeconomic effects, the treaty also fails to deal with an essential question that should be at the heart of the European project: sovereignty.

In 1998, one year before the launch of the euro, Charles Goodhart [2] published an article in which he raised a peculiar feature of the Economic and Monetary Union (EMU) with respect to monetary theory and history. Goodhart recalled that a currency is almost always inextricably bound up with the expression of political and fiscal sovereignty. However, in the context of the EMU, this link is broken, as the euro and monetary policy are controlled by a supranational institution even though they are not part of any expression of European sovereignty, as fiscal policy decisions in particular remain decentralized and regulated by the Stability and Growth Pact. Goodhart concluded that the creation of the euro portends tensions that will need careful attention.

The current crisis in the euro zone shows that this warning was well founded. The warning makes it possible above all to consider the crisis from a different perspective – a political one. The issue of the sustainability of the debt and compliance with rules in effect masks the euro's underlying problem, its "original sin": the single currency is doomed if it is not based on fiscal and political sovereignty. If there are any exceptions to this, they consist of micro-states that have abandoned their monetary sovereignty to neighbours that are far more powerful economically and politically. The euro zone is not the Vatican.

The renegotiation of the treaty or the opening of new negotiations with a view to the ratification of a European Constitution is not only urgent but vital to the survival of

the European project. Beyond the overarching objectives of growth, employment, financial stability and sustainable development, which, it must be kept in mind, are at the heart of European construction, as is evidenced by their inclusion in Article 3 of the [Treaty on the European Union](#), any new negotiations should now address the question of Europe's political and fiscal sovereignty, and therefore, by corollary, the issue of the transfer of national sovereignty.

It should be noted that this approach to the implementation of European sovereignty is not inconsistent with the existence of rules. In the United States, most states have had balanced budget rules since the mid-nineteenth century, prior to which a number of them had defaulted (see C.R. Henning and M. Kessler [3]). However, these rules were adopted at the initiative of the states and are not included in the US Constitution. There are, however, ongoing efforts to include a requirement in the Constitution for a balanced budget at the federal level. [For the moment, these have not been successful, and they are being challenged](#) on the grounds that this would risk undermining the stabilizing power of the federal budget. In the United States, before the crisis the resources of the federal state accounted for 19% of GDP, compared with an EU budget that does not exceed 1% of GDP and which must always be balanced, and therefore cannot be used for of macroeconomic adjustments. In the US, the stabilization of shocks is thus handled through an unrestricted federal budget, which offsets the poor responsiveness of local fiscal policies that are constrained by the requirement for balance. While the euro zone must surely find its own way, the fact remains that the euro should not be an instrument in the hands of the European Central Bank alone: it must become a symbol of the political and fiscal sovereignty of all the euro zone's citizens.

[1] It will only take effect, however, after a ratification process in the 25 countries. This could be a long and

uncertain process, as Ireland has announced that it will hold a referendum.

[2] See “The two concepts of money: implications for the analysis of optimal currency areas”, *Journal of European Political Economy* vol.14 (1998) pages 407-432.

[3] “[Fiscal federalism: US history for architects of Europe’s fiscal union](#)”, (2012) Peterson Institute for International Economics.