

France and Europe faced with the economic crisis

▶ PART 3. WHAT FISCAL POLICIES SHOULD EUROPE ADOPT AS IT COMES OUT OF THE CRISIS ?

In terms of the large-scale world recession, economic stimulus policies have achieved their aim : stabilising activity and smoothing capacity adjustment. Gradual consolidation, generalised over the Euro area as a whole would seem necessary today. In the case of France, this involves re-establishing fiscal margins for manoeuvre, so as to be able to cope with the next economic downturn, which the country has had difficulty in

achieving in previous economic cycles. Monetary conditions are conducive to this effort, making up for consolidation of around 2% of GDP in the short term. The risk of a negative impact on growth may also be mitigated by the choice of adjustment methods. Member States must above all focus on operating expenditure, while at the same time looking at future spending. European coordination would be desirable in this area. ■

▶ PROPOSALS

- 1 France should carry out a budget consolidation drive of around 4 to 5 GDP percentage points to re-establish a medium term path towards sustainable debt and restore countercyclical fiscal margins for manoeuvre.
- 2 Adjustment should not be deferred but should be gradual, to avoid weakening the recovery. The easing of monetary conditions in Europe since the beginning of the crisis has created a favourable adjustment window, absorbing 2 GDP percentage points of structural deficit reduction in the short term without harming growth.
- 3 Adjustment should be based on measures designed to be permanent and a strictly adhered to medium-term programme to increase credibility. This argues in favour of action preferably on spending in a situation where taxation is already high and there is fiscal competition, which tends to weaken the maintainability of tax rises.
- 4 Advantage should be taken of the low cost of capital related to expansionary monetary policies to support future investment policies coordinated over the European area as a whole.

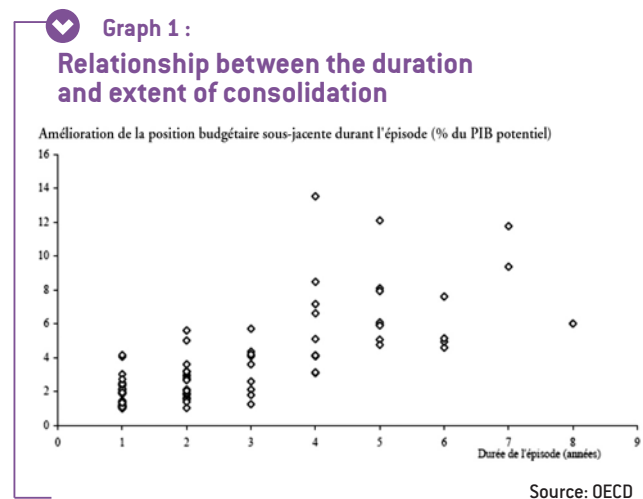
ISSUES Macroeconomic policies within the European area are faced with a dilemma. The critical position of certain member states in terms of sustainability exposes the area to the risk of higher government financing costs. However, the expected consolidation could, on the contrary, weaken recovery, slow down potential growth and erode the tax base, permanently damaging the fiscal equation. The G20 or the messages put out by international organisations are symptomatic of this pressure. They encourage governments not to stifle world recovery just as it begins, while at the same time warning them of the risks of a cumulative build-up of debts.

This report highlights that :

- ▶ an adjustment can be carried out gradually without compromising its chances of success ;
- ▶ restoring countercyclical margins for stabilising action is crucial in supporting potential growth ;
- ▶ the positive effect of the easing of monetary and financial condition can at the moment offset the consequences of 2 percentage points of fiscal consolidation, but this fiscal consolidation must be credible and spread out over a relatively long period of time ;
- ▶ the risk of a decline in potential growth is minimised by vigorous microeconomic innovation support policies.

LESSONS TO BE LEARNT FROM PREVIOUS CONSOLIDATIONS

Developed countries have experienced a large number of fiscal consolidation episodes over the last 30 years. The OECD lists 85 in 24 countries, the majority of which amounted to less than 2.8% of GDP and lasted less than 2 years. During this period, some twenty countries carried out consolidations representing more than 5 GDP percentage points and more than 10 percentage points for around ten countries. However, it is no use trying to set an optimal rule for consolidation based on these observations. Each episode corresponds to very specific contexts. The adoption of the euro opened up the prospect of a very sharp drop in the cost of debt financing, which made it easier to reach targets. In the past, in small open economies, currency devaluations lowered the cost of fiscal adjustments in growth terms. Other economies made isolated efforts, in a favourable world growth environment. What is specific about the present crisis is above all the simultaneous fiscal excesses and the efforts needed in developed countries to stabilise national debt ratios.



Nevertheless, some general findings can be highlighted. Past experiences do not necessarily support “shock therapies”. Announcements of large-scale adjustments concentrated within a short space of time are not always the most credible since they come up against the issue of their acceptability. Large-scale efforts tend to be spread out over a longer period of time (*graph 1*) than lesser measures, the period of time reducing the annual intensity⁽¹⁾. This approach was favoured in the past when the initial macroeconomic situation was particularly bad.

Restoring a long-term budget balance is above all depends on a contraction in public spending, rather than an increase in revenues. In the majority of cases, successful adjustments which lead towards sustainable public finances are based on cuts in primary spending⁽²⁾. Alesina and Perotti (1996)⁽³⁾ emphasise that efforts to reduce the public wage bill and transfer spending are more effective. On the other hand, an increase in revenues is often a less sustainable lever for balancing the budget⁽⁴⁾.

The timing and the macroeconomic conditions prevailing at the beginning of a consolidation phase are crucial elements. Successful fiscal adjustments have usually occurred during an ascending phase of the business cycle (measured by the difference between production and its potential trend), whereas most of those that have not restored a balanced budget have occurred in a descending phase⁽⁵⁾. A very negative initial financial position and a high level of debt servicing paradoxically increase the probability of a successful adjustment. Progress made with the primary deficit is accompanied by a positive effect on debt servicing.

Adjustments can even have an expansionary effect if they follow a major public finance crisis. Fiscal consolidation is not always bad for growth. In the past, a number of fiscal adjustments have been associated with phases of economic expansion, although these were sometimes short term (Denmark, 1983-1986; Ireland, 1986-1988 and Sweden, 1996-1998, for example). Recent IMF estimates, based on a VaR⁽⁶⁾ shock analysis method, indicate that temporary fiscal policies do have the expected Keynesian effects on growth in the short term. However, permanent deficit increases have lower immediate multiplier effects and can even have negative effects on production over the long term. A fiscal consolidation conducted over several years could therefore ultimately increase growth. As an illustration of his “fiscal stress”

theory, Perotti (1999) shows that if the national debt reaches a certain share of the nation’s wealth, a consolidation drive can reduce anticipations of future tax rises by households and companies. Giavazzi and Pagano (1990)⁽⁷⁾ also show that the increase in private consumption observed in some countries vastly exceeds the mechanical effect caused by the decline in government social spending and direct payment of these costs by households⁽⁸⁾. Other authors emphasise the **composition of the adjustment**. According to Alesina and Perotti (1996), in the case of non-sustainable adjustments, two thirds of the spending reduction affect public investment and leave the wage bill intact. On the other hand, capital cuts are much lower in successful adjustments (a fifth on average). For Lane and Perotti (1996), reducing in the state’s operating expenditures excluding the wage bill has little recessionary impact.

However, it should be added that **in the case of successful adjustments, monetary and foreign exchange policies were very accommodating, with strong devaluations, combined with pegging to other currencies immediately afterwards, to avoid a rise in interest rates.** The effectiveness of these devaluations was enhanced by the small size of the countries and their pronounced preference for exporting. **So-called expansionary consolidations** cannot therefore be easily transposed to medium or large-scale economies, with the notable exception of Germany, which has a trade openness ratio comparable to that of a small economy.

▶ ANTICIPATION OF FUTURE CRISES

France went into the crisis with a structural deficit above 3% of GDP (between 3% and 3.7% according to estimates in 2007 and 2008). **This situation of a relatively poor structural balance at the top of the business cycle is a recurrent one.** It reflects a more general trend



[1] There are, however, noteworthy exceptions to this general observation, such as Denmark in 1986 or Israel in 1983, which led to fiscal consolidations representing more than 10 GDP percentage points in less than four years.

[2] Two thirds, according to Brand T. (2008), “Après la crise, quel retour à l’équilibre des finances publiques à moyen terme ?”, *La Note de Veille*, No. 112, Centre d’analyse stratégique, October.

[3] “Fiscal adjustments in OECD countries: Composition and macroeconomic effects”, *NBER Working Paper*, no. 5730.

[4] Conversely, radical tax reduction strategies designed to “starve the beast” often require an increase in revenues one or two years later: Romer C. D. and Romer D. H. (2007), “Do tax cuts starve the beast? The effect of tax changes on government spending”, *NBER Working Paper*, No. 13548.

[5] Brand T. (2008), *op. cit.*

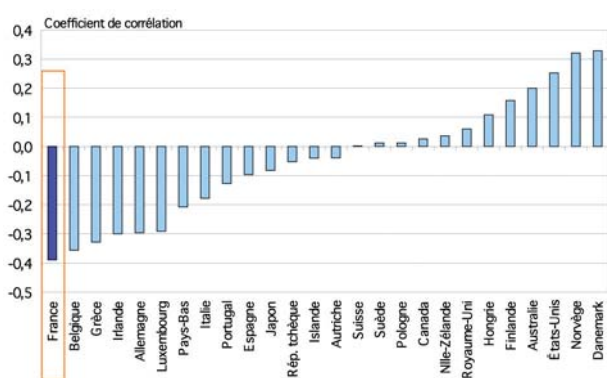
[6] VaR: Value at Risk.

[7] Blanchard O. and Fischer S. (dir.) (1990), “Can severe fiscal adjustments be expansionary?”, in *NBER Macroeconomics Annual*, Cambridge, MA: MIT Press.

[8] The authors show that the increase in private consumption directly attributable to the reduction in public services explains only 15% of the expansion of activity in Denmark in the mid 1980s.

towards implementing pro-cyclical fiscal policies, which relax at the top of the cycle phase and tighten prematurely at the beginning of the ascending phase, whereas the low stream of fiscal revenues reveals the reality of the budget balance's structural deterioration. This is characteristic of France and continental Europe, as shown by the degree of correlation between the position in the cycle (measured by the output gap⁽⁹⁾) and the direction of budget policy stimuli (*graph 2*), between 1980 and 2008. This is in contrast with what can be seen in Anglo-Saxon and northern European countries. It is typical of countries which could more effectively manage their inter-temporal constraint and partly finance new permanent spending through the extra revenues related to the cycle. This budget tempo contributes to the greater average length of recession phases, which are twice as long in Europe as in the United States.

Graph 2 :
Deliberate budget stimuli and cycle
Ratio of correlation between the change in the structural primary balance and the output gap



Note: a negative correlation means that a country tends to take discretionary measures to rebalance its budget at the bottom of the cycle

Source: OECD, CAS calculations

A second consequence of the **pro-cyclical approach to fiscal policy could be the weakening of potential growth**. Even if the cycle alternates between apparently symmetrical phases of business acceleration and deceleration,

some authors suggest that the extent and duration of recession episodes are not neutral in terms of long-term growth. This issue has been the subject of considerable discussion. According to the Schumpeterian view⁽¹⁰⁾ of business cycles, recessions encourage firms to correct organisational inefficiencies, innovate and move towards new demand opportunities. However, research highlights the fact that resource reallocation is difficult during recessions, thus limiting the scope of the creative destruction process (Caballero and Hammour, 2005)⁽¹¹⁾. A crisis can lead to technological sclerosis and does not necessarily encourage reorganisation in favour of “good” firms. Lee and Mukoyama (2008)⁽¹²⁾ show, based on American micro-data, that in periods of recession, failure behaviours change little, while influxes of high potential start-ups slow down. Other research shows the pro-cyclicality of R&D, not necessarily on average, but for a large number of SMEs, given the tougher constraints on internal financing due to the fall in profits, or on external financing related to the squeeze on bank lending (Aghion et al., 2009)⁽¹³⁾. It is therefore suspected that the cycle ascending and descending phases have asymmetrical effects on potential growth. By slowing down the arrival of new structures and intensifying the credit squeeze on innovative SMEs, recessions will affect overall factor productivity and therefore long-term growth, which recoveries will not offset⁽¹⁴⁾. For Aghion, Barro and Marinescu (2005), the Euro area could gain 0.2% in growth if it implemented policies as countercyclical as those of the United States.

Pro-cyclical management of financing constraints tends to gradually move the structural primary balance away from the zone where it stabilises debt. A consolidation drive is, in fact, problematic in periods of recession and could remain incomplete, contributing to the erosion of the country's financial position over time. If the economy is also faced with an unexpectedly severe crisis, as was recently the case, the total absence of “provisioning” for such a risk leads to a very considerable deterioration of the



[9] This indicator measures the difference between GDP and its non-inflationary potential. It decreases even when growth is positive, as soon as growth falls below its potential rate.

[10] This view is based on Schumpeter's “creative destruction” approach, which applies more to long Kondratiev cycles and therefore to the alternation of the major A and B phases that punctuate economic history, than to short, generally five-year business cycles.

[11] Caballero R. J. and Hammour M. [2005], “The cost of recessions revisited: A reverse-liquidationist view”, *The Review of Economic Studies*, vol. 72, no. 2, April, p. 313-341, and Caballero R. J. and Hammour M. [1998], “The macroeconomics of specificity”, *The Journal of Political Economy*, vol. 106, No. 4, August, p. 724-767.

[12] Hall B. [1992], “The financing of research and development”, *Oxford Review of Economic Policy*, 18(1), p. 35-51; Himmelberg C. et Peterson B. [1994], “R & D and internal finance: A panel of small firms in high tech industries”, *Review of Economics and Statistics*, 78(1), p. 38-51.

[13] Aghion P., Askenazy P., Berman N., Cetté G. and Eymard L. [2008], “Credit constraints and the cyclicity of R & D investment: evidence from France”, *Working Paper*, No. 2008-26, Paris School of Economics.

[14] Aghion, Angeletos, Banerjee and Manova [2004] showed in particular that the per capita GDP growth rate is in fact negatively correlated with growth rate volatility.

debt position. The magnitude of the financial cycles over the last 15 years and repeated instability episodes do, however, warrant anticipation of this type of event. If the government had provided for 1.5 a countercyclical intervention margin of 1.5 percentage points at the top of the cycle, in addition to the balance stabilising the debt over the long term, the primary balance would have been around 3 GDP percentage points lower than that recorded in 2008. With the same stimulus plan, the deterioration of the debt to GDP ratio would be 13 percentage points less in 2011 than what is currently projected for France. The effort needed to stabilise the debt after 2011 would be less than 1 GDP percentage point, instead of today's 4 to 5 percentage points. This situation corresponds more or less to that in Canada, Austria and, to a lesser degree, Germany.

The speed of the debt deterioration currently observed makes it difficult to defer adjustment for three main reasons: 1/ waiting too long could compromise the "soft" option and expose France and other countries in Europe to the adoption of national public finance restructuring plans under market pressure; 2/ the government should rapidly restore margins for manoeuvre to ensure that the necessary resources are available to provide stimulus when monetary policies take a less accommodating turn ; 3/ the first countries to re-establish their public finances' sustainability after the crisis will reduce the cost of issuing their sovereign debt and will have increased margins for intervention in sectors with a promising future. They will therefore give themselves the edge in terms of competitiveness and potential growth. A marked time lag in the economic positions of France and Germany should also speed up fiscal consolidation on the other side of the Rhine through the transfer of debt to France, issued at a higher cost.

PROPOSAL 1

France should carry out a fiscal consolidation drive of around 4 to 5 GDP percentage points to re-establish a medium-term path towards sustainable debt and restore countercyclical fiscal margins for manoeuvre.

MONETARY AND FINANCIAL CONDITIONS MAY CUSHION THE EFFECTS OF GRADUATED CONSOLIDATION

There are three aspects to monetary and financial conditions : the foreign exchange rate situation, which is a determining factor in the competitiveness of the Euro area, the level of interest rates, which is decisive in investment choices, and the value of assets, which affects household's spending and investment power and more generally the borrowing capacity of an economy, as this is sensitive to collateral value. The first two aspects have made progress in the last few quarters. The third, which is sensitive to property and share prices, deteriorated, then stabilised or partially recovered, in varying proportions depending on the economy. Overall, monetary and financial conditions⁽¹⁵⁾ eased significantly, under the impetus of central banks, with exceptionally accommodating policies. Assessment of the direction taken by discretionary macroeconomic policies should take into account the twofold budgetary and monetary aspect of public policy. The European policy mix has sometimes been suspected of pressing the monetary brake and the budgetary accelerator at the same time. The crisis has clearly paved the way for a twofold easing. The possibility of a moderate approach to consolidation with few adverse consequences for growth is largely dependent on expansionary monetary conditions being maintained. Moreover, the monetary policy must not come up against its inefficiency threshold, which is reached when a deflationary climate no longer allows interest rates to affect real activity (the so-called liquidity trap). In addition, the various aspects of monetary and financial conditions are not unchangeable. Their impact must be assessed taking into account their future trends. These trends themselves are not independent of the trade-offs to be made in fiscal terms.

(Real interest rates at historic 30 year lows

Even though, over the last few months, the emphasis has been on risk premiums which adversely affect the financing of certain countries and spreads have noticeably increased within the Euro area, the cost of financing sovereign debt has generally fallen for most developed

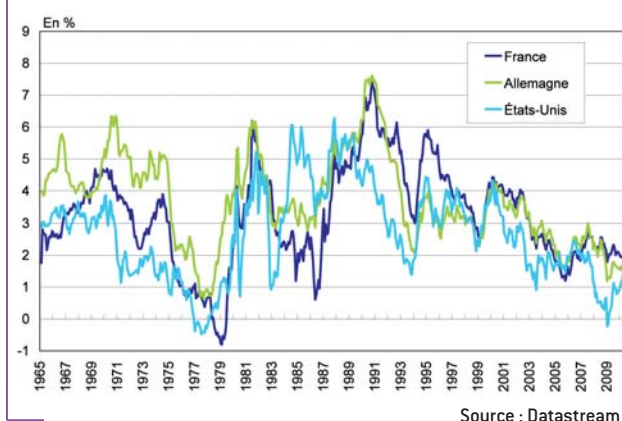
[15] See Guichard S., Haugh D. and Turner D. (2009), "Quantifying the effect of financial conditions in the Euro Area, Japan, United Kingdom and United States", *OECD Economics Department Working Papers*, No. 677, updated in the April 2010 *OECD Economic Outlook*.

countries. Real interest rates⁽¹⁶⁾ on 10-year government bonds hovered around 2% in the pre-crisis period, at record 30-year lows in a recovery phase (5% to 7% between 1986 and 1990, 3% to 4% between 1997 and 2000) and at levels also noticeably lower than those prevailing before the first two oil crises (*graph 3*). Real 10-year rates are currently closer to 0.5%- 1% if we look at the annual interest rate on inflation-indexed government bonds⁽¹⁷⁾. They have therefore dropped a percentage point since the beginning of the crisis.



Graph 3 :

Real 10-year interest rates 10-year government borrowing rates – inflation spread over 5 years



The drop in real 10-year rates, if it proves to be long term, is likely to result in nearly 0.2 of a percentage point additional growth per year over the next three years (0.5 of a percentage point cumulatively over three years), based on the average impact predicted by some standard major macroeconomic models which are used as a reference by international organisations or economic government departments (*table 1*).

The question is whether these historically low real interest rates should be considered as participating in renewed growth or whether they are an early sign of other risks. Two eventualities raise concerns:

► the formation of a liquidity trap: long rates would essentially reflect anticipation by investors of monetary policies condemned to maintaining short-term rates at their lower limit over the long term, like Japan in the 1990s. Maintaining such policies would be the consequence of persistent deflationary trends within economies, which would prevent monetary policy from operating since real rates would become rigid on the downside. This concern, voiced in particular by Paul Krugman, is particularly marked in the United States. It is also appearing today in recent Fed opinions⁽¹⁸⁾ ;

► a significant increase in real rates in response to the sharp rise in the national debt of developed countries: this rose by 20 GDP percentage points on average in OECD countries. Empirical research suggests that such an increase could add a further percentage point to real rates, with pronounced differences between countries, depending on the initial level of debt or the quality of certain fundamentals⁽¹⁹⁾. Cash flow approaches suggest similar orders of magnitude. The average deterioration of 3 percentage points in OECD country structural balances could lead to an additional 0.2 to 0.5 of a percentage point per deficit percentage point.

These two contradictory risks call for vigilance. **For the time being, objectively speaking developed countries are not experiencing deflation, even if the situation is worrying.** Underlying inflation on the goods market is close to 1% in France, the Euro area and the United States. This level is historically low on the other side of the Atlantic, but was already reached in France during the 1993 and 2000 recessions. Anticipated long-term inflation, as based on index-linked government bond prices, remains between 1.5% and 2.5% depending on the maturity⁽²⁰⁾. Above all, the situation of sustained world growth (4.5% forecast by the IMF for 2010) is keeping prices high on the commodity markets. As regards the second risk, renewed private saving, which is particularly



[16] Real interest rates measure the yield of a security after the effect of the debt's erosion by anticipated inflation. For long-term 10 to 30 year securities, it is generally considered that markets project inflation based on the inflation observed in the previous cycle. The average inflation recorded over the last five years can then be used to estimate anticipated inflation.

[17] In practice, investors in OATi (French Treasury inflation-indexed bonds) or OATÉi (French Treasury Euro inflation-indexed bonds) receive a lower fixed coupon than if they had acquired a nominal OAT with the same maturity, but are repaid more capital at maturity, with an additional amount equal to cumulative inflation over the bond's period of existence. OATi and OATÉi are listed on bond markets in the same way as OATs. Their market value can be used to calculate an annual interest rate called the real rate. Information about anticipated inflation can be extracted by comparison with the yield to redemption of nominal bonds with the same maturity: this difference, called the inflation breakeven, gives an approximate measurement of the inflation anticipated by the market at a given moment in time. More precisely, the inflation breakeven is the sum of three elements: anticipated inflation, the inflation risk premium and possibly a liquidity premium depending on the amount of supply and demand; see Coeuré B. and Sagnes N. (2005), "Un bilan de l'émission des obligations françaises indexées sur l'inflation", *Diagnostics Prévisions et Analyses Économiques*, No. 89, November.

[18] www.federalreserve.gov/newsevents/press/monetary/20100810a.htm.

[19] See IMF (2009), "The state of public finances cross-country fiscal monitor: November 2009", *IMF Staff Position Note*, SPN/09/25; Ardagna S., Caselli F. and Lane T. (2007), "Fiscal discipline and the cost of national debt servicing: Some estimates for OECD countries", *The B.E. Journal of Macroeconomics*, vol.7, 1.

[20] Nevertheless, it has been tending to decelerate again since the first quarter, which could raise concerns.

marked in heavily indebted economies, and the broad trend towards rebalancing portfolios in favour of so-called risk-free securities, are for the moment deferring the prospect of a rise in long term rates on the sovereign debt of most developed countries (see part 2, *Economic Intelligence Report No. 192*).

Table 1 :
Impact on GDP of a 1 percentage point drop in all interest rates in the Euro area, according to different reference models

| | 1 year | 2 years | 3 years | 4 years | 5 years |
|----------------------------|------------|------------|------------|------------|------------|
| Mésange (France) | 0.01 | 0.06 | 0.11 | 0.2 | 0.28 |
| Nigem (Euro area) | 0.3 | 0.9 | 1.2 | 1.2 | 1.1 |
| E-Mod (France) | 0.1 | 0.3 | 0.4 | 0.5 | 0.5 |
| Interlink (Euro area) | 0.4 | 0.6 | 0.6 | 0.6 | 0.6 |
| OECD new model (Euro area) | 0.0 | 0.1 | 0.3 | 0.5 | 0.7 |
| Consensus | 0.2 | 0.4 | 0.5 | 0.6 | 0.6 |

A virtuous scenario for coming out of the crisis, reducing risks relating to the cost of financing the private sector, may be envisaged. It requires credible medium-term public finance consolidation commitments, to prevent the current steep rise in public debt from being aggravated by a significant increase in the cost of servicing the debt. The empirical link between public debt and interest rates is particularly tenuous and thus leaves governments a great deal of leeway in setting the timetable for such consolidation. Accommodating monetary policies may, for their part, foster a moderate upsurge in inflation. Figure 8 shows that inflation is sensitive to the business cycle and the trend in monetary policies. Its limited acceleration could enable the burden of adjustment to be shared between real consolidation and monetary erosion of the debt.

The return to normal of the Euro exchange rate

Whatever the indicator chosen, the Euro exchange rate has returned to an average position as regards its long-term value or certain fundamentals. The Euro/dollar exchange rate stood at 1.22 dollars in June 2010, 23%

below its maximum historic value in July 2008 (table 2). High and low values generally reflect imbalances and cannot really be used as a reference. The June value indicates a mere return to the long-term average. This observation does not of itself mean that the balance has been re-established : everything depends on the productivity and inflation differences between the two areas. Purchasing power parity, measured by the OECD, is a useful reference for establishing whether an exchange rate is under or over-valued⁽²¹⁾. It indicates the exchange rate which would equalise prices between the two areas and would therefore be neutral in terms of competitiveness. This reference shows that the maximum value of the Euro, reached in the first quarter of 2008, made prices of French products more than 40% more expensive than equivalent American products. In terms of the June exchange rate, this difference is reduced to 10-15%. This indicator thus confirms that the exchange rate has returned to normal⁽²²⁾ (graph 4).

Table 2 :
Euro/dollar exchange rate average value and highs and lows over three decades

| | Average | Maximum | Minimum |
|--------------------|---------|----------------------|-----------------------|
| 1980-1989 | 1,04 | 1,44 January 1980 | 0,67 March 1985 |
| 1990-1999 | 1,21 | 1,40 August 1992 | 1,01 December 1999 |
| 2000-2009 | 1,19 | 1,58 July 2008 | 0,85 October 2000 |
| 2010 (janv.-juil.) | 1,32 | 1,43 January 2010 | 1,22 June 2010 |

Source : Datastream

The real effective exchange rate of the Euro measures the currency's parity against a currency basket, taking into account the structure of the Euro area's foreign trade and the inflation differential⁽²³⁾. This reference is relatively stable over the very long term and is also a means of identifying areas of strong over-valuation. The drop in the Euro's effective exchange rate observed until June 2010 appears to be normalising. The Euro has depreciated by 10% in real terms since the beginning of the crisis

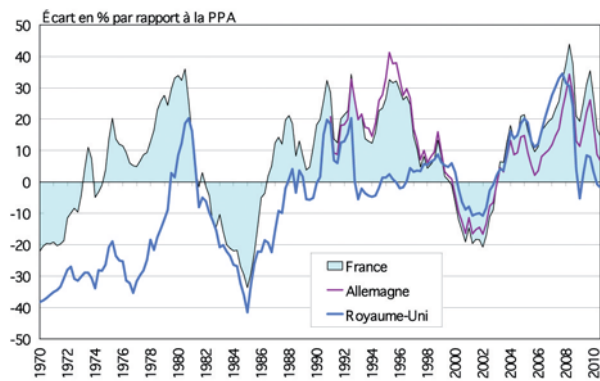
[21] However, this is not a good "predictor" of the future exchange rate in the short and medium term, since exchange rate differences can persist.

[22] A trend towards normalisation very probably related to the rebalancing of the American balance of payments and the partial absorption of surplus domestic demand caused by the credit squeeze; see Brand T. (2008), *op. cit.*

[23] An increase in inflation in the area compared with a partner reduces competitiveness and is therefore comparable to a higher Euro exchange rate.

compared with all currencies. Such a depreciation is likely to result in 0.4 to 0.5 of a percentage point of additional growth each year for three years over the Euro area as a whole (1.3% cumulatively), according to the variants of a number of reference macroeconomic models (*table 3*).

Graph 4 :
Difference between currency exchange rates against the dollar and PPP



Source: OECD

Table 3 :
Impact on GDP of a 10% drop in the Euro's effective exchange rate

| | 1 year | 2 years | 3 years | 4 years | 5 years |
|-----------------------|------------|------------|------------|------------|------------|
| Mésange [2010] | 0.5 | 0.8 | 1.0 | 0.9 | 0.9 |
| Nigem [2008] | 0.5 | 1.1 | 1.5 | 1.7 | 1.9 |
| Nigem [2003] | 0.8 | 1.3 | 1.0 | 0.9 | 0.9 |
| Interlink [2008] | 0.5 | 1.1 | 1.5 | 1.7 | 1.7 |
| OECD new model [2010] | 0.7 | 1.3 | 1.7 | 1.8 | 1.6 |
| Consensus | 0.6 | 1.1 | 1.3 | 1.4 | 1.4 |

Is the downward correction in the Euro's real effective exchange rate sustainable and does the recent rise in the Euro presage an upturn? The impact of the medium-term public finance strategy is sensitive to eminently uncertain foreign exchange assumptions. Nevertheless, the structural under-valuation of the dollar compared with the Euro is built on extreme imbalances in international payments, the consequence of surplus domestic demand in the United States fuelled by the credit bubble and massive recycling of surplus savings from emerging countries to

the rest of the world. These two factors contributing to the imbalance in the American current trade balance have become less powerful. Debt repayment by private agents has reduced the gap between domestic demand in America and the rest of the world and helped with the structural rebalancing of the current balance⁽²⁴⁾. However, the appreciation of the dollar most definitely relies on a more moderate approach to domestic lending in the United States. Too big a gap between American and European public debt strategies is likely to lead to a deterioration of the American current balance and recreate the conditions for a strong depreciation of the dollar and re-appreciation of the real effective exchange rate of the Euro. The need for a cooperative strategy thus goes beyond the borders of the Euro area. France is, as it were, torn between the German strategy of accelerated consolidation and the American strategy of prolonged fiscal activism. These are two options which increase the risk of the Euro's revaluation and may make European consolidation more costly in terms of growth.

Financial wealth effects very muted in continental Europe

Consideration of monetary conditions as a whole also encompasses the value of assets. Sharp depreciation in the long-term financial and non-financial investments of private agents affects demand through various channels. Households in particular may have a wealth target in terms of their disposable income – especially those who have a self-funded retirement plan. The active accumulation of cash reserves then results in a rise in the saving rate to the detriment of ordinary consumption. Access to lending by private agents may also be restricted due to the depreciation of collateral or the shareholders' equity of financial intermediaries. The credit squeeze thus occurring results in a rise in the saving rate (for equivalent income, ordinary spending is more limited) and a drop in investment. In nearly all countries, the restructuring of the balance of payments demonstrates the extent of this readjustment between private saving and investment .

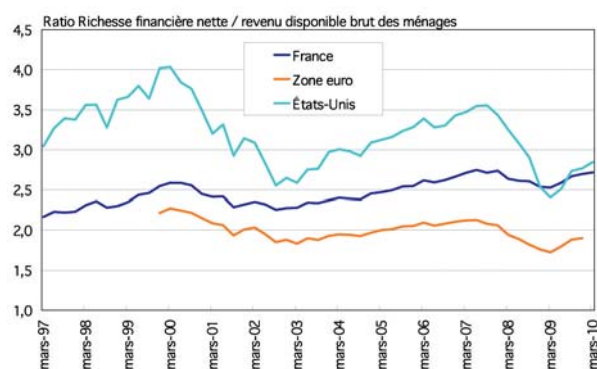
The recent financial crisis saw the combined depreciation of two categories of assets: equities and property. In the United States, where the proportion of net wealth held in

[24] Brand T. (2008), *op. cit.*

[25] This trend has only been partially offset by the public dissaving trend.

equities is particularly high, the impact of financial cycles on net wealth is very pronounced (*graph 5*). The ratio of Net financial wealth/Disposable income has dropped by nearly a third versus its pre-crisis peak. In addition, unlike the previous cycle, the trend has not been tempered by property prices. If the situation in the Euro area or France is compared against the American benchmark, it can be seen that the crisis produced very mitigated effects, which have already been partially reversed, in continental Europe and France.

Graph 5 :
Net financial wealth of households compared with their disposable income



Sources : BCE, Federal Reserve, Banque de France

The contribution of the over-adjustment of the asset markets must also be taken into account. The price-to-earnings ratio (PER) or price-to-book ratio minimise the risk of a further step decline on the stock markets. Property prices have also proved very resilient, but this inertia depends on interest rates. A rise in interest rates, which is unlikely in the short term, would probably be combined with a second wave of property asset depreciation.

The impact of negative wealth effects is significant when they reach developed economies simultaneously (*table 4*), which is the case in the current crisis. The depreciation of stock market prices to their lowest point during the crisis, compared with their period average value, was liable to lead to a loss of GDP of around 0.5% to 1%, which is a state of affairs aggravated by the fall

in property prices. The partial recovery of stock market prices and the stabilisation of property prices are an indication that these effects will now be very watered down.

Table 4 :
Impact sur le PIB d'une baisse de 20 % des cours boursiers

| | 1 year | 2 years | 3 years | 4 years | 5 years |
|---------------------------------------|--------|---------|---------|---------|---------|
| Crisis isolated in one country | | | | | |
| Nigem (France) | -0.1 | -0.2 | -0.2 | -0.1 | -0.1 |
| Interlink (France) | -0.1 | -0.1 | nd | nd | nd |
| Crisis common to all countries | | | | | |
| Interlink (France) | -0.4 | -0.5 | nd | nd | nd |
| Interlink (United States) | -1.0 | -1.0 | nd | nd | nd |

All in all, monetary conditions could absorb half the restrictive effects related to the 4.2 percentage points of consolidation envisaged in the French stability programme for 2013. The main uncertainty regarding this scenario comes from the simultaneous nature of the consolidation policies in Europe. Spending multipliers are generally considered to be close to 1 in developed countries (in other words, 1 Euro of additional public spending raises GDP by the same amount) according to the reference macroeconomic models, and noticeably less according to other approaches. For some economists, implementing consolidation policies simultaneously in Europe would increase their recessionary impact. The position in the cycle should also change the duration of the effects⁽²⁶⁾.

Table 5 :
Impact on GDP of a restriction in public spending of 1 percentage point of GDP

| | 1 year | 2 years | 3 years | 4 years | 5 years |
|--|--------|---------|---------|---------|---------|
| Mésange | -1,1 | -1,3 | -1,3 | -1,2 | -1,0 |
| E-Mod | -1,3 | -1,1 | -1,0 | -0,8 | -0,6 |
| Crisis common to all countries in the euro area | | | | | |
| E-Mod | -1,7 | -1,6 | -1,6 | -1,6 | -1,5 |
| OCDE new model | -0,8 | -0,8 | -0,5 | -0,3 | -0,1 |



[26] Creel J., Heyer E. and Plane M. (2010), "Fiscal policy and the multiplier effect: Season 3", to be published.

PROPOSAL 2

Adjustment should not be deferred but should be gradual, to avoid weakening the recovery. The easing of monetary conditions in Europe since the beginning of the crisis has created a favourable adjustment window, absorbing 2 GDP percentage points of structural deficit reduction in the short term without harming growth.

PROPOSAL 3

Adjustment should be based on measures designed to be permanent and a strictly adhered to medium-term programme to increase credibility. This argues in favour of action preferably on spending in a situation where taxation is already high and there is fiscal competition, which tends to weaken the maintainability of tax rises.

➤ REALLOCATION OF SPENDING TOWARDS SECTORS WITH A PROMISING FUTURE

During a consolidation phase, it is legitimate to try to identify the public spending or revenue flows whose adjustment would least adversely affect potential growth. The composition of the adjustment, just as much as its amount, seems decisive. However, the literature on multipliers gives highly disparate results⁽²⁷⁾. Traditionally, standard macroeconomic models produce spending multipliers (consumption or investment) substantially above revenue multipliers. It could therefore be inferred that raising taxes would be the method of adjustment which would least affect growth. However, this result contradicts those mentioned above concerning the probability of successful, i.e. sustainable, consolidation, which emphasise the greater effectiveness of measures directed at spending. It is also attacked by a lot of more recent research which rejects the idea that the macroeconomic impact of taxation on growth is less than that of

spending. Only one result seems to stand up against the research : preserving public investment would seem to increase the chances of success of consolidation policies and minimise the growth cost of adjustment.

Severe crises including the deflation of balance sheets have their roots in over-capacity problems. The depreciation of financial assets and provisions for losses leads to the risk of cumulative depression, in which the deterioration of balance sheets causes a drop in demand which prolongs financial difficulties⁽²⁸⁾. Debt reduction measures could fuel a deflationary loop, whatever the interest rate levels. Growth in public borrowing then becomes vital and the accompanying intervention of central banks accelerates the purging of toxic assets and the restoration of bank balance sheets. This twofold stimulus can be found in nearly all countries faced with similar crises.

What should the public strategy be once private agents' debt has been transferred to the government ? The question of adjustment is all the more problematic as there is no spontaneous return-to-average mechanism for national debt. For each growth and interest rate level, there are several combinations of deficit and sustainable debt. The notion of sustainability thus provides very little indication as to the right level of debt. Unlike private agents, the trade-off between capital cost and returns does not set a limit on accumulation and debt. Be that as it may, the national debt has its counterpart in the form of the accumulation of material and immaterial growth factors. Expansionary fiscal policies certainly prevent the destruction of successful firms in the long term and the loss of certain know-how which is difficult to recover. But, in so doing, they also maintain material over-capacity which would generally have been scaled down by the crisis.

The danger of tolerating the level of debt acquired at the end of the crisis is in endorsing investment choices that are bad for potential growth and maintaining financial and non-financial zombies, which prevent new investments and weaken growth potential. Failing an optimum debt reference, the choice of consolidation, by arbitrarily organising the national debt's return to its previous average,



[27] Spilimbergo A., Symansky S. and Schindler M. [2009], "Fiscal multipliers", *IMF Staff Position Note*, SPN/09/11.

[28] Koo R. [2001], "The Holy Grail of macroeconomics: Lessons from Japan's Great Recession", Norton agency titles.

can limit this risk of endorsing bad investment choices. When carried out gradually, it comes down to smoothing the adjustment of capacity over time. This strategy of smoothing capacity only makes sense if it is accompanied by support for sectors with a promising future and for the redeployment of skills.

Experience of past crises and identification of the reasons for the success of certain countries highlight the importance of implementing macro and microeconomic policies simultaneously and harmoniously. During large-scale financial crises, it would be a mistake to reason on the basis of the traditional division between a supply crisis (requiring microeconomic solutions) and a demand crisis (requiring macroeconomic stabilisation policies). An endogenous view of growth reminds us that any persistent shock affecting production factors can cause long-term losses in growth. A drop in employment and investment can go hand in hand with the depreciation of human capital and innovation.

The fiscal strategies adopted by Scandinavian countries during the banking crisis in the 1990s are representative of these trade-offs. In Sweden, just as the country was engaged in an unprecedented consolidation effort, the share of R&D expenditure in the GDP rose from 2.5% of GDP in 1993 to 4.5% in 2000. The rise is also striking in Finland (2% to 3.5%). There was also considerable development of resources for higher education.

This emphasis on innovation is characteristic of “small” countries, which have rethought their areas of specialisation. For several decades, France has been up against the difficulty of organising the build-up of highly intensive R&D sectors. Past experience and the very mixed results of the Lisbon Strategy show that it is difficult to achieve such goals in a medium-sized country. Financing or giving fiscal incentives to R&D will only pay off in sectors already positioned in this segment. For a given specialisation and size of company, financing R&D too proactively could produce over-capacity, in other words structures dedicated to innovation but that are not very productive in terms of registering patents. This observation means that projects

must undergo strict prior selection based on their economic and social returns. It also suggests that a policy of encouraging innovation should be linked to a strategy on growth sectors and company demographics. It This is the key to the approach initiated by the general investment commission, the central theme of whose activities is the analysis of sectors and company linkups.

The effectiveness of this spending would be increased by real technological coordination in Europe, going beyond the formal framework of the Framework Programme for Research and Technological Development. Strengthening Europe’s economic governance as well as raising the innovation part of the community budget increased technological spillovers in Europe. Implementing predominantly national innovation policies, as is generally the case today, encourages each region to develop an innovation policy based on comparative micro-advantages, which are not really advantages on a worldwide scale, and the duplication of support. Concerted management at European level would result in the emergence of a rationale of aggregation differentiated according to region and more efficient organisation of value streams across the whole of Europe.

PROPOSAL 4

Advantage should be taken of the low cost of capital related to expansionary monetary policies to support future investment policies coordinated over the European area as a whole.



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