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**GLOBAL FINANCIAL CRISIS: THE FRENCH POLICY
ANSWER IN A EU PERSPECTIVE**

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Global financial crisis: the French policy answer in a EU perspective *

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Abstract:

The 2007-2009 crisis has led to a return of Keynesian analyses and policies. The paper analyses the contradictions between a structural crisis, the implementation at a very large scale of Keynesian policies and the denial to undermine financial capitalism. The crisis has led the French government to endorse French traditional views according to which government actions have a major role. Although stimulus measures have been limited in France, the economy has been less affected than others thanks to the size of its automatic stabilisers and financial and economic *archaisms*. However the French government has not abandoned the objective of large public expenditure cuts. European authorities have had to admit that public deficits would rise but they have not implemented coordinated stimulus policies. EU countries are still requested to bring their budgetary positions back into balance, independently of economic developments. Yet the rise in public deficits and debts has not generated any rise in long-term interest rates and in inflation expectations. Two main issues remain: can fiscal and monetary policies alone be expected to boost activity if the roots of the crisis lie in structural imbalances? Will fiscal exit strategies be an opportunity for leading classes to cut massively social and public expenditures?

Résumé : La crise financière des années 2007-2009 a conduit à un retour en force des analyses et des politiques keynésiennes. L'article analyse les contradictions entre une crise de nature structurelle, la mise en œuvre à une très large échelle de remèdes de type keynésien et le refus de remettre en cause le capitalisme financier. La crise a amené le gouvernement français à retrouver les positions françaises traditionnelles sur l'importance des interventions publiques. Les mesures de soutien à l'activité ont été limitées, mais la France a été protégée par l'importance de ses stabilisateurs automatiques et ses *archaïsmes* économiques et financiers. Le gouvernement n'a toutefois pas renoncé à l'objectif de fortes réductions des dépenses publiques. Les instances européennes se sont résignées au gonflement des déficits publics, mais n'ont guère organisé une stratégie coordonnée de relance. Elles continuent à réclamer des engagements de retour à l'équilibre des finances publiques, indépendamment de l'évolution conjoncturelle. Pourtant, la hausse des déficits et des dettes publiques n'a pas provoqué de hausse des taux longs et des anticipations d'inflation. Deux grandes questions demeurent : les politiques budgétaires et monétaires de soutien peuvent-elles permettre à elles seules de relancer la croissance si la crise est causée par des déséquilibres structurels ? Les classes dirigeantes réussiront-elles à utiliser le déséquilibre actuel des finances publiques pour réduire massivement les dépenses publiques et sociales ?

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Keywords: Financial crisis, fiscal policies, French economy, EU economies.

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1. Introduction

The 2007-2009 crisis has led to a return of Keynesian analyses and policies, which contrasts with the 1980-2007 period when liberal analyses and policies were prevailing. However, this return of Keynesian analyses and policies may soon come to an end, since the pre-crisis mainstream liberal views were matching the interests and policies of new leading classes, the winners of financial and economic globalisation. In France, Nicolas Sarkozy's government had the objective of introducing a break in the French model, based on large public spending and taxation, assumed to be detrimental to labour, savings, investment and competitiveness. But the crisis has led the government to change their objectives and call for a re-foundation of capitalism, which would reduce the weight of finance at the benefit of entrepreneurs and workers. The paper analyses the contradictions between a structural crisis, the implementation of Keynesian policies at a very large scale and the denial to undermine financial capitalism.

Section 2 puts in contrast the Keynesian features and the structural causes of the crisis: the growth model chosen by the winners of globalisation, China's and Germany's mercantilism, the rise in inequalities associated with rising indebtedness and financial bubbles in Anglo-Saxon economies; financial globalisation boosted by greedy and adventurous financial institutions. Keynesian remedies proposed and implemented in G-20 countries are described.

Section 3 focuses on French specificities: the weight of taxes and public spending, a large redistribution, persisting large public deficits, the difficulty of implementing liberal reforms. Structural fiscal policies implemented before the crisis are analysed: tax cuts, followed by spending cuts, efforts to generate a supply shock. The crisis has led the French government to endorse French traditional views on the importance of world governance, on financial regulation, on government support to domestic industries, on social protection. Stimulus measures have been limited, and hardly targeted on the victims of the crisis: the unemployed, especially the young, companies and industry sectors in difficulty. But the French economy was less affected than other economies thanks to the size of its automatic stabilisers and financial and economic *archaisms*. The government has let the public deficit and debt rise, but has not abandoned the objective of large public expenditure cuts, which it could impose in the coming years under the EU commitments of bringing back budgetary positions into balance.

Section 4 analyses the EU strategy during the crisis. European authorities have had to admit that public deficits would rise but they have hardly implemented coordinated stimulus policies. Fiscal stimulus packages have been much smaller in the euro area than in the US or in the UK. The EU Commission still requests Member States to bring their budgetary positions back into balance, independently of economic developments. The Commission does not draw lessons from the crisis and maintains its liberal reforms strategy. Several economists recommend cutting public deficits through large spending cuts (and not through higher growth or wealth and speculative profit taxation). They call for governments to reassure markets by announcing large cuts in pensions and health expenditure. Yet the rise in public deficits and debts has generated no rise in long-term interest rates and in inflation expectations.

Two main issues remain: can fiscal and monetary policies alone be expected to boost activity if the roots of the crisis lie in structural imbalances? Will fiscal exit strategies be an opportunity for leading classes to cut massively social and public expenditures?

2. Economic policies in the crisis

2.1. Short-term and structural issues

The 2007-2009 crisis can be analysed as a Keynesian crisis of insufficient demand. The fall in equity prices has led to a substantial fall in households' wealth. The impact was particularly large in Anglo-Saxon economies, where households hold a larger amount of equities, where a large part of retirement pensions is based on pension funds. Under the effects of the banking crisis, banks in difficulty had to cut lending to households and companies. The equity market crisis reduced the value of companies and hence made them financially more fragile, which reduced their capacity to borrow. Growth prospects were rapidly downgraded. Companies reduced their investments. The fear of unemployment led households to increase their savings ratio. Lower spending led output and incomes to fall. The crisis has spread around the world through foreign trade contraction and flight to quality in financial markets, which limited the capacity of many emerging countries to borrow.

The world economy entered a depressive spiral, the opposite of the strong growth that had taken place under the effects of trade globalisation, financial globalisation and rapid economic growth of emerging countries in the 1995-2007 period.

All countries were affected but the output fall was especially dramatic in Russia, the NMS, Ireland, Finland, Spain, Sweden and UK while it was relatively limited in the US, France, Portugal and Africa (see Table 1).

Expansionary monetary and fiscal policy answers are needed to tackle the crisis. Central banks have responded by cutting their base rates to lowest floors: 0-0.25% for the Fed, 0.1% for the Bank of Japan, 0.5% for the Bank of England, 1% for the ECB. Besides, central banks have provided huge liquidity to banks; they have provided support to financial markets in difficulty through widening their refinancing conditions; they have used non conventional tools to signal clearly to financial markets that they will durably maintain low interest rates. In many countries, governments intervened by recapitalizing banks and guaranteeing their deposits and their loans.

Active fiscal policies have then been implemented to such an extent that according to the June 2009 OECD estimates, fiscal deficits will exceed 6% of GDP in 2010 in almost all large economies, reaching 14% of GDP in the UK, 11% in the US, 8.7% in Japan, 8.5% in France, 7% in the euro area, 6% in Italy and Germany.

The crisis has destroyed the liberal point of view that the market economy was fundamentally stable and did not need government interventions. The view according to which only supply policies matter and demand policy should be restricted to monetary policy alone was forgotten. Policy-makers now agree that fiscal policies are needed to get out of the crisis.

Table 1. GDP Growth Prospects, in %

	Weight	2007	2008	2009	2010
Germany	4.4	2.6	1.0	-4.9	1.1
France	3.2	2.2	0.3	-2.1	0.8
Italy	2.8	1.4	-1.0	-4.8	0.6
Spain	2.1	3.7	0.9	-3.7	-0.1
Netherlands	1.0	3.5	2.0	-4.1	1.1
Belgium	0.6	2.8	1.0	-2.9	0.7
Austria	0.5	3.1	2.1	-3.7	0.7
Finland	0.6	4.4	0.8	-6.9	0.8
Portugal	0.4	1.8	0.0	-2.9	0.3
Greece	0.3	4.0	2.9	-0.2	0.7
Ireland	0.3	6.0	-3.2	-6.8	-0.2
Euro area	16.4	2.6	0.6	-3.8	0.8
UK	3.4	3.0	0.6	-4.4	1.0
Sweden	0.5	2.9	-0.4	-4.7	1.2
Denmark	0.3	1.7	-1.2	-3.3	0.4
EU-15	20.5	2.7	0.5	-4.1	0.8
NMS	2.7	6.1	4.0	-4.1	0.6
EU-27	23.3	3.0	0.9	-4.0	0.7
Switzerland	0.5	3.3	1.8	-1.8	0.3
Norway	0.4	6.3	2.1	-1.0	1.8
Europe	24.1	3.2	0.9	-4.0	0.8
USA	21.8	2.0	0.4	-2.5	1.9
Japan	6.7	2.0	-0.7	-5.9	2.2
Canada	2.0	2.7	0.4	-2.6	1.7
Industrial countries	56.3	2.5	0.5	-3.5	1.4
EU candidates	1.2	4.6	1.1	-6.5	3.4
Russia	3.2	8.1	5.6	-7.3	2.3
Other CIS	1.3	8.8	5.4	-7.2	1.6
China	11.0	11.9	9.0	8.0	9.4
Other Asian countries	13.2	7.3	5.1	2.3	5.4
Latin America	7.9	5.6	3.9	-3.0	2.4
Africa	3.4	6.2	5.2	1.7	4.1
Middle East	2.5	5.8	5.4	2.0	4.3
World	100.0	4.9	2.8	-1.3	3.1

Source: OFCE forecasts, October 2009.

However, the nature of the crisis needs to be addressed. The origins of the crisis lie in fundamental imbalances of the world economy, directly linked to production, trade and financial globalization. Is it possible to get out the crisis without questioning the functioning of the recent global financial capitalism?

The crisis questions growth strategies of the largest economies which were the winners of globalisation. These countries have chosen two types of extremely contrasted strategies:

- Anglo-Saxon economies have opted for a growth strategy characterised by the stagnation of wage earnings and incomes of most households and rising income inequalities (table 2) offset by rising households' indebtedness and financial and housing bubbles. US have supported this type of growth through maintaining low real interest rates which allowed for rising indebtedness and generated rises in assets prices.
- A large number of countries, like Germany and China, have implemented a “mercantilist” growth strategy based on external demand with low domestic wages and the accumulation of external surpluses. Their growth occurred at the detriment of trade partners who had to accumulate deficits.

Table 2. Interdecile ratio D9/D1

	1985	2005
United States	5.5	5.9
Italy	3.9	4.3
United Kingdom	3.8	4.2
Germany	3.0	4.0
France	3.6	3.4
Sweden	2.4	2.8

Source: OECD.

The configuration of the current account was deeply unbalanced (table 3). The countries (China, Germany) which based their growth on exports accumulated huge external assets while the Anglo-Saxon countries, able to attract foreign capitals, due to their sophisticated financial system, accumulated unsustainable deficits. Many emerging countries were unwilling to rely on financial markets spirits and to be at risk of asking support from IMF, chose to accumulate surpluses.

The countries which had based output growth on wage restraint and external surpluses created a shortfall of aggregate demand which had to be compensated. In the years before the crisis, this has been done by public deficits in some countries, by low interest rates driven by the US Federal Reserve policy which induced the development of private credit and financial and real estate bubbles. Due to trade globalization and leading classes' interests, countries refused to support demand by increasing wages or social expenses.

The US economy massively supported world growth; the US external deficit was a more a sign of growing imbalances than a medicine for reducing world imbalances. The US became progressively unable to continue to play a leadership role in terms of global growth.

The economic developments in the years 1995-2007 led to deep macroeconomic and financial imbalances, which was neither satisfactory nor stable.

Table 3. Current account balances, in 2007 and 2008

	Billions dollars, 2007	% of GDP	Billions dollars, 2008	% of GDP
United States	-727	-5.2	-706	-4.9
United Kingdom	-75	-2.7	-46	-1.7
Euro Area	34	0.3	-93	-0.7
<i>Germany</i>	250	7.5	235	6.4
<i>Netherlands</i>	60	7.6	66	7.5
<i>Portugal</i>	-21	-9.4	-30	-12.1
<i>France</i>	-26	-1.0	-65	-2.3
<i>Italy</i>	-51	-2.4	-79	-3.4
<i>Greece</i>	-44	-14.2	-52	-14.4
<i>Spain</i>	-144	-10.0	-154	-9.6
Sweden-Denmark	41	5.4	41	40.6
NMS	-83	-8.0	-98	-7.8
Iceland	-4	-19.9	-7	-40.6
Japan	211	4.8	157	3.2
Norway	62	15.9	88	19.5
Switzerland	43	9.9	12	2.4
China	372	11.0	426	9.8
Other Asia	146	3.4	74	1.6
Latina America	13	0.4	-30	-0.7
Middle East	270	18.1	347	18.3
Africa	32	2.9	32	2.5
Australia/Canada/N. Zealand	-53	-2.2	-50	-1.9
CIS (inc. Russia)	72	4.2	108	4.9
Turkey	-38	-5.8	-41	-5.7
Other Central and Eastern Europe	-15	-11.2	-22	-13.5
World	299		191	

Source: IMF, WEO October 2009.

The crisis was mainly caused by the excessive size of the financial sector, the large amounts of capital available, the cupidity of capital owners and the adventurous strategies of banks and financial institutions. Since the early 1980's, financial markets and institutions have developed incredibly in the world economy, dealing with huge amounts of capital flows in search of high profitability unrelated to real performances. Through a succession of booms and bursts, globalisation has shown once again that financial markets are myopic, instable, herdic and cyclothymic. Financial globalisation allows for a durable increase of imbalances which burst at some point. Exchange rates instability and unpredictability, stock market bubbles, credit excessive growth show that financial markets exacerbate economic instability instead of playing a stabilizing role.

The triumph of liberalism was a Pyrrhic victory. Markets have been unable to ensure a stable, durable world growth. Thus, the 2007-2008 crisis has destroyed the theoretical bases of global

finance and led world financial markets to implode. The crisis questions the sustainability of global economy dominated by financial markets, without world economic governance.

The financial crisis is accompanied by an environmental crisis with immediate economic consequences. Consumption and production patterns will have to change due to depletion of energy resources and environmental constraints, which raises uncertainty for many economic sectors.

Domestic strategies, world economic governance and financial markets functioning need to be questioned. A strong monetary and financial support is needed to bring the economy out of the crisis, but restoring confidence in a satisfying growth requests to define a new world economic growth model. The financial and banking system needs to work again properly but here also the issue of a new functioning of finance has to be raised. There is a need for a re-foundation of capitalism.

A new world economic strategy needs to be implemented to restore a durable growth.

1. Growth should be based on domestic demand and not on exports; consumption should be based on wages and not on borrowing or capital gains.
2. Companies should pay less attention to the value for their shareholders and more on jobs and output. This implies a redistribution of power in the firms.
3. World growth must become less intensive in energy, raw materials, greenhouse gas emissions and pollution. This requires a world regulation, a concerted environmental taxation, settling a World Environment Organisation with substantial powers. Government should help their companies to shift their production techniques towards green growth (transportation, buildings,...).
4. Financial returns required by markets should be lowered; the role of financial markets and the weight of speculation should be reduced; the banking system should be re-focused on its missions to finance productive investments.
5. A world economic governance should be implemented.

But where are the social forces which can impose such a change? The winners of the globalisation refuse to change the growth model of 1995-2007. How to implement global economic governance that would arbitrate between conflicting interests between countries and social classes? Will capitalism be able to find a new robust growth without curing the factors which induced the imbalances which caused the crisis?

2.2. The G-20 summits

Three G-20 summits were held during the crisis (Washington, 15 November 2008; London, 2 April 2009; Pittsburgh, 25 September 2009). The US, supported by the IMF, wishes the meetings to focus on how to revive world economic growth. On the contrary, EU countries consider that the G-20 should tackle in priority the issue of improving world economic governance and financial markets regulation, observing that world economic governance failure and financial markets deregulation were at the origins of the crisis.

There is probably a need to pursue both objectives: the need for active policy measures should not hide the need for deep reforms. A substantial fiscal and monetary stimulus is required to bring economic recovery, but restoring confidence in a sustainable and durable growth requires the design of a new world growth model. Banking and financial systems need to

function properly again; although, here also, the implementation of a new functioning of the financial system is a major issue to be addressed.

Short-term stabilisation policies often come in contradiction with structural issues. The stimulus objective requires that interest rates remain durably low and that banks are massively rescued so that they can rapidly provide lending; the reform objective advocates for preventing the emergence of financial bubbles, hence for a tighter credit control.

The G20 summits laid the blueprint for a better governance of the world economy and a better regulation of financial markets, although we can consider they do not go far enough in these two subjects.

In most countries, fiscal and monetary policies have responded vigorously to the crisis. There was no coordination problem, even if the instruments used were not identical. Similar fiscal actions are desirable as concerns stabilisation policies, while differentiated measures should be introduced as concerns structural developments. It would make sense that countries with unsustainable external deficits and particularly hit by the financial crisis (US, UK) allow their exchange rates to depreciate while countries running external surpluses (like China) let their exchange rate rise significantly. Countries running surpluses should have implemented larger expansionary measures than others; wages should have been increased in order to raise domestic consumption in countries like Germany and China.

Openly protectionist measures have been very rare. It is not shocking that countries implement stimulus measures mostly benefitting their producers. It is not shocking that countries introduce specific support to industry sectors most affected by the crisis and help these sectors to adopt more environmentally friendly production processes.

In September 2009, the Pittsburgh summit reaffirmed the need to maintain measures to support activity as unemployment rates remain high. It is not appropriate cut public deficits now, even if it is said that in the future coordinated strategies to end the crisis would have to be developed.

The need for global economic governance has been reaffirmed. It should be ensured by the G20, with the help of the IMF. The G-20 took the commitment to challenge their national economic strategies: structural deficit countries will increase their private savings rate and cut their public deficits, countries with structural surpluses will increase domestic demand. But this would require exchange rates realignments, which the G-20 does not organise, simply writing that exchange rates should “reflect underlying economic fundamentals”. The G-20 countries will have undertaken structural reforms (but their contents are not specified) and will improve their “social safety nets”. It remains to be seen whether the G-20’s commitment will be held, especially by the countries at the origins of the imbalances: the US, China, Germany...

The G-20 took the commitment to collectively monitor the evolution of the global economy to ensure that implemented economic policies allow for “a strong, sustainable and balanced growth”, to identify risks (particularly financial risks) and to suggest adjustments. The IMF should help “its members to cope with financial volatility”, reducing the perceived need for excessive reserve accumulation” and “strengthen its ability “to provide even-handed, candid and independent surveillance of the risks facing the global economy and the international financial system”. Meanwhile, the G-20 is refusing to “restrict capital flows”, to fight against speculative behaviours, to settle more stable financing laws or to reorganize the International Monetary System.

The G-20 recognizes that the crisis was induced by “reckless and irresponsible unconscious risks” taken by banks and financial institutions. The objective remains to better control the institutions and financial markets, but not to greatly reduce their role and their weight. Banks will have to hold more capital, especially to cover market risk, securitized credit and off-balance assets. The capital requirements will be anti-cyclical. But the risk remains that banks fulfil these requirements by reducing their lending to businesses and households or by increasing their profits. The G-20 does not prohibit banks from engaging in speculative activities or from lending to hedge funds; the G-20 did not consider to oblige banks to restrict their activity on the credit distribution to businesses and households and on safe and low-remunerated assets.

The derivatives markets should be more transparent, but the G-20 does not propose to strictly limit it to the coverage of actually held assets.

All institutions whose failure could raise systemic risks should be subject to regulation. Large financial groups and cross-border groups will be better controlled. But the G-20 does not propose measures to reduce the size and the internationalisation of financial groups.

Wage practices should be reformed: bonuses should be spread over time, should reflect risks exposure and should be recouped in case of losses. But traders’ incomes will not be capped and there was no agreement to harmonise their taxation at a high level.

The G-20 welcomed the progress in the fight against tax and regulations heavens and agrees to continue. But the G-20 did not re-examine the list of these heavens; the G-20 maintained lax criteria for allowing a country to leave the list. The G-20 refused to take a strong measure: to prohibit financial institutions and firms to set up subsidiaries and to locate any financial (or having tax consequences) activity in these countries.

There have been worrying signs more recently: banks are making high profits in 2009 by taking advantage of very low refinancing rates they did not fully passed on to borrowers; many banks have repaid State aids in order to recover rapidly their entire freedom; Anglo-Saxon banks pay again high bonuses and compete again to attract traders to speculate like before; the crisis has caused mergers among financial institutions which can now benefit from their monopolistic situation to make huge profits (like Goldman Sachs and BNP-Paribas). The foreign exchange market is again unstable: the euro is appreciating and has come close to \$1.50 which endangers EU firms’ competitiveness. World equity markets, which had dropped by about 55% from March 2007 to February 2009 have risen since by more than 40%. The global economy is not immune to the resurgence of asset bubbles.

The G-20 has gone very far in the right direction, but the reforms hit the interests of large capital owners and financial sector leaders. They will try to delay reforms, hoping to quickly resume their activities as before, as they did after the implosion of the dot.com bubble. Will the willingness of reforms of the G-20 leaders be strong and durable enough?

2.3. About expansionary monetary policies

Central banks have responded to the crisis in cutting drastically their base rates, providing massive liquidity to banks and using non conventional tools (accepting lower quality assets as collateral and buying if necessary long term assets).

However, in a deep crisis, monetary policy rapidly reaches limits. Low nominal interest rates remain high as compared to growth and inflation, especially as the spread between central

bank rate and credit or corporate bonds rates increases. At the beginning of 2009, the interest rate on the Aaa corporate bonds was 5.05% in the US, for a 1% expected GDP growth in value for 2009: the spread between the two variables was 4 percentage points, when it was only 0.5 in July 2007. In France, the interest rate for companies' credit was 4.6% for a 1.3% expected growth of GDP in value in 2009; the spread was 3.3 points as compared to 1 point only in July 2007. Borrowing costs remain high for companies anticipating a decline or a stagnation of their prices and output. Uncertain economic prospects discourage companies and households to borrow and banks to lend. It is very difficult for monetary policy not to be pro-cyclical.

Table 4. Interest rates and GDP growth expectations

	June 07	January 08	June 08	January 09	June 09
<i>USA</i>					
Fed funds	5.25	4.0	2.0	0.15	0.15
Treasury 10-year	5.0	3.75	4.0	2.5	3.6
Corporate bonds*	5.7/6.65	5.3/6.55	5.65/7.15	5.05/8.15	5.4/6.3
Forecast GDP growth**	5.2	4.8	-3.2	1.0	3.9
<i>France</i>					
ECB rate	4.0	4.0	4.2	2.3	1.0
Treasury 10-year	4.6	4.15	4.7	3.6	3.7
Companies credit rate	4.9	5.2	5.5	4.6	3.4
Forecast GDP growth **	3.9	3.75	-2.8	1.3	1.3

*Aaa/Baa; ** In value

Sources: Fed, Banque de France, OFCE calculations.

In a financial economy, central banks face a difficult choice: should interest rates be durably maintained at very low levels at the risk of generating new financial and housing bubbles and hence giving again illusionary wealth to companies and households?

2.4. What fiscal stimulus to tackle the crisis?

In a situation of falling output, governments should respond through fiscal policy in allowing public deficits to rise.

First the automatic stabilisers will play: they have the advantage of playing without delay and they can be reversed. They are larger in economies with a high level of public taxation, progressive taxation and unemployment benefits, larger in continental Europe than in Anglo-Saxon economies. Second will come discretionary measures explicitly designed to support activity: rise in public spending and investment, tax cuts or increase in social benefits (table 5).

According to the 3T rule, stimulus measures should be *timely, temporary and targeted*. However, their temporariness may be questionable if the crisis has structural causes: for instance, inequalities have dramatically risen in Anglo-Saxon countries and social benefits may be increased on a permanent basis through higher taxation on the wealthiest; China needs to support durably consumption through the introduction of a decent social protection.

Table 5. Advantages and drawbacks of fiscal stimulus

Measures	Advantages	Drawbacks
Rise in public investment	Temporary; direct effect on activity; useful for low run growth; no impact on the net public balance	Too long lags; Too sector-targeted
Households' direct taxation cuts	Temporary	Benefit to the wealthiest; small impact on consumption
Rise in social benefits	Benefit to the poor; strong effect on consumption; cooperative	Irreversibility risks
Rise in unemployment benefits	Temporary; benefit to people in difficulty; strong effect on consumption; cooperative	Obstacle to return to the labour market (?)
VAT cut	Temporary; cooperative	Impact on prices is uncertain; indexation management; deflationary risk
Companies' tax cuts	Temporary	Does not benefit to firms in difficulty; impact on investment uncertain; anti-cooperative
Firms' subsidies	Temporary (?): may be targeted towards innovative or in difficulty firms	Difficult to implement; may introduce distortions; anti-cooperative
Employers' social contribution cuts	Temporary	Impact on investment uncertain; anti-cooperative

If fiscal policy is seen as temporary, then private agents may fear that the end of the fiscal stimulus will depress activity. It should be announced that the stimulus will last as long as necessary.

The housing sector is particularly hit by the crisis and should be supported. However countries like Spain have no alternative but reduce the weight of this sector in their economies. Investment goods sectors are also strongly affected by the crisis and cannot be so easily supported by fiscal policy: this is a problem for Germany.

The needs for a rapid stimulus (supporting existing sectors) may come in contradiction with long-term needs (shifting production towards less energy-intensive and more environmentally-friendly processes).

In a situation of insufficient demand, output needs to be substantially supported. The IMF had suggested a fiscal stimulus of 2% of GDP at the world level; the European Commission of around 1.5% of GDP at the EU level.

Ideally policies should be strongly coordinated in order to:

- Prevent free riding behaviours (some countries benefiting from the stimulus policy in neighbour countries),
- Avoid strategies with detrimental effects on other countries (exchange rate depreciation, wage moderation, protectionism)
- Design a long-term strategy (in particular as concerns the financial system and taxation)

But coordination takes time and is difficult to settle. Each country has reasons for doing less than other countries: EU countries may request the bulk of the effort to be made by the US, responsible for the crisis, but the US may reply that on the contrary the crisis is due to the fact that in the past the US was the only country to support world growth; Germany may not wish to undermine its previous restructuring efforts although this efforts are viewed as counter-productive by EU partners.

The current crisis has highlighted the general problem of fiscal policy: the rise in public deficits and debt. This should come to an end at some point, but without pushing the economies back to the crisis. The level of public debt has been permanently increased under the effects of the crisis. Once the crisis is over, can the implementation of a durably restrictive fiscal policy stance be avoided?

3. The French fiscal policies during the crisis

3.1. French fiscal specificities

France has remained a mixed economy with a high level of public spending and taxation, persistent public deficits and a rather Keynesian fiscal policy. France has not implemented an extensive programme of structural liberal reforms, because of the disapproval in the population, of the State tradition and of the lack of enthusiasm among leading classes, closely linked to the State.

In his 2007 electoral campaign, Nicolas Sarkozy set the objective of substantial cuts in taxation levels and public deficits which should imply dramatic public spending cuts (but the contents of the strategy were never totally unveiled, except for the reduction in waste of public money and in the number of public servants).

This objective was based on:

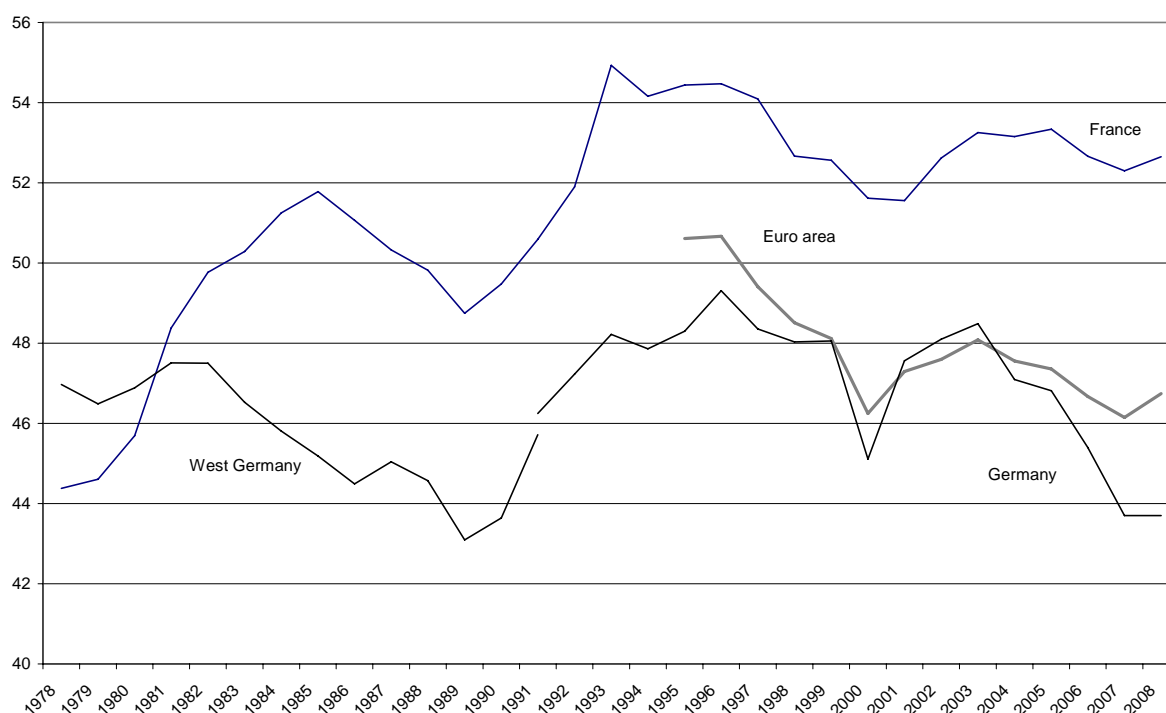
- 'liberal' considerations (lower tax rates will boost employment, savings, investment, and so production)
- the difficulty to maintain high taxation in the context of globalisation and the European single market without tax harmonisation.

In 2007-2008, the French government cut taxes but did not succeed in reducing substantially public spending. In the crisis, France has had difficulty to implement a large-scale temporary fiscal stimulus. There is a contradiction between the need to increase public expenditures and the desire to reduce them structurally. Most of the implemented tax cuts will be permanent. The discretionary stabilisation measures were insufficient. But, due the weight of automatic stabilisers, France was less hit by the crisis than most EU countries. Nevertheless, France has now to face a structural crisis of its public finances.

3.2. A relatively high public spending

The weight of public spending has remained high in France: 52.7% of GDP in 2008 as compared to 46.8% in the euro area (see Chart 1).

Chart 1. Public spending, as a percentage of GDP



Note: Total expenditure: general government:- Excessive deficit procedure (Including one-off proceeds (treated as negative expenditure) relative to the allocation of mobile phone licences (UMTS))

Source: European Commission, AMECO Database.

Contrary to most euro area countries, France has made very limited effort to cut the weight of public spending in GDP (table 6). France benefited less than the area average from the reduction on public debt interest payments. In 1990, public spending amounted to 49.5% of GDP in France i.e. 1 percentage less than the euro area average. In 2007, the ratio was 6 percentage points above the euro area average. In 2007, France became the EU country with the highest public spending level as a percentage of GDP.

Table 6. Public spending growth (in real terms)

In % per year

	1991/2001	2001/2008
France:		
GDP	2.05	1.6
Public expenditures	2.25	1.9
Euro area :		
GDP	2.1	1.6
Public expenditures	1.7	1.5

Sources: OECD, OFCE calculations.

The weight of primary public spending in GDP has remained stable since 1990 in the EU-15 taken as a whole. There have been significant cuts in some countries: the Netherlands (7 percentage points), Sweden (6.5 percentage points), Spain (4 percentage points), either because of social protection privatisation or because of rapid GDP growth. But public

spending as a percentage of GDP has risen in some other countries: Portugal (10 percentage points), UK, Belgium and Greece (4 percentage points). It increased by 2.5 percentage points in France, where it was already at a relatively high level.

Table 7. Primary public spending in EU countries

	Primary public spending, as a % of potential GDP		
	1990	2000	2007
Germany	42.6	45.2	41.5
Austria	48.5	49.2	47.7
Belgium	41.0	43.0	45.1
Finland	48.4	46.3	46.7
France	47.5	49.1	50.1
Greece	36.1	39.5	40.0
Ireland	36.2	31.1	35.5
Italy	43.4	41.7	43.3
Spain	41.2	36.4	37.3
Netherlands	50.5	42.5	43.4
Portugal	33.0	41.3	42.7
Denmark	48.5	51.3	50.0
UK	38.8	38.0	42.8
Sweden	56.4	53.7	50.0
EU-15	43.4	43.2	43.7

Sources: OECD, OFCE calculations.

Public spending composition

Public spending is about 6 percentage points of GDP higher in France than in the euro area. The gap is particularly large in the field of social protection (including health) where public spending is almost 4 percentage points higher in France than in the euro area (table 8). France has an almost entirely public health system and pays generous housing and family benefits, family supports such as child care expenditure and support to mothers who leave their job to care after their young children; unemployment benefits are relatively generous; France has also a minimum income system; the basic and the complementary pension systems are public and older people are entitled to a generous minimum allowance.

Public spending in education is 1 percentage point of GDP higher in France than in the euro area, due to a higher share of young people in the population and to the low level of private spending in education in France. Public spending is slightly higher in France in housing and collective infrastructure (0.9 percentage point) and in culture (0.5 percentage point).

A large cut in public spending would require substantial cuts in public expenditures directly benefiting the population (health, pensions, family benefits, etc), which would be unpopular and questionable from a social point of view (inequalities would rise) and from an economic point of view (people would have to replace public expenditure by private ones; it is not certain that it would be more efficient for education, health, pensions,...).

Table 8. Government expenditure by function in 2007

As a % of GDP

	FR	EA	EU-15
General public services	6.9	6.6	6.2
Defence	1.8	1.3	1.5
Public order and safety	1.3	1.6	1.7
Economic affairs	2.8	3.9	3.7
Environment protection	0.9	0.7	0.8
Housing and community amenities	1.9	1.0	1.0
Recreation, culture and religion	1.5	1.1	1.1
Education	5.9	4.8	5.1
Health	7.2	6.5	6.7
Social Protection	22.2	18.8	18.8
Total	52.3	46.1	46.1

Source: Eurostat.

Recent projects for large public spending cuts in France

Since 1998, all updates of the Stability Programmes submitted by France have announced a significant deceleration of public spending growth. But this did not occur before 2006 (see Table 9). Public spending in volume grew by 2.1% in 2005 and slowed down to 1.1% in 2006, 1.5% in 2007 and 1.2% in 2008. Public expenditures were managed with a strong discipline: for instance, family benefits, pensions, minimum incomes were indexed on prices only and not on wages. However, this did not allow for a reduction of public spending as a share of GDP.

Table 9. Public expenditures growth, per year, in real terms

In %

	Stability programme	Observed
2000-2002	1.0	2.3
2001-2003	1.3	2.5
2002-2004	1.5	2.5
2003-2005	1.3	2.2
2004-2006	1.3	1.8
2005-2007	1.1	1.6
2006-2008	1.2	1.3
2007-2009	0.6	2.0
2008-2010	0.6	1.9
2009-2012	1.125	
2011-2013	1.0	

Sources: OFCE calculations.

Many texts (in particular the Peberreau's Report) have called for a strong decrease of public spending in order to lower the tax burden on the productive sector. But this assumes that the

existing public expenditures are unnecessary. However, many public expenditures are useful to growth (education, research) or production (infrastructure, child care support). Others are crucial for households (health, retirement) and their reduction would have to be offset by increased private insurance spending, at a similar or higher cost. Finally, some reflect a social choice for a society with more solidarity (minimum income, unemployment benefits). While a rigorous management of public finances is needed, a social choice has to be made between public and private expenditure but we may think that households prefer more nurseries than more bank branches and that the ratio of teachers to golden boys' wages should be increased rather than the opposite.

The LOLF (*Loi organique relative aux Lois de Finances*) adopted in 2001 and enforced from 2006 has modified management practices and adoption rules of the French budget. Expenditure limits are classified into 120 programmes, then grouped in 'missions'. The manager of each 'mission' has a certain degree of freedom to reallocate expenditure. The outcomes of each mission are controlled through precise indicators. Performance reports are expected to control the evolution of indicators and budget costs. The LOLF aims at improving public spending efficiency. There is no certainty that it will allow to cut spending. For instance, as concerns family policy, the LOLF sets targets in terms of living standard parities for families relatively to couples without children, of child poverty rates and of child care; but the fulfilment of these targets would require an increase in public spending.

According to the Attali's Report (January 2008) the government and other public administrations should be substantially reformed and public spending should be cut and focused on some precise objectives. However, the Report recommends substantial programmes aiming at increasing infrastructure, supporting social housing, reducing the number of poor people down from 7 to 3 million, improving pre-primary, primary and higher education, adapting France to innovation. At the same time, the report advocates for cutting public expenditure by 1 percentage point per year during 5 years, which implies that public spending should grow by 0.5% per year only (the report even says 0). Are these objectives consistent? Yes, according to the report, owing to expenditure reallocations and development of private-public partnership. But is this credible? Some cuts recommended by the Report are arguable: reducing family allowances according to incomes (but the government has refused this measure); introducing a non-refundable payment on medical costs depending on incomes; abolishing a regional level of government administration - the 'départements' (but who will manage social assistance?). But the main idea is to increase efficiency, like abolishing a large part of support to companies, employment and housing which would be inefficient (but is this true?). The Report recommends a change in civil servants earnings' growth rules. However, their average real wage decreased by 0.4% between 2000 and 2007 (as compared to an increase by 5.7% in the private sector). Can it decrease even more rapidly? The report recommends not to replace 2 civil servants over 3 retiring, i.e. a 8.5% cut in the number of civil servants in 5 years and a 5 billion euro reduction in costs (0.25% of GDP), the third of which would be allocated to civil servants' wage increases. No evidence that substantial savings measures could be implemented is given.

The General Revision of Public Policies intends to reduce public spending albeit increasing efficiency and quality of public intervention. Here also, there is a bet that more can be done at a lower cost, which avoids social choices to be debated and made. Public policies have been assessed by high civil servants and private consultants. Decisions are made by a steering committee in which the weight of the finance ministry is very high. On the contrary, the

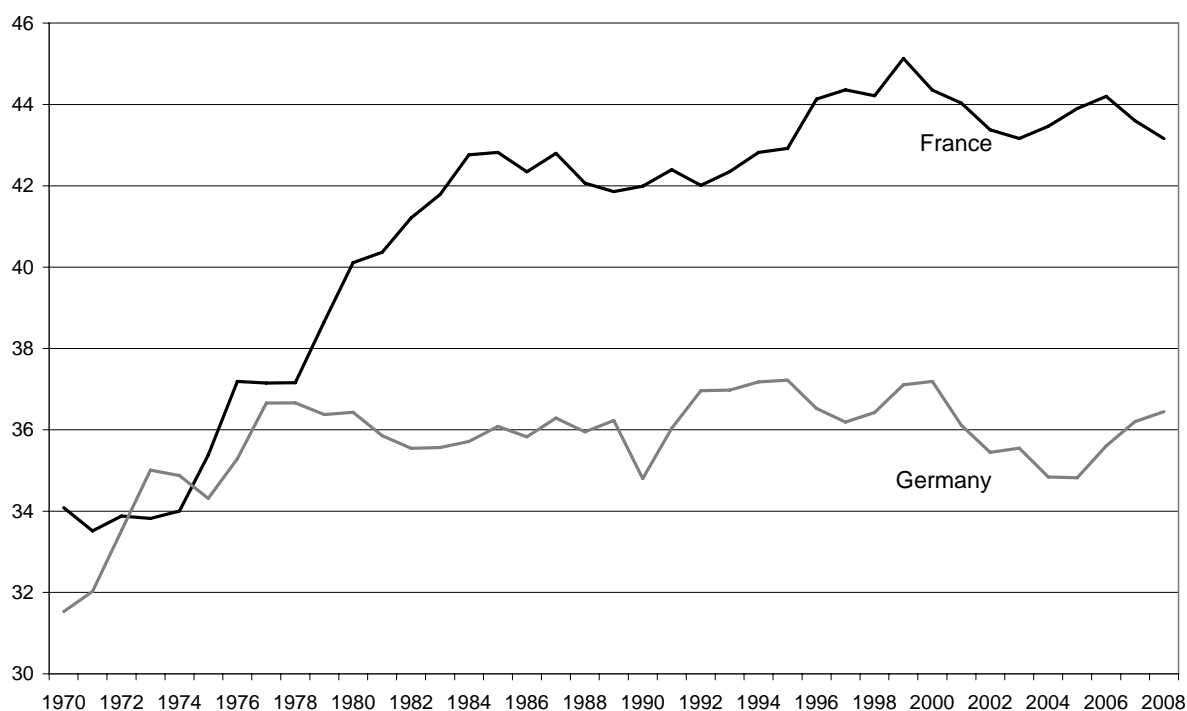
opinions of the concerned administrations and especially of concerned people are not taken into consideration. The announced measures deal with merging some administration branches, reducing the field of the administration, privatising some tasks and abolishing some benefits. Most measures are arguable and it is not certain that the government could resist the opposition of people (and even administrations) involved.

Until now, the French governments have refused to cut massively public expenditure and especially benefits. Benefits slowly diminish in relative terms, but there is no massive privatisation of health, education or pensions systems; no massive cuts in family or assistance benefits. The EU pressure and liberal mainstream views on the one hand and the wish of the population on the other hand lead rooms for manoeuvre to be very small.

3.3. French taxation system

The French tax to GDP ratio increased significantly from 34% in 1974 to 42.5% in 1984 and remained stable at that level until 1993. It reached 44% in 1996 and remained roughly at that level until 2007, 4 percentage points above the EU15 average. In 2007, France ranked 3rd among OECD countries (behind Sweden and Belgium) in terms of tax to GDP ratio.

Chart 2. Tax revenues as a percentage of GDP in France and Germany since 1970



Sources: OECD, *Revenue Statistics*; estimates for 2008 based on AMECO database, April 2009.

Since 1984, French governments have considered that the tax-to-GDP ratio had reached a maximum and that structural adjustment would be done through spending cuts. Since it is difficult to cut spending levels in a short period of time, this choice explains the rapid rise in public deficits in 1992-1995 and later in 2002-2004. The government raised taxes in 1996-1997 only because of the Maastricht binding rules.

According to Eurostat classification, taxation is slightly heavier on labour in France than in the EU-27. This is much more true for capital, which may be justified both from fairness and economic efficiency view points in a context of mass unemployment, but raises today a problem because of free movements of capital.

Table 10. Implicit tax rates, 2007

In %

	France	EA	EU27
Consumption	19.5	19.6	20.0
Labour	41.3	38.7	36.5
Capital	40.7	32.1	34.2

Source: Taxation trends in the EU, Eurostat (2009).

The French taxation system has four main features:

- Households' income taxation is especially weak (7.5% of GDP against 9.4% in the EU). This is partly offset by a high local taxation.
- Employers' social contributions are particularly high (11% of GDP against 7.2% in the EU).
- Business tax is high (corporate tax, business tax (*taxe professionnelle*))
- Households' wealth taxation is relatively high (tax on higher wealth ISF, estate and inheritance taxes).

French taxation remained relatively redistributive, with some specific taxes like wealth taxation and business tax (*taxe professionnelle*) which make France an isolated example in Europe. The higher marginal tax rate earnings is 56.8% which is higher than in Germany (47.5%) or in UK (46.8%).

The current French government is tempted to implement liberal reforms in order to adapt to globalisation, through lowering the tax burden on the most mobile factors: companies, capital, the highest wages or the wealthiest. At the same time, the government projects to cut labour taxation, although there is no budgetary room for manoeuvre and no implementation of a strategy of massive public spending cuts.

3.4. French fiscal policy

In 2007 and in 2008 - before the crisis-, France was the only large country in the euro area keeping a close to 3% of GDP public deficit and hence looked as the only 'sinner' in the area. In Germany and Italy, public deficits had been substantially reduced. France looked like the only country resisting the prevailing anti-Keynesian view in Europe. The latter inspires euro area economic policies, the independence of the ECB and the Stability and Growth Pact. This framework seems unable to support growth in Europe and thus France has some reasons for departing from this view.

However, France does not explain its policy and does not seem to try to impulse a change in economic policy in Europe. France regularly promises to bring the government deficit back to 0 and hence seems more like being unable to control its public finances than trying to implement another policy in the EU.

Table 11. French public balances according to the stability programmes

	General government balance (per cent of GDP)											
	Stability Programmes											Actual
	J99	J00	J01	J02	J03	J04	J05	J06	J07	J08	J09	
98	-2.9											-2.6
99	-2.3	-2.1										-1.8
00		-1.7										-1.5
01			-1.0									-1.6
02	-1.2		-0.6	-1.4	-2.8							-3.2
03		-0.5	-0.4	-1.3	-2.6	-4.0						-4.1
04			0.2	-0.5	-2.1	-3.5						-3.6
05				0	-1.6	-2.9	-2.9	-3.0				-3.0
06					-1.0	-2.2	-2.2	-2.9	-2.7			-2.4
07						-1.5	-1.6	-2.6	-2.5	-2.4		-2.7
08							-0.9	-1.9	-1.8	-2.3	-2.9	-3.4
09								-1.0	-0.9	-1.7	-3.9	-8.2*
10									0.0	-1.2	-2.7	-8.5*
11										-0.6	-1.9	
12										0.0	-1.1	

* French government 2009 forecast.

Sources: European Commission, Stability programmes, Eurostat, own calculations.

From 1998 to 2000, the fiscal stance was rather expansionary: France refused to implement restrictive policies, in order not to put the economic recovery at risk. In 2000, government deficits reached 1.5% of GDP. France was far from the 3% of GDP limit, but had not built any room for manoeuvre.

In 2002-2003, in a context of a world economic slowdown, France ran an expansionary policy (1.5 percentage point of GDP) which added to the cyclical deficit and led deficits to reach 4% of GDP in 2003, like in Germany, initiating a crisis of the SGP in November 2003. At the whole euro area level, the fiscal impulse only reached 1.2 percentage point of GDP over these 3 years, as compared to 6 percentage points in the US and 5.4 percentage points in the UK.

From 2004 to 2006, while France had a small negative output gap, restrictive fiscal policies were run (1.6 percentage point), which allowed France not to reach the 3% of GDP limit.

Fiscal policy was therefore pro-cyclical from 1994 to 1997 (due to the convergence process to the Maastricht criteria), in 2000 (for electoral purposes), from 2004 to 2006 (due to the lack of room of manoeuvre). On the contrary, fiscal policies were stabilising in 2002-2003 although probably insufficiently.

Table 12. Fiscal developments in France

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
Public balance	-3.3	-2.6	-1.8	-1.5	-1.6	-3.2	-4.1	-3.6	-3.0	-2.3	-2.7	-3.4
Output gap	-1.2	-0.1	0.7	2.4	1.8	0.6	-0.6	-0.6	-0.9	-0.7	-0.6	-2.4
Cyclical component	-0.6	-0.1	0.3	1.2	0.9	0.3	-0.3	-0.3	-0.4	-0.3	-0.3	-1.2
Interest payments	3.1	3.0	2.8	2.7	2.7	2.7	2.6	2.5	2.4	2.3	2.5	2.6
Cyclically-adjusted primary balance	0.4	0.5	0.7	0.0	0.2	-0.8	-1.2	-0.8	-0.2	0.3	0.1	0.4
Fiscal impulse		-0.2	-0.2	0.7	-0.2	1.0	0.4	-0.4	-0.6	-0.5	0.2	-0.3
Sustainability index*	1.0	0.5	0.3	-1.2	-0.9	-1.1	-0.9	-0.5	0.3	0.7	0.4	1.6

*Cyclically-adjusted primary balance less 0.5 output gap. *Source:* own calculations.

Is the French public debt sustainable?

The French public debt (according to Maastricht definition) reached 63.8% of GDP at the end of 2007. Since 1991, public debt rose by 28 percentage points of GDP in France, as compared to 8 percentage points for the euro area as a whole. Although in terms of debt trends, France performed less well than the average, the French debt level does not depart from most EU countries and even shows a more favourable position. The French debt level is below the euro area average (66.4%) and close to the US level (65%), well below Belgium (84%), Italy (106%) and Japan (181%).

The Maastricht definition for government debt does not account for assets owned by the general government sector and among them financial assets. The general government sector owns substantial financial assets in France. At the end of 2007, the net financial debt was 34% of GDP in France. The French net public debt is well below the euro area average (43.5%), the Germany (43%), the US (43%) and Japan (80.4%).

From 1995 to 2007, the net financial debt remained roughly stable in France (-3 percentage points of GDP). The rise in the French gross public debt was to a large extent offset by the rise in the value of financial assets owned by the general government sector. The choice made by EU authorities of a gross definition for the public debt is not neutral; it penalizes the countries where the government owns public firms.

Table 13. General government accounts

In % of GDP

	1994	2007	2008
Non financial assets	57.0	76.3	74.3
Financial assets	30.5	45.4	42.2
Debts	62.9	80.3	86.4
Net value	24.6	41.5	30.1

Source: INSEE, own calculations.

If we take non financial assets into account, then the net value of general government sector was 41.5% of GDP in 2007. France is not indebted vis-à-vis the rest of the world: French net overseas assets are slightly positive, around 1% of GDP at the end 2007.

Many definitions of public finance sustainability have been proposed:

1. Fiscal policy is satisfactory when it does not generate an inflation rate above the central bank objective; it does not lead the central bank to set the interest rate above the nominal GDP growth rate; it does not induce an excessive external deficit. This is the case with the current French fiscal policy.
2. Financial markets do not fear any default risk. French government debts are ranked AAA by notation agencies (Standard and Poor's, Fitch ratings). Financial markets are willing to hold French government debt at low interest rates: in September 2009, 3.6% for 10-year bonds; in January 2009, 4.1% for 30-year bonds.
3. We can define public finance sustainability as the stability of the public debt-to-GDP ratio. If the nominal interest rate is close to nominal GDP growth and if the stabilising discretionary measures may represent half of the output gap, the primary structural balance should be higher than half of the output gap. French public finances seems unsustainable from 2000 to 2004, sustainable since 2005 (table 12).
4. The European commission defines sustainability as the stability of the debt-to-GDP ratio in a scenario where tax rates are stable and public expenditures rise due to an ageing population (European Commission, 2009). But this definition is not acceptable: a country should not raise tax rates today because, in the future, its health or pensions expenditure will rise. A country has the right to envisage that its taxes rates will be increased when expenditures rise, not before.
5. If the objective is that net public debt equals general government assets, then the structural deficit should be higher than: net investment + government debt depreciation due to inflation + capital gains on owned shares. The upper limit for the French structural deficit is thus at around 2.8% of GDP, i.e.: net investment (1% of GDP) + debt depreciation (1.2%) + capital gains on shares (0.6%).

Public finances need to be managed seriously, but in the light of these different indicators, the French public debt does not currently raise any sustainability problem.

3.5. Nicolas Sarkozy's fiscal policy (2007-2008)

During the electoral campaign, Nicolas Sarkozy announced the objective of cutting the French tax-to-GDP ratio from 44% to 40%, at the EU average. He wanted to cut labour taxation (to give a work incentive to workers), companies' taxation (to improve their competitiveness), and taxes on the wealthiest and high-income earners (to encourage them to remain in or come back to France). At the same time, France had a public deficit of 2.3% of GDP in 2006 and the government promised to cut it by at least 0.5 percentage points per year.

Simultaneously, Nicolas Sarkozy promised to increase many social expenses and public spending for research and higher education; the new announced measures amounted to around 32 billion euros per year. At the same time, Nicolas Sarkozy also announced a huge cut of total public spending although its content was not explained, except for a reduction of *waste of public money*, a reform of the pension system of public firms (the *régimes spéciaux*¹) and to reduce the number of public servants by replacing only 1 over 2 retiring.

Nicolas Sarkozy expected a robust growth. This growth would have been boosted by an increase in labour supply induced by measures increasing gains from work (the motto was

¹ In fact, the government reformed the *régimes spéciaux* in 2008, but this reform had no financial impact in the short-term, as wages were increased to offset the degradation of the pension system.

‘work more to earn more’, ‘*travaillez plus pour gagnez plus*’) and by the shock of confidence that its liberal policy would induce for companies’ owners. This growth would have brought revenues allowing to finance the programme.

This hope of robust growth has vanished with the crisis. The fiscal stimulus objective requires the government to boost public spending, which is in contradiction with its fiscal programme for the long run.

On the revenue side, a tax package was adopted in the summer of 2007 (the ‘*paquet fiscal*’). It introduced an income tax reduction for mortgage interest payments, a tax cut for overtime worked hours, a significant reduction in inheritance taxation, a reduction of households’ wealth taxation and a ‘tax shield’ (the ‘*bouclier fiscal*’): households will not pay more than 50% of their before-tax income in direct taxes, including the income tax, the local tax, the CSG (the social contribution), the ISF (the wealth tax). The tax shield benefits to the wealthiest households, especially to people who live in a flat that they own or rich people who do not realize their gains on their wealth (as implicit rents and unrealized gains are not included in their before-tax income).

The government increased the research tax credit and abolished the local business tax (*taxe professionnelle*) on new investment spending. In 2009, the French government was allowed by its EU partners to cut VAT on restaurants, which is an expensive and inefficient measure that the government had promised to the restaurant lobby.

In 2009, the government has decided to reform the local business tax. The reform will cost 7.3 billion euros; the reduction will benefit mainly firms in the industrial sectors.

In 2010, the government will introduce a carbon tax as an incentive for households and firms to reduce CO₂ emissions. To avoid that this tax would unpopular, the amounts of the tax paid by households will be returned to them by a lump sum, although the French public deficit is large.

Altogether, the permanent tax cuts amount to 1% of GDP.

On the expenditure side, the RMI (minimum income, *revenu minimum d’insertion*) was transformed into the RSA (*revenu de solidarité active*). The reform provides a supplementary income for vulnerable workers and their family; it increases their gains when they return to work (but the impact will be small in the short run as the labour market situation dramatically deteriorates); the measure costs 1.5 billion euros and is financed by a levy of 1.1% on capital incomes. It is the only case where the government has increased taxation.

The non-replacement of 1 over 2 civil servants who retire will amount to a 7 billion euros cut after 5 years. This measure is problematic in a context of high and rising unemployment. The reduction weighs mainly on teachers, which come in contradiction with the objective of raising the education level and diminishing social inequality through education.

The whole set of fiscal measures will have increased the deficit by 0.8 of GDP on a permanent basis. France has undertaken its stimulus plan before the crisis.

The government refuses any significant increase in the tax burden, believing that the tax rate is too high in France. The government refuses to reform the *bouclier fiscal* which protects the richest from any taxation rise. The government wants to rebalance public finances by reducing public expenditure. The strategy is to cut taxes first and to rely afterwards on the public deficit to force a reduction in expenditure.

Table 14. Permanent fiscal measures

In billions euros

	2007	2008	2009	Full year
Mortgage tax reduction		-0.3	-1.1	-4.0
Overtime work tax cuts	-0.9	-3.3	-5.0	-5.0
Wealth taxation		-1.0	-1.2	-1.2
Inheritance taxation	-0.4	-1.6	-2.0	-2.0
VAT on restaurants			-1.2	-2.4
Local taxation on firms		-3.0	-3.0	-7.3
Flat tax on firms			-0.3	-1.6
Research tax credit		-0.6	-1.2	-2.0
Carbon tax				+1.4
Tax on capital incomes			+1.3	+1.5
Tax on health insurances			+1.1	+1.1
Taxes	-1.3	-9.2	-12.4	-21.5
RSA			0.7	1.5
Cuts in the number of civil servants		-1.4	-2.8	-7.0
Expenditures		-1.4	-2.1	-5.5

Source: Ministry for finance, own estimations.

3.6. French policy answers to the crisis

During the crisis, Nicolas Sarkozy has changed the tone of his speech, from a liberal to a social, interventionist and industrialist one. During the three G-20 summits, France advocated for a reform of financial markets and institutions and a reform of world economic governance. At Argonay, on 23 October 2008, Nicolas Sarkozy said: "The ideology of the market being powerful and the public being powerless died with the financial crisis. We must re-establish the world capitalism by giving the leading role of the entrepreneur and the worker, not the speculator". He announced heavy public interventions:

1. "Alongside investment in universities, research and the environment, we are going to invest heavily in the digital economy, which will be the driver of future growth, along with clean technologies"
2. Introduction of a public intervention fund, "*Fonds stratégique d'investissement*" which could provide support to French strategic companies to protect their capital or help them finance their growth (capital: 20 billion euros; 14 billion in already made participation and 6 billions in available liquidity).
3. Over three years, "175 billion euro of direct investment" will be injected by the government into economic activity
4. Complete exemption from local business tax for investments made between now and the beginning of 2010.

At the same time, he maintained a liberal strategy by making the legislation for work on Sundays more flexible.

French policy answers to the crisis: December 4th 2008

The stimulus package announced in December 2008 was relatively limited in size (26 billion euros, i.e. 1.3% of GDP). But automatic stabilizers are high in France. The government refused to strongly support households' consumption and preferred to focus on public investments and firms aids. The argument was that public investments prepare the future and do not increase the net public debt, while support to firms allows them to maintain employment, thus benefiting households.

Public investments should be raised by 10.5 billions euros, of which 4 should be made by the State, 4 by Public companies and 2.5 by local authorities. The initial announcement was to implement all investment in 2009, but from the Finance Law adopted in early 2009, 70% of planned investment was expected to be implemented in 2009. In 2009, the government has made a lot of efforts to accelerate the implementation of these new investments, at the detriment of their relevance. For instance, the government has accepted to suspend urbanism rules and environmental objectives.

The stimulus package (4th December 2008): 26 billion euros (1.3% of GDP)

Public investment: 10.5 billion euros (0.5% of GDP)

General government investment: 4.0 bn

- Infrastructure: 1.4 bn
- Research and higher education: 0.7 bn
- Military defence, public order and safety: 1.36 bn
- Historical buildings. 0.6 bn

Public corporations' investment: 4.0 bn

- EDF (2.5), GDF Suez (0.2), RATP (0.45), SNCF (0.3), La Poste (0.6)

Support to local government investment: 2.5 bn

- advance payment (€2.5 billion) of the 2008 FCTVA in 2009 (due to be paid in 2010).

Support to companies: 11.4 billion euros (0.6% of GDP)

- Reimbursement of sums due by the Treasury to companies. Reimbursement of research tax credit and VAT on a monthly basis.
- Accelerated depreciation of investments made in 2009;

Support to the housing sector and automobile sector: 2 billion euros (0.1% of GDP)

Housing sector: 1.8 bn

- Doubling the size of the 0% interest rate mortgage credit: 0.6 bn
- Building 100,000 houses: 0.6 bn
- Urban renovation, specific investment in housing : 0.6bn

Automobile sector: 0.2 bn,

- car-scrapping scheme (*prime à la casse*)

Employment policies: 1.2 billion euros

- Incentive for job creation in companies with less than 10 workers: 0.7 bn
- Active employment policies (*transition professionnelle contract*): 0.5 bn

Social policies

- Bonus for low-income earners: *Prime de solidarité active* (PSA).

Social Summit (18th February 2009): 2 billion euros

- Unemployment benefits: 0.25 bn
- Family allowances: 0.8 bn
- Income tax cut: 1.100 bn

The measures aimed to support companies are mainly cash-flow measures. The final cost is only interest payment: 6% on 10 billions euro (600 million per year). They may help firms facing short-term financing difficulties in the crisis.

The *prime de solidarité active* (PSA, active solidarity bonus) is a €200 per household bonus, paid in one payment, in April 2009. It does not depend on the size of the family. The PSA was a temporary measure implemented before the introduction of the RSA in June 2009. It equals roughly two monthly RSA. It benefited 3.8 million low-income households: families at the minimum income (RMI, *revenu minimum d'insertion*), single parent allowance (API, *Allocation de parent isolé*), low-benefit unemployed, low-wage workers (single earning the minimum wage or slightly above, 2 minimum wages for couples, 3 minimum wages for families with 4 children).

Social Summit (18th February 2009): 2 billion euros

In February, when the crisis became deeper, the government organized a social summit and announced new and more targeted to households measures amounting to 2 billion euros.

1. 250 million to improve unemployment benefits:
 - Benefits for part-time unemployment rise from 60% to 75% of the wage,
 - 500 euro given to the unemployed who have worked more than 2 months but not enough to be entitled to the unemployment benefit.
2. 450 million to families: 150 euros for the families entitled to the ARS (*allocation de rentrée scolaire*, a means-tested benefit for low-income families with children of school age). The benefit does not depend on the number of children.
3. 200 million to low-income families (with children, disabled or old people) to buy services to the persons.
4. 1,100 million for a reduction by 2/3 of income taxation for people at the first income bracket (at 5.5%) and for people at the lower range of the second bracket (14%).

The introduction of a “*Fonds d'investissement social*” (Social Investment Fund) was also announced to finance young people’s participation in the labour market, reconversion and vocational training and part-time work schemes. The fund should be allocated 3 billion euros in 2009 (1.3 given par the State, 0.2 by the European Social Fund, 1.5 by the Unedic, the French unemployment fund managed by social partners).

The social measures seem randomly spread among households (table 15): some benefits depend of the family size, some do not; tax cuts benefit middle-income families. Single people receive more than families, unless they earn more than 1.25 minimum wage. Households with an income of one minimum wage per unit of consumption can receive 0, or 200 euros (single person) or 150 euros (family with 2 children). Among the poorest, the single are favoured; above a certain level of income, families are favoured.

The total amount of these measures is rather low (2.8 billion, or 0.14% of GDP); the goal is more to support targeted households than to provide a large support for consumption. But the target has not been clearly defined between three groups of the population: the poorest, the victims of the crisis and “the most modest of the middle class”, which the government wanted to support for political reasons.

The plan should have been more focused on the people hardest hit by the crisis: households becoming unemployed and people at risk of falling into poverty: the young who cannot find a

job and are not entitled to any benefit; the unemployed who reach the end of the period of benefit entitlement.

Table 15. Random benefits?

	Income in minimum wage	<i>by uc</i>	PSA	ARS	Income tax	Total	<i>Total by uc</i>
Single	0.5	0.5	200	0	0	200	200
	1	1	200	0	0	200	200
	1.25	1.25	0	0	0	0	0
Couple	0.75	0.5	200	0	0	200	133
	1.5	1	0	0	0	0	0
	1.875	1.25	0	0	234	234	156
Family with 2 children of school age	1.15	0.5	200	150	0	350	152
	2.3	1	0	150	0	150	65
	2.875	1.25	0	0	529	529	230

Source: own estimations.

What assessment of the French fiscal package?

It is difficult to assess the impact of this fiscal plan:

1. What is the amount of additional investments induced? Will they be implemented in 2009 or later?
2. What will be the impact of measures designed to improve companies' cash-flow?

According to OFCE's estimates, the effective stimulus package amounts to 19 billion euros in 2009 and will have an effect of 0.8% of GDP (without Barro-Ricardo effect and without coordinated stimulus package effects, table 16).

Table 16. An assessment of the French fiscal package: OFCE's estimates

In billion euros	Announced stimulus	Effective in 2009	Multiplier	Impact on GDP
Public investment	4	3	1.2	3.6
Public corporations investment	4	2	1.2	2.4
Local government investment	2.5	1.5	1.2	1.8
Support to firms' cash flow	11.4	7.1	0.4	2.8
Housing sector	1.8	1.4	1.2	1.7
Car industry	0.2	0.2	1.2	0.25
Employment policies	1.2	1.2	1.0	1.2
Social measures	2.8	2.8	0.8	2.25
Total	28.0 (1.4% of GDP)	19.2 (1.0% of GDP)		16.0 (0.8% of GDP)

The French stimulus package has several drawbacks:

- 1) Economic prospects have darkened since the plan was adopted. In November 2008, French GDP was expected to stagnate in 2009 - now forecasts are closer to -2.25% for 2009. The government has refused to adopt a second fiscal plan to support the economy. The main impulse of the plan is on public infrastructure, which is adapted in a longer term perspective. It includes some measures to support the automobile and housing sectors. But the impact remains too sector-oriented.
- 2) It misses important measures to help productive sectors to restructure and make their technologies and their products greener.
- 3) It includes too few measures on consumption, which would be more effective in the short-run. The benefits for low-income earners were relatively small.

Nevertheless, France was less affected by the crisis than the other industrial large countries (table 17). France was less hit than the US, the UK and Spain by the housing crisis; less affected than the US and the UK by the fall in equity markets; less affected than Germany and Japan by world trade's decline. French households' consumption was automatically supported by the size of social benefits and by labour market rigidity; French GDP declined in value by 1.5% from the 1st quarter of 2008 to the 2nd quarter of 2009, but households' disposable income rose by 2.9% (for a 0.4% inflation rate) while firms' gross operating surplus decreased by 6.7%; the French social model continues to protect households. Social benefits amounted to 0.2 percentage point of the 0.6% increase of households' real disposable income in 2008; 1.45 point of 1.6% in 2009. Contrary to the US and the UK, France did not see a depreciation of its exchange rate and its fiscal impulse was rather limited.

Table 17. The larger industrial economies in the crisis

	GDP	Consumption	Investment	Net exports	Fiscal impulse
United States	-3.8	-1.8	-20.6	1.8	4.8
Japan	-7.1	-0.7	-25.6	-2.6	1.9
United Kingdom	-5.1	-3.1	-19.7	1.9	5.4
Germany	-4.9	1.0	-17.3	-4.7	0.8
France	-2.7	0.4	-7.1	-0.4	1.5
Italy	-6.2	-2.4	-25.8	-1.3	0.1
Spain	-4.0	1.0	-28.4	5.8	7.6
Euro Area	-4.2	-1.0	-18.4	-1.2	1.2

Source: OECD, *Economic Outlook*, 2009/1.

According to the government, the stimulus package would save about 100,000 jobs (which is compatible with a 0.8% growth impact). But unemployment has rapidly risen since the beginning of 2008: +600,000 up to August, i.e. 2.6 million unemployed, with the unemployment rate reaching 9.1% against 7.1% at the beginning of 2008. Unemployment is expected to continue to rise until the end of 2010 (3 million people unemployed and an unemployment rate of 10.6%).

The government has chosen to not increase the number of subsidised jobs in the private and public sectors. Part-time unemployment was encouraged by an increase in the replacement rate (from 50 to 75%) and by an increase in the numbers of hours entitled to the benefit. At mid-2009, this was concerning around 320,000 workers. In France, social partners

implemented limited measures in terms of vocational training and part-time contrary to Germany where these measures were used to prevent employment to fall too substantially (table 18).

Table 18. Change in GDP growth, employment and unemployment rate

Q2-2009/Q1-2008

	GDP, %	Employment, %	Unemployment rate, percentage point
Germany	-4.9	-0.8	-0.4
Spain	-4.0	-5.6	+9.3
France	-2.7	-1.9	+1.2
Euro area	-4.2	-2.3	+1.9
UK	-5.1	-2.6	+2.6
USA	-3.8	-3.6	+4.5

Source: National sources.

The crisis has led neither to a sharp decline nor to a sharp increase in French unemployment benefits. Two schemes (*convention de reclassement personnalisé* and *contrat de transition professionnelle*) allow for a replacement rate of 80% during the 1st year for people laid-off for economic reasons but they benefited only 75,000 persons at mid-2009. It would have been necessary to focus support on the long-term unemployed and on young people entering the labour market, for instance by extending by 6 months the period of benefit entitlement for all the unemployed during the crisis.

Young people (15-25 year olds) are particularly affected by the crisis. Their unemployment rate rose from 17.4% to 23.9%, i.e. from 6.2 to 8.9% in terms of unemployed to population of the same age ratio (instead of 5.8 to 7.3% for 25-50 year olds). It would be necessary to give allowances to young people who have never worked (or did not accumulate sufficient rights to be entitled to unemployment benefits). In October 2009, the government decided to entitle young people to the RSA, although under very restrictive conditions (they must have already worked for two years).

During the crisis, the French government refused to increase the level of unemployment benefits fearing that an increase would become permanent whereas its strategy is rather to reduce assistance and unemployment benefits to encourage people to work.

Public finance sustainability?

In 2009, permanent fiscal measures induce a fiscal impulse of 0.2% of GDP, the restrictive expenditure strategy reduces public expenditure by 0.3% of GDP, the stimulus package induces an impulse of 1.2% of GDP. There is an unexpected overshooting of fiscal revenues (mainly taxes on profits, but also VAT and social contributions). So the fiscal impulse is around 2.3% of GDP (table 19).

In 2010, the stimulus package will be dramatically reduced. But the reform of the business tax will strongly reduce tax revenues. The government plans to continue its policy of public spending cuts. According to the Budget presented in October 2009, fiscal policy will be restrictive in 2010 by 0.5 percent of GDP.

In 2011, fiscal policy would be restrictive with the end of the stimulus package and a reduction of the overshooting effect. The fiscal impulse would be negative by around 1.4 percentage point of GDP. But is this consistent with a satisfactory GDP growth?

Table 19. French public finances (2008-2011)

% of GDP, except *	2007	2008	2009	2010	2011
GDP growth*		0.4	-2.25	0.75	2.5
Expenditures	52.3	52.6	55.3	55.6	54.8
		+0.3	+3.0	+3.3	+2.5
Interest payments	2.7	2.8	2.8	2.8	2.9
Unemployment benefits	1.0	1.0	1.2	1.4	1.4
Stimulus package			0.6	0.3	0.0
<i>Permanent expenditures*</i>		0.8	1.6	1.5	1.3
Permanent expenditures		-0.7	-1.0	-1.4	-1.8
Taxes	43.2	42.8	40.7	40.7	41.4
		-0.4	-2.5	-2.5	-1.8
Permanent measures		-0.4	-0.6	-1.5	-1.1
Stimulus package			-0.6		
Overshooting			-1.3	-1.0	-0.7
Public balance	-2.7	-3.4	-8.2	-8.5	-7.0
Cumulated fiscal impulse		-0.3	2.3	1.8	0.4

* Growth rate, %. *Source* : own estimations.

At the end of 2010, the French public deficit could reach 8.5 percent of GDP, 4.5 percentage points of cyclical deficit, 2.6 percentage points of interest payments and 1.7 percentage point of primary structural deficit (PSD) which are transitory (impact of the overshooting of tax revenues and of the business tax reduction, stimulus package).

In principle, the French government should wait until GDP growth leads the cyclical deficit to disappear. France should accept a permanent deficit of 2.5 percentage points of GDP, which allows for a stabilisation of public debt at 60% of GDP.

Nevertheless, we may fear that the huge output gap (-8.3% of GDP) will not rapidly disappear. GDP would have to grow by an annual 3.9% during 5 years to bring the output gap to 0, which looks unlikely. The risk is that the government is not brave enough to rely on growth and runs a restrictive policy, reducing GDP growth.

Table 20 a shows the medium-term scenario judged the more likely by the government. GDP grows by 2.5% per year after 2010; the tax burden is stable (except for the overshooting which disappears); primary public expenditure increase by 1.2% per year. In such a scenario, the public deficit remains above 5% of GDP until 2014 and the public debt comes above 90% of GDP. The scenario assumes that GDP will continue to grow by 2.5% despite a restrictive fiscal policy, which requires robust activity in the private sector.

In fact, the French government may be tempted to bring public deficits more rapidly to balance. Table 20b shows a scenario where the government would succeed to cut by 0.2% per year primary public expenditure growth after 2012. The public debt ratio would stabilise at 90% of GDP after 2013. The 3% limit would not be reached in 2015, where the public deficit would remain at 3.5% of GDP. But this scenario is unlikely from both an economic and a social point of view. The fiscal restrictive policy would have a strong negative impact on growth since the fiscal impulse would be -1.0 percentage point of GDP per year.

Table 20 a. Fiscal developments in France

	2008	2009	2010	2011	2012	2013	2014	2015
PIB	0.4	-2.25	0.75	2.5	2.5	2.5	2.5	2.5
Output gap	-2.4	-6.8	-8.3	-8.0	-7.7	-7.4	-7.1	-6.8
Public balance	-3.4	- 8.2	-8.5	-7.55	-6.75	-6.1	-5.6	-5.1
Cyclical balance	-1.2	-3.4	-4.15	-4.0	-3.85	-3.7	-3.55	-3.4
Interest payments	2.6	2.6	2.6	2.9	3.1	3.2	3.35	3.5
CAPB*	0.4	-2.2	-1.75	-0.65	0.3	0.8	1.3	1.8
Fiscal impulse	-0.3	2.6	-0.45	-1.1	-0.95	-0.5	-0.5	-0.5
Public debt	67.4	74.9	81.7	85.6	88.6	90.8	92.5	93.6

*Cyclically-adjusted primary balance. *Source:* own estimations.

Table 20 b. Fiscal developments in France

	2008	2009	2010	2011	2012	2013	2014	2015
PIB	0.4	-2.25	0.75	2.5	2.5	2.5	2.5	2.5
Output gap	-2.4	-6.8	-8.3	-8.0	-7.7	-7.4	-7.1	-6.8
Public balance	-3.4	- 8.2	-8.5	-7.55	-6.65	-5.6	-4.5	-3.45
Cyclical balance	-1.2	-3.4	-4.15	-4.0	-3.85	-3.7	-3.55	-3.4
Interest payments	2.6	2.6	2.6	2.9	3.1	3.2	3.35	3.35
CAPB*	0.4	-2.2	-1.75	-0.65	0.4	1.4	2.4	3.4
Fiscal impulse	-0.3	2.6	-0.45	-1.1	-1.05	-1.0	-1.0	-1.0
Public debt	67.4	74.9	81.7	85.6	88.5	90.3	90.9	90.5

*Cyclically-adjusted primary balance. *Source:* own estimations.

Table 20 c. Fiscal developments in France

	2008	2009	2010	2011	2012	2013	2014	2015
PIB	0.4	-2.25	0.75	2.5	3.5	3.5	3.5	3.5
Output gap	-2.4	-6.8	-8.3	-8.0	-6.7	-5.4	-4.1	-2.8
Public balance	-3.4	- 8.2	-8.5	-7.55	-6.25	-5.1	-4.15	-3.0
Cyclical balance	-1.2	-3.4	-4.15	-4.0	-3.35	-2.7	-2.15	-1.4
Interest payments	2.6	2.6	2.6	2.9	3.1	3.2	3.3	3.4
CAPB*	0.4	-2.2	-1.75	-0.65	0.3	0.8	1.3	1.8
Fiscal impulse	-0.3	2.6	-0.45	-1.1	-0.95	-0.5	-0.5	-0.5
Public debt	67.4	74.9	81.7	85.6	87.2	87.8	87.4	85.9

*Cyclically-adjusted primary balance. *Source:* own estimations.

The third scenario (table 20 c) illustrates a situation where the recovery would be strong: GDP would grow by 3.5% from 2012 to 2014. The output gap would quickly be reduced. The public debt ratio would decrease after 2013. The 3% of GDP limit would be reached in 2015. But this strong recovery seems unlikely today.

The government would have to choose between a strong rise in taxation (which is contrary to its programme) and strong public expenditure cuts. The government considers that public expenditures can be lowered by reducing the amount of waste of public expenditure. But, in fact, dramatic public spending cuts require social expenditure cuts or to ask households to pay for education or to privatise pensions, education, health, ... It would be difficult to tell people that, because of the crisis, they will have to subscribe health and pensions insurance offered by the financial institutions which caused the crisis.

The government has announced a new pension reform in 2010. If it is necessary to increase the 55-65 year olds employment rate of in a long run perspective, it is counterproductive to introduce this debate in a situation where the unemployment rate is high and where the strategy decided in 2003 to induce firms to keep and hire older workers has not yet produced significant effects.

In France few economists and politicians propose the introduction of a binding rule on public deficits. Nevertheless, in October 2009, some MP of the UMP have proposed “to prohibit unless exceptional period of crisis, to adopt a budget with a deficit beyond a certain percentage of GDP”, but the issue is “how to define a crisis” and “which percentage”? The only rule that would make sense from an economic point of view would be that “the structural deficit can not deviate from the golden rule by more than the amount of the output gap”. If we estimate that the output gap is -6.8% in 2009 then rule allows a 9% of GDP deficit in France.

A national loan?

In June 2009, Nicolas Sarkozy announced that the government will launch a national loan (*emprunt national*) in 2010. This loan is not needed to finance the public sector as France has no difficulty to get funding in the domestic and international markets. It is not decided yet if this loan will be opened to the general public (which may impose a higher cost to attract households) or only to financial markets (which is more likely). It is expected to amount between 30 and 50 billion euro (1.5 or 2% of GDP).

This loan would finance “productive expenditures”, like research, universities, public infrastructures (transport, housings, urbanism), new or green technologies (electric cars), energy sectors (nuclear, solar). It could also finance the *Fonds stratégique d'investissement*, which is a public fund created in 2008 to take capital participation to help French innovative firms to develop or to securitize their capital.

It is also a way to launch and to finance a second stimulus plan.

At the same time, Nicolas Sarkozy announced that current public expenditures will continue to be cut, which is rather strange: more schools, less teachers; more research, less researchers.

There is a contradiction in the French right-wing parties between a ‘liberal’ tradition (less State) and a ‘Gaullist’ one; France must have an industrial policy to guide and support firms; the State should show the way and finance innovations. The choice has not been made.

4. EU fiscal policies in the crisis

4.1 An ineffective coordination

At the beginning of 2008, the EU's struggle against *excessive public deficits* appeared to have been successful (table 21). In June, the ECOFIN Council announced that no euro area country was under an excessive deficit procedure (EDP), while five countries in the euro area were under an EDP in 2006. In the first half of 2008, European Institutions welcomed the 10 years of the euro; they prepared the update of the Lisbon strategy. It is only at the beginning of October that the importance of the crisis started to be taken into account.

The ECOFIN Council of 7 October 2008 stressed the need to curb inflation and to vigorously pursue the structural reforms: “wages should be supportive of employment and competitiveness” ; “fiscal prudence is necessary to support confidence notably in view of the ageing of the population” ; “relatively large European automatic stabilisers can help cushion the slowdown while respecting the 3% of GDP deficit threshold” ; “in countries facing more severe slowdown and where room for manoeuvre exists, temporary and targeted measures may be taken” . The depth of the crisis was not yet understood.

Table 21. The Excessive Deficit Procedures

	2002	2003	2004	2005	2006	2007	2008	2009
Portugal	24/9...	EDP	..11/5	22/6...	EDP	EDP	...3/6	07/10...
France		2/4...	EDP	EDP	EDP	...30/1		18/2...
Germany	19/11...	EDP	EDP	EDP	EDP	...16/5		07/10...
Netherlands			28/4...	...7/6				07/10...
Greece			19/5...	EDP	EDP	...16/5		18/2...
Italy				16/6...	EDP	EDP	...3/6	07/10...
Spain								18/2...
Ireland								18/2...
Belgium								07/10...
Austria								07/10...
Slovenia								07/10...
Slovakia			12/5...	EDP	EDP	EDP	...3/6	07/10...
Malta			12/5...	EDP	EDP	...16/5		13/5...
Cyprus			12/5...	EDP	...11/6			
UK				21/9...	EDP	...12/9	11/6...	EDP
Czech Rep.			12/5...	EDP	EDP	EDP	...3/6	07/10...
Poland			12/5...	EDP	EDP	EDP	...8/7	13/5...
Hungary			12/5...	EDP	EDP	EDP	EDP	EDP
Latvia								18/2...
Lithuania								13/5...
Romania								13/5...

On 27 November 2008, the Commission adopted “A European economic recovery plan”. The plan announced four objectives: stimulate demand, lessen the effect of the crisis on the most vulnerable people, pursue the structural reforms under the Lisbon strategy, and prepare the

conversion to a greener economy. The plan proposed a fiscal stimulus of 1.5% of GDP, the Member States being expected to implement coordinated fiscal measures of 1.2% of GDP and the EU providing a stimulus of 0.3% of EU GDP. However, the text remained vague on the content of the measures, their coordination and distribution among countries.

Despite the crisis, the Commission continues to claim for public pension spending cuts and increased flexibility of the labour market: “Member States putting in place counter-cyclical measures should submit an updated Stability or Convergence Programme by the end of December 2008. This update should spell out the measures that will be put in place to reverse the fiscal deterioration and ensure long-term sustainability, in particular through reforms curbing the rise of age-related expenditures”; “A comprehensive recovery plan also needs to encompass ambitious structural reform agenda. A resilient, flexible economy helps mitigate the adverse impact of an economic crisis.” The Commission wants to control national fiscal policies, although it is unable to present an effective coordinated plan.

In February 2009, the Commission initiated excessive deficit procedures (EDP) against 4 euro area countries. These countries have until 2012 to bring their deficit below the 3% limit. However, this would require a strong recovery of growth, which seems currently unlikely, or a restrictive fiscal policy in a period of depression. Once again, the Commission does not give a very helpful advice.

On 19 March 2009 the European Council stated that the fiscal effort for 2009 and 2010 amounted between 3 and 4% of GDP, adding cyclical and structural deficits. Member States must “quickly interrupt fiscal expansion, while continuing economic recovery”. We need “a coordinated strategy for public finances consolidation.” The Council is concerned with competitiveness disparities, but has been unable to propose a strategy different from “more wage flexibility”. In particular, the Council did not ask Germany to increase domestic wages.

On 19 June 2009 the European Council announced that the fiscal effort for 2009 and 2010 amounted to 5% of GDP, including 1.8% of fiscal stimulus. “New measures of recovery would not be justified. MS should now focus on the consolidation of public finances.” Strangely, the Council recommends a non-cooperative strategy: “the small and open countries should focus on wage restraint while largest should support domestic demand.” The Council advocates for wage moderation and reforms of the national social security systems while recognizing that “social protection systems and social inclusion measures have played their role of automatic stabilizers and mechanisms to cushion the social impact of the recession and facilitate the return to the labour market.”

It is difficult to assess the amount of national stimulus plans. The output fall has been so large that it is difficult to assess potential growth. The *ex ante* impact on public finances is also difficult to measure due to the importance of the fall in GDP (which has non-linear effects on some tax revenues) and to the fall of asset values. The public balances for 2009 and 2010 are not precisely known yet.

The euro area deficit widened by 1.4 percentage points of GDP in 2008 as compared to 2007 (against 2.3 in the UK and 3.7 in the US), by 4.5 percentage points in 2009 (9.4 in the UK and 8.6 in the US), 6.3 percentage points in 2010 (10.2 in the UK and 10.3 in the US), see table 22.

Table 22. Public balance (DG-ECFIN forecasts, Q1-2008 and Q3-2009)

	2007		2008		2009		2010
	Q1-2008	Q3-2009	Q1-2008	Q3-2009	Q1-2008	Q3-2009	Q3-2009
Belgium	-0.2	- 0.2	-0.4	-1.2	-0.6	-5.9	-5.8
Germany	-0.2	- 0.2	-0.5	-0.1	-0.2	-3.4	-5.0
Ireland	0.2	0.3	-1.4	-7.2	-1.7	-12.5	-14.7
Greece	-2.8	-3.3	-2.0	-7.7	-2.0	-12.7	-12.2
Spain	2.2	1.9	0.6	-4.1	0.0	-11.2	-10.1
France	-2.7	-2.7	-2.9	-3.4	-3.0	-8.3	-8.2
Italy	-1.5	-1.5	-2.3	-2.7	-2.4	-5.3	-5.3
Netherlands	0.3	0.2	1.4	0.7	1.8	-4.7	-6.1
Austria	-0.5	-0.6	-0.7	-0.4	-0.6	-4.3	-5.5
Portugal	-2.6	-2.6	-2.2	-2.7	-2.6	-8.0	-8.0
Slovenia	0.5	0.0	-0.6	-1.8	-0.6	-6.3	-7.0
Slovakia	-2.2	-1.9	-2.0	-2.3	-2.3	-6.3	-6.0
Finland	5.2	5.2	4.9	4.5	4.6	-2.8	-4.5
Euro area	-0.6	-0.6	-1.0	-2.0	-1.1	-6.4	-6.9
Denmark	4.4	4.5	3.9	3.4	2.9	-2.0	-4.8
Sweden	3.5	3.8	2.7	2.5	3.9	-2.1	-3.3
UK	-2.7	-2.7	-3.3	-5.0	-3.3	-12.1	-12.9
Czech Rep.	-1.6	-0.7	-1.4	-2.1	-1.1	-6.6	-5.5
Hungary	-5.5	-5.0	-4.0	-3.8	-4.1	-3.4	-4.2
Poland	-2.0	-1.9	-2.5	-3.6	-2.6	-6.4	-7.5
Romania	-2.5	-2.5	-2.9	-5.5	-3.7	-7.8	-6.8
EU	-0.9	-0.8	-1.2	-2.3	-1.3	-6.9	-7.5

Source: European Commission, *European Economic Forecast*.

Under the assumptions that the crisis does not affect potential growth and that the cyclical balance equals 50% of the output gap, the fiscal impulse cumulated from 2007 to 2009 would be 5 percentage points of GDP in the US and in the UK and 2 in the euro area (table 23). The fiscal stimulus was dramatically lower in the euro area. In the EU, public deficits are automatic rather than policy-induced. There were huge disparities between MS: the fiscal impulses were large in Spain and UK, weak in Germany and Austria, nil in Italy. Hungary and Czech Republic pursued fiscal consolidation during the crisis.

Our estimations are lower than the estimations of the European Commission, which include a dramatic fall of the potential growth due to the financial crisis. But all estimations are fragile, due to the deepness of the recession.

In October 2009, the Commission initiated an EDP against 8 euro area countries: Austria, Belgium, Germany, Italy, the Netherlands, Portugal, Slovenia, Slovakia and one non-euro area country: the Czech Republic. Hence, among the 16 euro area countries, only three are not under an EDP: Cyprus, Finland and Luxembourg; the large majority of the EU member states are under an EDP: 20 out of 27 (Denmark, Estonia, Bulgaria, Sweden are not yet under an EDP).

Table 23. Fiscal impulse (cumulated since 2007)

	2008	2009	2010	Discrepancy debt/deficit 2008-2010
Belgium	0.6 (0.5)	3.0 (3.1)	2.6 (2.0)	6.7
Germany	0.4 (0.2)	0.8 (0.3)	2.4 (1.7)	3.7
Ireland	5.2 (3.1)	6.5 (1.4)	7.3 (0.7)	16.1
Greece	3.4 (2.7)	6.7 (6.2)	4.7 (3.7)	3.6
Spain	5.6 (4.7)	11.0 (8.0)	8.9 (5.9)	4.3
France	0.0 (-0.3)	3.2 (2.4)	3.1 (1.8)	2.2
Italy	0.4 (0.0)	0.8 (-0.6)	1.1 (-0.7)	1.8
Netherlands	-0.2 (-0.4)	1.7 (1.5)	2.9 (2.0)	10.7
Austria	0.2 (-0.1)	1.4 (0.3)	2.3 (0.8)	6.5
Portugal	-0.3 (-0.7)	3.7 (2.2)	3.6 (1.6)	2.7
Finland	0.3 (0.3)	3.6 (2.7)	5.3 (2.8)	9.5
Euro area	1.0 (0.7)	3.1 (2.1)	3.3 (1.8)	4.1
Denmark	-0.4 (-0.4)	1.7 (1.6)	5.1 (3.9)	5.4
Sweden	0.2 (-0.3)	2.0 (0.8)	3.5 (1.2)	2.3
UK	1.8 (1.2)	7.0 (5.1)	7.1 (4.1)	7.4
Czech Rep.	1.1 (0.1)	2.7 (-1.7)	1.0 (-4.2)	-1.7
Hungary	-1.5 (-2.7)	-4.5 (-7.7)	-4.5 (-9.5)	4.1
Poland	1.9 (2.0)	3.0 (2.8)	3.1 (2.3)	1.7
EU	1.1 (0.8)	3.1 (2.3)	3.6 (1.8)	2.4
USA	n.a. (2.8)	n.a. (5.2)	n.a. (6.5)	
Japan	n.a. (0.3)	n.a. (0.6)	n.a. (1.3)	

Source: European Commission, *European Economic Forecast*, with own calculations of output gap in bold.

On 20 October 2009, the ECFIN Council recognized that “it is not yet time to withdraw the support government”. The Council announced that he will prepare “a coordinated fiscal exit strategy”. The consolidation should start in 2011 at the latest and should go beyond the benchmark of 0.5% of GDP per year. But the Council did not explain what countries should do if the recovery is not sufficient in 2011. The positive point is that the SGP and the 3% of GDP constraint are forgotten in the short and medium run. The ECB requested that consolidation begins in 2011, whatever the economic situation, and be at least 1% by year. Although some voices in Europe argue that governments should announce today when budgetary positions are back into balance in order to reassure markets, it is too early to make such a commitment since no one knows when the recession will be over. In November 2009, the Commission requires that countries whose public deficit exceeded the 3% return below this limit in 2012, 2013 or 2014, according to some arbitrary criteria. It is positive that the deadlines are so long but it remain unrealistic to fix constraints to fiscal policies disregarding economic developments.

The Commission continues to watch gross public debts. However, the latter increase much more rapidly than the cumulated rise in public deficits and net debt since they incorporate government support to banks and companies (table 23). Focusing on gross public debts impedes government interventions, which are essential today because governments can

borrow more easily than banks or companies. The public debate and European surveillance should focus on net public debts. In the future, governments will have to choose between reducing their debt (in particular through selling back the financial institutions' shares they have been buying in the crisis) and maintaining their debt in order to play a more important financial or industrial role.

The Commission keeps on repeating that public debts should come down to 60% of GDP. But the crisis increases the need for households to own safe assets, especially to fund their pensions (as the Commission advocates also for lower public pensions). Companies are reluctant to borrow in view of the risk premium embedded in today's interest rates. The equilibrium level of the public debt has increased due to the crisis. Debts cannot rapidly come down to the levels they had before the crisis.

The Commission continues to call for wage restraints, as if wage increases were responsible for the crisis. However, the wage share in value added declined by 2.3 percentage points between 2000 to 2007 in the euro area (by 4.7 percentage points in Austria, 2.3 in Germany and Spain). The Commission does not see that growth should be based on wages and social benefits and not on competitiveness or financial bubbles.

Overall, EU institutions have been unable to implement a coordinated stimulus strategy. Each country chose its programme. Huge disparities remain in Europe and each country has their own points of view and interests. Some countries need more public infrastructures; some (Germany, France) have an important car industry, which they want to support. The British pound depreciated by 25% against the euro; the Swedish Krona by 10%. The UK decreased its main VAT rate, which does not provide any direct competitiveness advantage, but helps to fight against inflation. No strategy was proposed to reduce competitiveness disparities between Germany, Austria and the Netherlands on the one hand, Italy, Greece, Spain and Portugal on the other hand.

On the whole, the fiscal stimulus has been too limited: in 2009, although the crisis came from Anglo-Saxon countries, GDP growth will be as depressed in the euro area (-3.9%) as in the UK (-4.3%) and more than in the US (-2.5%).

EU institutions have not been able to implement a new growth strategy, and not even to launch a discussion: after the crisis, are the renovated PSC are the Lisbon strategy still relevant? For instance, what about States aids to companies? What about the choice between public pensions and pension funds? What future for the European industry? What is the optimal debt level? What governance in Europe to account for disparities between MS? What wage policy coordination?

Yet Britain is planning to raise the retirement age from 65 to 66, to reduce state pensions and family allowances, to cut public investment; Britain will also introduce a maximum income tax rate of 50% (instead of 40%) in April 2010. The Netherlands announced a 20% cut in public expenditure in 2011: postponement of the retirement age from 65 to 67, abolition of the pension supplement for without income spouses, reduction of health reimbursements, lower family allowances. On the contrary, Spain announced VAT and income tax increases. Germany has announced a comprehensive programme to cut taxes from 2010 (24 billion euro, 1% of GDP) while it had just passed a law creating a "debt brake" imposing a deficit of less than 0.35% of GDP from 2016.

The risk is that governments try to make households pay for the crisis through lower social spending. It would be a suicide from a macroeconomic perspective (how to compensate for

declining demand? by a new financial bubble?), a microeconomic one (households are expected to buy their own health insurance and pensions offered by financial institutions which are responsible for the crisis) and a social one. If private spending increases effectively in the future entailing that the public deficit will be no longer necessary for macroeconomic purposes, then the choice between lower spending and higher taxes should be based on social trade-off between public spending utility and private spending utility. But the crisis has highlighted the risks arising from growing inequalities, which argues for higher taxes on highest incomes, on highest wealth, on financial and real estate gains, and on the financial sectors. The crisis has also highlighted the need to struggle against “tax and regulation heavens” and the need for some tax harmonization.

4.2. A technical issue...which becomes a political one

The estimation of the fiscal stimulus and the distinction between structural and cyclical deficits are based on the assessment of potential growth. But the OECD and the European Commission have lowered substantially their potential growth estimates over the last few months (table 24).

24. Output gaps and potential output growth

	Output Gap		Potential output growth							
	2007		2000-2007		2008		2009		2010	
According to	Autumn 2007	Spring 2009	Autumn 2007	Spring 2009	Autumn 2007	Spring 2009	Autumn 2007	Spring 2009	Autumn 2007	Spring 2009
...OECD										
USA	0.4	0.9	2.6	2.4	2.5	2.5	2.5	1.6		1.4
Japan	0.2	3.3	1.4	0.9	1.0	1.3	0.6	0.6		0.7
Germany	0.0	2.6	1.5	1.0	1.7	1.7	1.6	1.2		0.5
France	-0.3	1.8	2.0	1.9	1.9	1.9	2.0	1.3		1.0
Euro area	-0.3	1.8	2.1	1.8	1.9	1.9	2.0	1.1		0.5
UK	0.4	1.9	2.6	2.4	2.7	2.2	2.7	1.5		1.0
... ECFIN										
Germany	0.3	2.7	1.2	1.0	1.8	1.0	1.9	0.7		0.8
France	-0.3	2.2	2.1	1.7	2.0	1.25	2.1	0.9		0.7
Euro area	-0.2	2.5	2.1	1.7	2.1	1.3	2.2	0.7		0.7
UK	-0.1	2.4	2.8	2.4	2.5	1.5	2.7	0.9		0.9

Source: OECD, *Economic outlook*, European Commission, *European Economic Forecast*, own calculations.

The OECD has revised downwards the euro area potential output level for 2009 by 3.0%, while the Commission has revised it by 5%. The annual potential growth rate of the area in 2009-10 would be only 0.7% according to the EC. Such an estimate leads to increase significantly the size of structural deficit and of the fiscal impulse.

In 2010, the French output gap would be -1.85% according to the new estimate; -7.5% according to the previous one. The structural primary deficit would be - 5% in the first case; - 2.1% in the second. The efforts required to bring primary structural deficits to balance are

very different. According to the French Ministry for Finance, French potential output growth slowed down from 2.1% per year between 2001 and 2007 to 1.7% since 2007. Since the European Commission now evaluates the potential growth rate at 0.7%, their estimate of the variation of the structural deficit will differ by 0.5 percent of GDP each year.

What will be the GDP growth objective of the euro area in the coming years: 0.7 or 2.2% per year? The risk is that the choice of a low target is self-fulfilling as restrictive fiscal policy would be undertaken.

These uncertainties question the notion of potential production and growth. In 2007, France had an unemployment rate of 8.3% without inflationary pressures. The European Commission said that France had an output gap of -0.3%. Can it be decided two years later that the output gap was 2.2% and so that France was running at above capacity in 2007? The recession led investment, and therefore production capacity, to fall. Should we conclude that potential output has declined? Should the rise of unemployment in the crisis be considered temporary or permanent?

4.3. A difficult comparison...

It is difficult to assess effectively implemented policy actions: some countries include in their fiscal plans measures like price indexation of social benefits, transfers between different government levels, expenditures decided before the crisis; in some countries expansionary fiscal measures are implemented together with consolidation measures (like public sector jobs cuts in France or tax increases in Italy); some countries aggregate the fiscal impulse and the cyclical deficit. Government balance developments for 2009 and 2010 remain highly uncertain.

One can write:

Public balance = cyclical balance + structural balance + discretionary balance + one-off balance + interest payments.

Fiscal impulse = - Δ (structural balance + discretionary balance + ? one-off balance).

One-off balances include in 2009 the costs of banks rescue packages, the impact of the fall in asset values on tax receipts and the overshooting of tax revenues. However, whether one-off balances should be included in the fiscal impulse or not is unclear.

Public deficits will rise substantially between 2007 and 2010 (table 25) but the output gap will have widened so much that the rise in deficits will be mainly cyclical. According to OECD's June 2009 estimates, expansionary fiscal measures implemented since 2007 were substantial - amounting to 4 percent of GDP in the US, the UK, Spain but much smaller in Germany (1.5 percent of GDP), France (1 percent of GDP) and even smaller in Japan (0.5) and Italy (0); at the euro area level, they amounted to 1.3 percentage point.

Current fiscal plans cannot prevent the dramatic rise in unemployment (table 26). Are they insufficient or has fiscal policy become ineffective? The crisis has disrupted the functioning of the financial sector and generated a strong uncertainty on future world economic growth. The crisis has cut world equity wealth by \$ 28,000 billion, i.e. 42% of annual GDP. It is difficult for fiscal policy alone to counterbalance such a huge shock. The rise in deficits may worry private agents, who fear today's deficits will lead to future rises in taxation or decrease in social spending. They may also be afraid of the effect of the reversal of the fiscal policy

stance. If the depression lasts longer than currently expected, it will be difficult to maintain such deficits in 2011. But a too rapid consolidation may prevent any recovery.

Table 25. Assessing fiscal plans 2007/2010 (OECD figures)

As a percentage of GDP

	Gov. balance 2007	Gov. balance 2010	Output gap	Increase in deficit	Fiscal impulse
USA	-2.9	-11.2	-6.3 (-10.7)	8.3	6.0 (3.8)
Japan	-2.5	-8.7	-9.4 (-12.8)	6.2	2.2 (0.5)
UK	-2.7	-14.0	-8.3 (-12.0)	11.3	5.5 (3.7)
Germany	-0.2	-6.2	-8.4 (-9.7)	6.0	2.1 (1.5)
France	-2.7	-7.9	-8.0 (-9.1)	5.2	1.4 (0.9)
Italy	-1.5	-5.8	-9.2 (-10.9)	4.3	0.5 (-0.3)
Spain	2.2	-9.6	-7.7 (-13.8)	11.8	7.2 (4.2)
Euro Area	-0.7	-7.0	-9.0 (-10.9)	6.3	2.4 (1.3)

Sources: OECD Economic Outlook, June 2009, with own calculations of output gap in bold.

Table 26. OECD prospects for unemployment rates

	2007	2010 (OECD forecasts)
United States	4.6	10.1
Japan	3.9	5.7
Germany	8.3	11.6
France	8.0	11.2
UK	5.4	9.7
Italy	6.2	10.2
Spain	8.3	19.6
ZE	7.4	12.0

Source: OECD, 2009.

4.4. Fiscal policy in debate

Over time, fiscal multipliers' estimates have become smaller out of large-scale macroeconomic models. For the euro area, for instance, fiscal multipliers were above 1.5 for government consumption in the first year (Wallis, 2004), but more recently, models estimate lower multipliers, well below 1 (or even 0.5 in DSGE models).

The mainstream ideology in academic leading reviews is that a model must embed microeconomic foundations based on neo-classical hypotheses. Most models have become neo-classical. They assume that output cannot be very far from an equilibrium path, due to wage, price and spending adjustments. But these models are unable to explain the depth of the crisis. They assume that private agents and markets have forward-looking and rational expectations, which is not consistent with financial bubbles. In most models, public debt increases the long-term interest rate. But this mechanism does not have to play when public debt only compensates for the fall in private debts. People are assumed to anticipate future tax rises when public debt increases, but if the rise in public deficit is cyclical then taxes will not have to rise in the future. The output rise will bring the public balance in equilibrium.

Moreover, even these models should suggest much higher multipliers in the current crisis, as Giavazzi (2009) recognises:

1. The increasing degree of openness of the economies reduces the size of multipliers in case of isolated fiscal policy action. But, currently, there is a case for worldwide-coordinated action.
2. Credit crisis increases the proportion of liquidity-constrained households and firms.
3. There is no doubt that the output gap will remain negative in the future period and that production is and will be constrained by demand.
4. There is no doubt that the public deficit is due to automatic stabilizers and discretionary stabilising policies and not to excessive public expenditures.

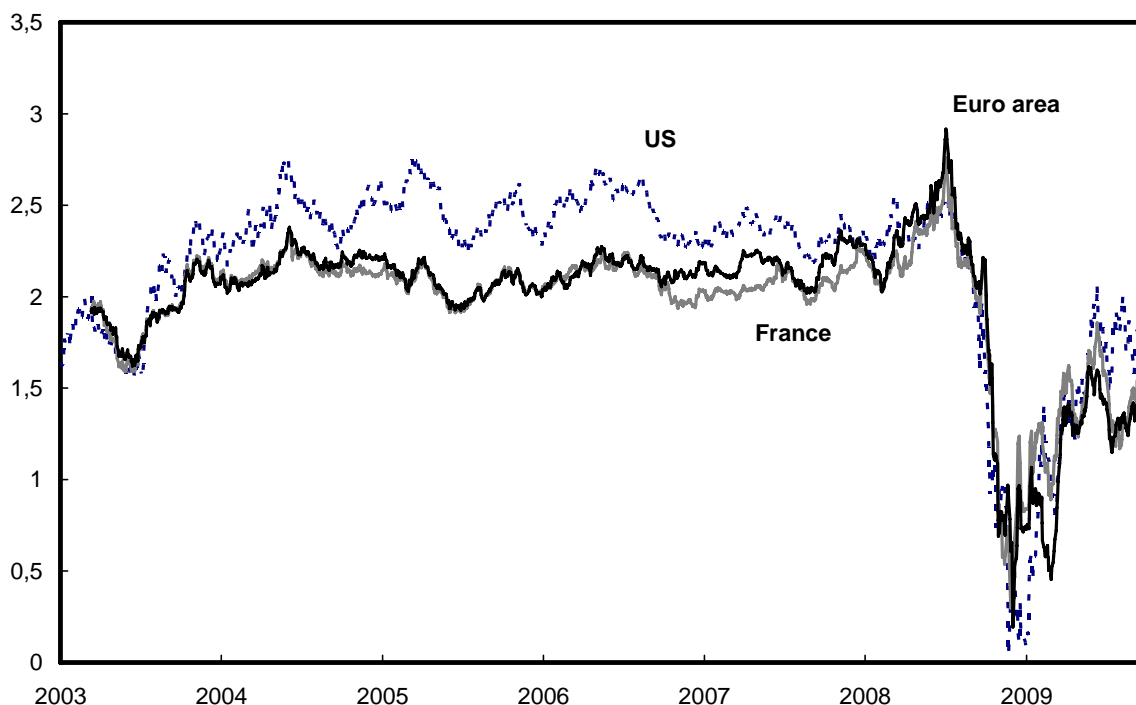
The rise in public deficits raises four issues which should not be overstated:

The fear for inflation. The rise in public debts would generate inflationary pressures according to an awkward but widespread view. This is unfortunately very unlikely. The world economy suffers today from a substantial lack of demand. It is difficult to see where a strong pressure from higher demand or higher wages generating higher inflation would come from.

Markets are indeed confident about the absence of inflationary risks: price-indexed bonds yields currently reflect 10-year ahead expected inflation at 1.8% in the US like in France and in the euro area (chart 3).

Chart 3. Inflation rate expectations derived from interest rate differentials

Percentage point



Sources: AFT, US Federal Reserve

The fear of a Barro-Ricardian effect. Households may observe the rise in government debts and may anticipate future tax rises and thus reduce their current consumption, which would lead active fiscal policy to be inefficient.

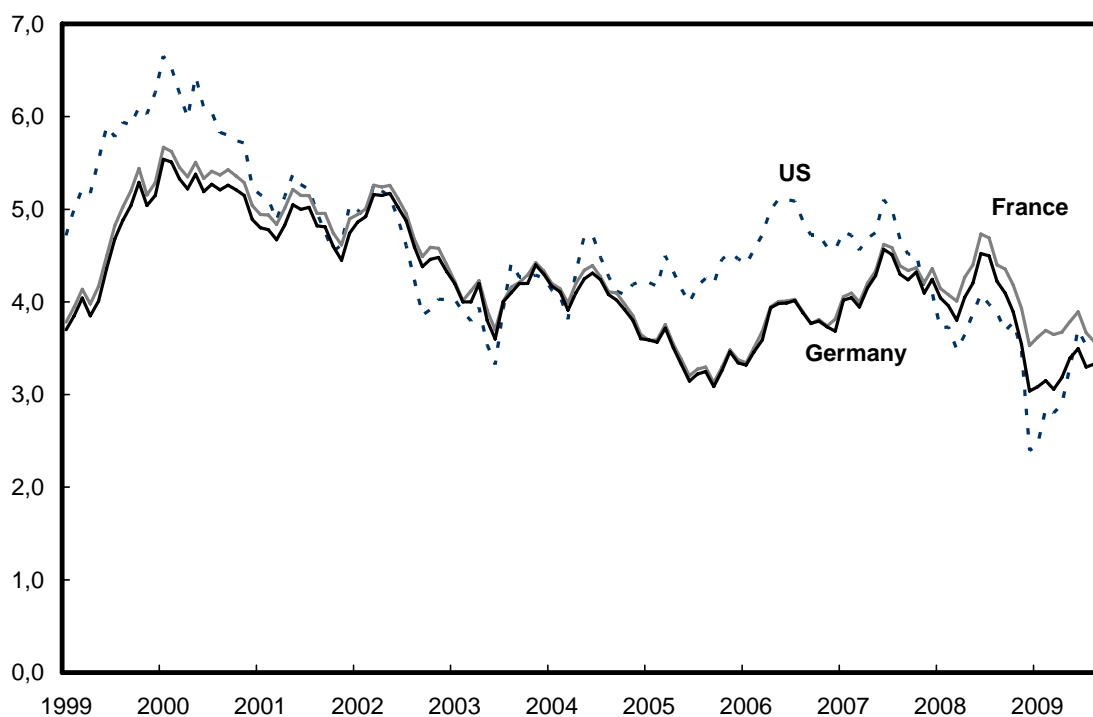
1. Such a behaviour is probably not widespread among households.
2. As the rise of public deficit is cyclical, taxes will not have to rise. It is the increase of activity which must equilibrate the public balance.
3. The rise in public deficits and debts could generate a climate of uncertainty. But the saving rate will dramatically increase due to the fall in household's wealth, the fall in credit supply and the rise in unemployment. It is difficult to determine if the public deficit will exacerbate this increase by increasing the perceived risks or will reduce it by showing that fiscal policy will support activity.
4. Firms and workers may fear that government will be obliged to reduce too quickly its deficit, which would have a depressive effect.

Governments must explain that budgetary positions will be brought back to balance thanks to higher output growth, not through higher taxation or social expenditures reduction.

The fear for high interest rates. Under the same reasoning, no economic reason can induce a rise in long-term interest rates due to the actual level of public deficit and debt. Fiscal policies will become less expansionary when the output gap will return to zero; there no reason to predict that they will induce excessive demand in the future.

But financial markets are not rational and their irrationality they may induce excessive long-term interest rates. The US 10-year interest rate fell from 4% in July 2008 to 2.5% in January 2009; before rising to 3.5% in the middle of 2009. In France, the 10-year interest rate fell from 4.7% in July 2008 to 3.6% in January 2009, before rising to 3.5% in the middle of 2009 (chart 4). The real interest rate remains at the level of potential growth.

Chart 4. 10-year interest rates, in percent



Source: 10-year government bonds, national sources.

The default risk. Markets do not anticipate that governments will be in default. They know that government borrowing will automatically be reduced when private consumption and investment grow again. They know that governments have no choice but borrow in the current circumstances since they are the only ones in which markets still have trust.

4. 5. About the fiscal exit strategy

More and more voices call for fiscal exit strategies. In October 2009, two distinguished European economists were invited to give papers at the informal ECOFIN meeting at Göteborg.

Giavazzi (2009) explained that the fiscal stimulus was effective during the crisis because it was accompanied by an accommodative monetary policy and because the output gap was largely negative (but we do precisely need a fiscal stimulus under these circumstances). Giavazzi explained that governments should announce they will end the fiscal stimulus when the output gap comes back to zero to reassure financial markets and the ECB and to avoid a rise in interest rates. But it is obvious that the government will not run an expansionary policy forever; long-term interest rates did not increase during the crisis, despite the large rise in public debts. Giavazzi proposes cuts in future public retirement pensions to show the credibility of this announcement. At the same time he recognises that there is a need to induce households resume spending. How is it possible if households have to save more in view of their pensions? According to Giavazzi, public debts should return to their pre-crisis levels, but is this economically possible if households want to own more public debt assets because the crisis has shown financial markets fragility? The author proposes to counterbalance the fall in potential output by increasing labour force participation through labour taxation cuts, but one can observe that Nordic countries, where tax rates are higher, also have the higher participation rates. The only interesting proposal made by the author is that EU countries should undertake a coordinated increase in financial assets taxation.

Pisani-Ferry (2009) presented again his old and unwise proposals: a commitment by governments to undertake consolidation strategy from 2010 to 2015, without accounting for the economic situation; setting independent Budgetary Councils; reducing public pensions. Pisani-Ferry fears that the expansionary fiscal policy will provoke inflationary pressures, which will induce the ECB to increase too quickly the interest rate and so coordination is needed. But this fear is not justified: inflation will accelerate only if there is strong demand revival which is unlikely in the years to come. If this revival shows up, public deficits will be reduced, automatically or with discretionary measures, but the timing of this retrenchment cannot be decided now. Pisani-Ferry proposes to retrench the value of bank capital held by the government from the public debt supervised by EU authorities. It is a step towards net debt supervision. It is fortunate that debt supervision by EU instances plays no role in the current situation.

During the crisis, the IMF has exhorted governments to undertake large stimulus programmes. Nevertheless, two IMF economists, Cottarelli and Viñals (2009), have recently proposed an exit strategy which is not satisfying.

Cottarelli and Viñals say that debts should come down to their pre-crisis levels, but without providing any analysis of the optimal public debt level. They do not give any analysis on the public debt level private agents wish to hold. They write that we must avoid that ‘concerns about high deficits and debt cause a surge in interest rates’, but we have not seen any rise in

2008-2009. The authors propose that countries adopt debt ratio objectives of 60% of GDP in 2030. They evaluate the structural primary balance of advanced countries at -3.5% of GDP in 2010 (including 1.5 percentage point of temporary fiscal stimulus²). They estimate that primary balances should increase at 4.5% of GDP in 2020 for debt ratios to reach 60% of GDP, which requires a negative fiscal impulse of 0.8% per year. The authors do not analyse the impact of this restrictive policy on growth. They must assume implicitly that there will be a deficit of private spending and that there will be a boom in investment or consumption, but we do not see why such a boom would occur and the authors do not say explicitly that the adjustment strategy depends on this boom.

Of course, the authors advocate for structural reforms (more competitive goods markets, removal of labour market and tax distortions, but no financial markets reforms), but they recognise that: “there is too much uncertainty on both the magnitude and timing of the effects structural reform on potential growth to build a fiscal adjustment strategy primarily around this”. Of course too, they advocate for ‘fiscal rules and fiscal councils’.

They propose to keep health and pensions spending constant in relation to GDP, but households would have to pay premiums to private institutions to obtain a satisfying coverage. The authors do not give evidence that this will be less expensive or more efficient. They propose to freeze all real primary spending but they implicitly suppose that these expenditures are not useful, or less useful than private ones, which remains to be proven. We do not understand why the financial crisis should lead to a decrease of the share of public spending in GDP. The authors propose to increase taxes by 3 percent of GDP by using externally correcting taxes (carbon taxation or sale of emission rights).

In fact, even if the interest rate is 1 percentage point higher than the output growth rate, a primary public surplus of around 1% would stabilize the public debt at the level reached in 2010 (around 90% of GDP): the required effort (after the end of the fiscal stimulus and overshooting) is only about 1 percent of GDP. Raising taxes by 1% of GDP should be sufficient. If necessary, taxation could be increased on capital gains (on financial assets or real estate), financial sectors, higher incomes and wealthiest people in a context of tax harmonisation in Europe (or in the world). The crisis should not be used as a pretext for introducing dramatic public spending cuts, especially as concerns social expenditures and pensions.

5. Some concluding remarks

The 2009-2010 fiscal stimulus was too low at the euro area level. It was too low in France and not sufficiently targeted on lower incomes, on the unemployed, and on part-time work (work shared with vocational training).

European institutions were unable to change substantially their economic strategy to account for the crisis. The French government has modified, at least in words, his strategy, from a liberal one (break with the mixed economy; less social assistance, lower taxes on workers and entrepreneurs) to a new one: the re-foundation of capitalism, oriented towards productive

² According to the authors, the structural permanent deficit increased by 2 percentage points between 2008 and 2010, but this number incorporates the overshooting of fiscal revenues and a sudden fall of potential output during the crisis.

firms and workers at the detriment of the financial sector albeit keeping the objective of lower public and social expenses and lower taxation.

Two main issues remain: can fiscal and monetary policies be expected to support activity if the crisis was caused by real and financial structural imbalances? Will the fiscal exit strategy be the opportunity for the leading classes to decrease public and social expenditures?

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