Journal of Globalization and Development

Volume 1, *Issue* 1 2010 *Article* 17

Europe: How Deep Is a Crisis? Policy Responses and Structural Factors Behind Diverging Performances

Jean Paul Fitoussi* Francesco Saraceno†

*Sciences Politiques, jeanpaul.fitoussi@ofce.sciences-po.fr

†OFCE - Center for Research in Economics of Sciences Po, Paris, francesco.saraceno@sciences-po.fr

Europe: How Deep Is a Crisis? Policy Responses and Structural Factors Behind Diverging Performances*

Jean Paul Fitoussi and Francesco Saraceno

Abstract

The effects of the current crisis on the level of output, and consequently on unemployment and poverty, are likely to be deep and long lasting; they should not be underestimated, especially now that some timid signs of recovery are appearing. The crisis was triggered by the US financial sector, but its roots are real, and can be traced to the deepening income inequality of the last three decades, which led to a chronic deficiency of aggregate demand. In the Unites States, the

*Jean-Paul Fitoussi is a Professor of Economics at the Institut d'Etudes Politiques de Paris where he has taught since 1982. Currently he is President of the Scientific Council of the Institut d'Etudes Politiques de Paris and President of the Observatoire Français des Conjonctures Econoniques, an institute dedicated to economic research and forecasting. Born in 1942, Dr. Fitoussi received a Ph.D. cum laude in Law and Economics from the University of Strasbourg (France). His doctoral thesis was on inflation, equilibria and unemployment. Since 1998, Professor Fitoussi has been a member of the board of the Ecole Normale Supérieure. In 1997, he became a member of the Council of Economic Analysis of the Prime Minister while, in 1996, he was appointed member of the Economic Commission of the Nation. He has been General Secretary of the International Economic Association, since 1984. Since 2000, he has been an expert at the European Parliament, Commission of Monetary and Economic Affairs. From 1990 until 1993, Dr. Fitoussi was the Chairman of the Economic Advisory Board of the European Bank for Reconstruction and Development. His research has focused on the theories of inflation, unemployment, foreign trade and the role of macro- economic policies. Francesco Saraceno was Born in Rome, Italy. He majored in Economics at the University of Rome "La Sapienza" with a thesis on Money and Economic Growth. In 1994 he enrolled in the PhD program of the University of Rome, where he specialized in disequilibrium macroeconomics. He obtained his PhD in economic theory in July 1999, with a thesis on Demand Complementarities in a Trade Model. In 1995 he was awarded the Bonaldo Stringher Scholarship from the Bank of Italy, and was accepted for a PhD in Economics in the department of Economics at Columbia University. There he specialized in macroeconomics and industrial organization. He obtained the PhD at Columbia University in May 2003, with a thesis entitled Essays in Disequilibrium Macroeconomics. In January 2000 he passed a public examination and became part of the Council of Economic Advisors for the Italian Prime Minister's Office. He has been on leave since March 2002, when he moved to Paris to work in the French Observatory on Economic Conditions (Observatoire Français des Conjonctures Économiques), a prestigious think tank headed by Jean Paul Fitoussi.

center of the crisis, the policy reaction has been bold, and as a consequence the effects of the crisis are less important than in the eurozone, where only France has a comparable performance. The policy inertia of the eurozone countries, in fact, is more structural, and is related to the institutions for the economic governance of Europe. The statute of the ECB and the Stability and Growth Pact, that reflect a doctrine opposed to discretionary macroeconomic policies, constrain eurozone governments and its monetary policy. The relatively better performance of France can in fact be explained with these lenses: on one side it has a well developed system of automatic stabilizers, and on the other it suffered less than other OECD countries the deepening of income inequality.

KEYWORDS: Europe, counter-cyclical policy, crisis

1.Introduction

A debate is raging between those who think that the crisis is now behind us and those who believe that it still lies ahead. One of the reasons of the debate, besides the doctrinal one, is that the two camps are not looking at the same statistics, nor speaking of the same things, while nonetheless using the same vocabulary. The first are looking at the *change* in flows (the rate of growth of GDP) and at the level of the stock of public debt. The former is becoming positive almost everywhere, hence their conclusion that the crisis is behind us; the second has grown to fairly high levels which, according to them, legitimates the call for an "exit strategy", by which they mean the progressive withdrawal of the state from its sudden intrusion into "economic affairs", in particular by strongly decreasing its spending. In sum, the crisis was just a parenthetical and there is no reason why the world after it would not resemble the previous state of affairs. Looking at the (non) decisions taken at the various meetings of the G's, this stream of thought seems to dominate the scene. While most proponents of exit strategies are cautious about the timing, the shift of public attention from growth and unemployment towards debt sustainability is inexorably taking place. At the national level, its dominance is reflected by the noise made around the urgency of beginning to curb public debt and deficit, and by the emphasis that is put on positive growth signs.

The second camp, on the other hand, is rather focusing its attention on the *levels* of flow (GDP, GDP per capita, and output gaps), at the stock of unemployed, at the poverty rate (the stock of poor) and at the wealth of nations. Seen from this perspective, the situation does not look very healthy. On average in OECD countries, the level of GDP is now about 4 percentage points lower than it was in 2008, and the larger countries are doing even worse (see Figure 1). Output gaps have reached such a high level that it would take several years before closing them. In most developing countries the situation is similar, if not worse. For these countries, especially those which have followed a strategy of openness, the situation is all the more dramatic as world exports have decreased by about 30% between October 2008 and July 2009. But the most dramatic feature inherited from the crisis is unemployment: since the first quarter of 2008, unemployment has increased by 7.4 million units in the US, by 1.2 million in Japan and by almost 6 million in the European Union. At the world level it has increased by 50 million while the number of persons in absolute poverty increased by about 200 million. Even worse, we may infer from the level of the output gap that those numbers are going to keep growing at least for the year to come.

Figure 1 - Output Gap

Source: OECD Economic Outlook. EMU4= Germany, France, Italy, Spain

Thus, when looking at the level of flows and at the relevant stocks –those that matter the most for the people – we are far away from having outpaced the crisis. Compared with the pre-crisis situation, the present one appears as being one where, on average, people are less wealthy, have a lower income, a higher probability of being unemployed, etc. In short their overall well-being has strongly worsened. The only strategy that matters is an exit "from" the crisis, not from the hands-on policy that the governments have followed with diverse fortunes. In what follows, our inclination lies without any ambiguity towards the second interpretation of the present situation: in a context where unemployment is expected to grow further and to recede only slowly after having reached its climax– where during a rather long period the rate of unemployment will be very high by historical standards – it could hardly have been different.

In what follows, we will take successively a global (section 2), an European (section 3) and a French view (section 4).

2.The Impact of the Crisis and the Perspectives for Recovery

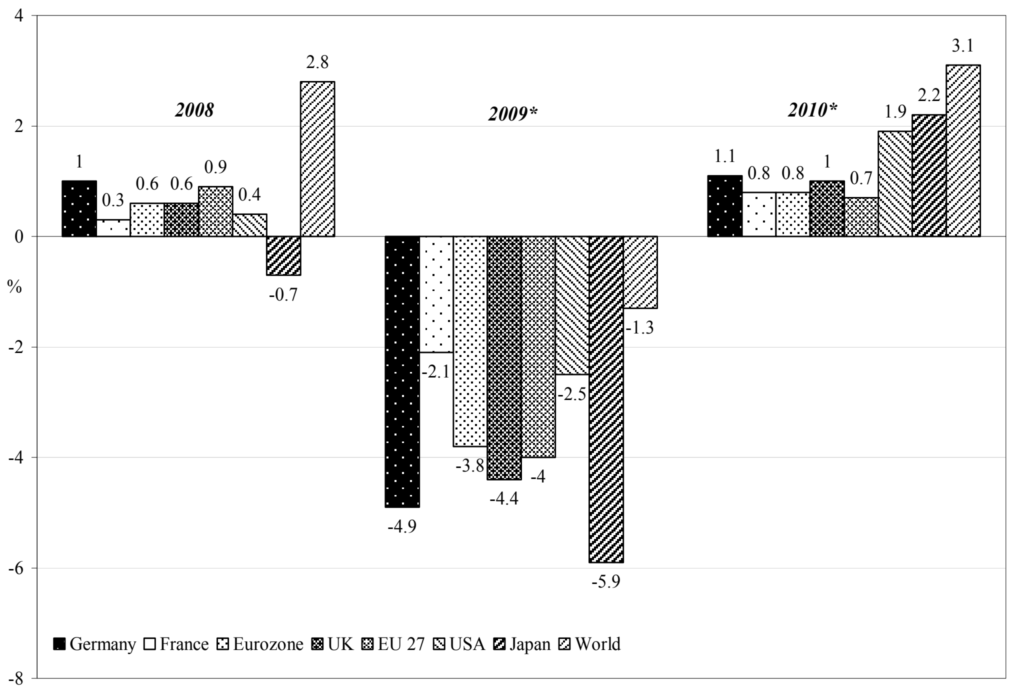
At least since Wicksell and Keynes we know that most of the disequilibria in the real economy originate in the financial sector. For example, we understood that unemployment is more often than not the consequence of too high a level of real interest rates, rather than of too high wages. This should not, however, lead one to think of these disequilibria as being exogenous to the real economy. When

DOI: 10.2202/1948-1837.1053

confronted with a malfunctioning of the financial sector of this magnitude, we need to ask how this malfunctioning originates in the interaction with the real sector. Many stories may be told, but the one we believe has much to tell in a nutshell is the following: at the outset there is an increase in inequalities which depressed aggregate demand and prompted monetary policy to react by maintaining a low level of interest rate, which itself allowed private debt to increase beyond sustainable levels. On the other hand the search for high-return investment by those who benefited from the increase in inequalities led to the emergence of bubbles. Net wealth became overvalued, and high asset prices gave the false impression that high levels of debt were sustainable. The crisis revealed itself when the bubbles exploded, and net wealth returned to normal level. So although the crisis may have emerged in the financial sector, its roots are much deeper and lie in a structural change in income distribution that had been going on for twenty-five years. From this perspective, the causes of the crisis have been building up endogenously (United Nations, (2009)).

Between the end of 2008 and the beginning of 2009 the world economy experienced the most severe recession in decades. The excessive losses linked to

Figure 2 - GDP Growth



Sources: IMF, OECD. *OFCE forecasts (October 2009)

subprime mortgages and to related derivative markets severely disrupted the financial sector (leading to a near-collapse of the interbank market in the fall of

2007) and triggered a race to deleveraging and to the accumulation of safe assets by financial institutions, firms and households alike. The most obvious effect of this flight to safety has been a severe tightening of credit conditions, that constituted the main (albeit not the only one) channel for the transmission of the crisis to the real sector. The credit crunch was further deepened by the drastic fall in the value of financial assets, used among other things as collateral in fund raising by firms and households. Through decreased trade and exports, the crisis quickly spread from the US to other countries (including developing countries), even those which had kept their financial sector in order.

The downward spiral lasted at least two quarters, the last one of 2008 and the first of 2009, with violence unseen since the thirties. True, some signs of reversal started to appear (at least in some countries) in the second and third quarters of 2009. But the cause of this reversal may be traced back to strong policy action that supported aggregate demand both directly and through a positive effect on private sector's expectations and spending. **Error! Reference source not found.** shows GDP growth figures and forecasts for 2009-2010 (OFCE, (2009)).

The figure shows that in spite of the weak recovery currently under way, the overall decrease in GDP in 2009 remains historically high. Furthermore, for the same year, European countries, with the exception of France, seem to be suffering more than the US from the crisis. This finding is somewhat puzzling as the US is considered the epicenter of the crisis. We will explore the point further in the next section.

The green shoots of recovery, nevertheless, do not make room for excessive optimism. Each of the economic actors has cumulated old and new fragilities that explain why growth in the future should remain modest. *Banks and financial institutions* are recovering[1], as witnessed by the normalization of interbank markets in terms of volumes and spreads. Still, the real "health" of their balance sheets is not yet clear, also because the losses linked to the financial crisis have to be added onto those imposed by the current contraction of economic activity, whose extent cannot be fully appreciated yet. Investment by *firms* is not to be expected to strongly recover in the short-to-medium run either, since even if credit conditions will revert to normal again (which remains to be seen), the crisis has left many firms with excess capacity, and bankruptcies offer the possibility to acquire capital at low cost without fresh investment. Finally, *households* have experienced a serious negative wealth effect, caused by the sharp decrease of

[1] This fast recovery may signal a worsening of the moral hazard problem. The bailing out of banks has been done in such a way (almost without conditionalities) that it has increased the certainty of the actors that they were too big to fail, especially because thy have taken advantage of the process to become even bigger. Moreover, the bail outs and the fast recovery have further increased the feeling of unfairness among the population.

DOI: 10.2202/1948-1837.1053

stock and housing values since 2007. This contractionary effect on disposable income and consumption is strengthened by the credit crunch, and even more importantly by the increase in unemployment that is following with a lag the contraction of GDP, and which is forecasted to keep increasing well into 2010. That is of great concern: if it is true that one of the causes of the deficiency in global demand and thus of the crisis is the increase in inequalities that took place in most countries over the last 25 years, the expansion of unemployment and of job precariousness makes the present state of inequality worse than what it was on the eve of the crisis. Finally, the stimulus plans and the working of automatic stabilizers have seriously deteriorated government finances. We cannot exclude that some governments will try to invert this trend in the next year or so, thus contributing to suffocating the recovery under way: as the recovery owes more to the oxygen tank built by governments than to the capacity of capitalism to self regulate, it will be foolish to withdraw the tank.

All of these factors explain why the forecasts for 2010 reported in remain well below potential for all the countries considered, and that a prolonged period of deflationary pressure is still a possible future scenario.

3. Why has the Crisis Hit Harder Europe than the US?

At the early stages of the crisis it was expected that Europe would be hit less strongly than the US, as the crisis was traced back to the excessive activism of macroeconomic policies (in particular of monetary policy) of the Unites States, combined with excessive deregulation of financial markets. Europe, we were told, would not suffer from the same fate because its growth model was based on strong regulation and prudent macroeconomic policies.

But, in fact, financial globalization had already accomplished its work: the world market was simply localized in the US, and all the financial actors mainly from the rich countries played in this market, spreading the toxic assets all over the world. Hence, even if the number of spectacular bankruptcies in Europe was limited, the banking sector proved to be as fragile as the American one. The consequence is that the chain of events is extremely similar, even in size, across the ocean: banking sector insolvencies, confidence crisis, drying up of interbank markets, flight to safety and asset depreciation, negative wealth effects and credit crunch, drastic private spending reduction.

In particular, the argument that prudent macroeconomic management was the winning strategy proved to be flawed, and it actually has to be reversed if we want to explain the apparent paradox of a crisis that hits harder the Eurozone than the US. As happened virtually in all occasions since the early 1990s, US fiscal and monetary policies were more reactive to the shock, and this major distinction (in timing and size) is the only major difference that can be observed over the past twelve months. We have argued elsewhere (Fitoussi and Saraceno, (2004)) that the set of institutions for the economic governance of Europe is consistent with the doctrine that dominated in the 1990s, that pledged for a rule-based system aimed at preventing discretionary interventions and at pursuing nominal stability, because the growth objective would be attained through structural reforms alone. The Stability and Growth Pact (SGP) and the strict inflation targeting contained in the statute of the European Central Bank (ECB) did in fact succeed in attaining nominal stability and convergence (Fitoussi and Laurent, (2009)). But, not surprisingly, this came at the price of two decades of soft growth that could have been easily forecasted, had the dominant theory not failed to take into account the tradeoffs implied in the exclusive focus on nominal stability (Fitoussi and Saraceno, (2004)). Moreover the emphasis on supply-side adjustments aimed at boosting competitiveness most notably through wage moderation, a leaner welfare state, and lower employment protection (the "structural reforms") constrained European governments to engage in a non-cooperative strategy through fiscal and social competition.

We discussed elsewhere the effects of excessively restrictive macroeconomic policies in the Eurozone countries during the recessions of the early 1990s and more recently of 2001, comparing them to the strategy followed by American policy makers (Fitoussi, (1996; 2001)). The current crisis constitutes no exception, as we will see next.

Monetary Policy and the Subprime Crisis

The subprime crisis represents a typical case in which solvency and liquidity problems are difficult to disentangle. Nevertheless, in August-September 2007 the crisis was hitting the credit sector with no regard to actual solvability of individual institutions, dramatically increasing the systemic risk. Thus, in spite of the difficulties for central banks to act as lenders of last resort in a context of increasing sophistication of the financial system, the praise for the early intervention of the Fed and the ECB was unanimous. Nevertheless, this intervention took a very different form across the ocean.

The driving principles of the ECB action can be summarized as follows. Inflation is mainly a monetary phenomenon, and price stability has to be the priority, if not the sole objective, of central bank action[2]: in the classic assignment problem the instrument for controlling inflation is the interest rate. This essential and somewhat radical assumption explains the peculiar importance that money aggregates took in the initial strategy and communication of the ECB, and also the

[2] It has to be emphasized that this mandate of the ECB is written in European treaties which are more binding than a constitution as they can be modified only by unanimity. The Government of Europe is constrained by rules and is prevented from discretion; see e.g. Fitoussi, (2002), Fitoussi and Saraceno, (2004).

DOI: 10.2202/1948-1837.1053

refusal to consider differences between headline and core inflation when assessing monetary conditions in the Euro area[3]. Other tasks, for example ensuring liquidity of the banking sector, need to be addressed without hampering the main objective of price stability; thus, on one side, interest rates cannot be used for other objectives, and on the other, any other operation by the ECB needs not affect the medium run target growth rate of money supply. It is why the focus on price stability through strict or flexible inflation targeting is neither a sufficient, nor a necessary condition for macroeconomic stability. Nevertheless, the solution of the assignment problem is flawed. You can separate economic objectives and assign to each a privileged instrument – the so-called Tinbergen-Mundell rule – if and only if the model of the economy is linear; otherwise all instruments should concur together to the different objectives.

During the crisis the ECB remained faithful to its credo. The key Eurozone interest rates remained unchanged from June 2007 to July 2008 (at a level of 4%!), when the ECB *increased* them, because of the increase in energy prices; an error that raised doubts about its understanding of the real extent of the crisis. Only in the fall of 2008, when it became clear that the threat was deflation and not inflation, did the ECB began a series of rate decreases that in May 2009 brought the marginal lending facility rate and the REPO at their current level of 1.75% and 1% respectively (Figure 3).

The subprime crisis was primarily dealt with through short term refinancing operations, which provided the very short term liquidity that the system needed, without nevertheless increasing the long term amount of money.

The strategy pursued by the Fed was rather different. At least in an initial phase, the US central bank used the interest rate instrument to curb the interbank rates (LIBOR), and to inject liquidity into the system. The first reaction of the Fed was a reduction of the Primary Discount Rate, in order to narrow the band for short rates (The ECB did the same thing only in October 2008, for the 4 months up to January 2009). Subsequently, the Fed cut all rates on five different occasions, keeping the window constant. Overall, Fed Funds target rates went down 225 basis points in 4 months, and were further lowered in the fall of 2008 to the current level of 0.25% (the discount rate being 0.5%).

Late in the fall of 2007, the Fed also turned to open market operations on a much larger scale, most notably through the creation in December 2007 of the Term Auction Facility (TAF). In this regard it is worth noticing that in order to improve the liquidity of the system most central banks also put in place non-conventional interventions, with the specific objective of providing sufficient

[3] There are pros and cons to this distinction: it is obviously not relevant for developing countries where energy and food represent a high proportion of household expenditures; it may also loose its relevance in developed countries where inequality and poverty are increasing.

liquidity to the interbank market, and de facto substituting commercial banks in that market. Open market operations have been reinforced notably by expanding the range of assets required as collateral, and including assets whose value was difficult to determine in the market (thus transferring some of the bad loans onto the balance sheets of the central banks). Furthermore, central banks have increased their exposure, by engaging in longer term loans to the banking sector. Hence one of the common features of central banks' reaction has been to largely increase their quasi-fiscal operations without entering into formal agreement with the treasuries.

Figure 3 also reports the 1 week Libor and Euribor. It emerges quite clearly that while very different in the initial phase, both strategies succeeded in bringing down to acceptable levels the spread between short term rates in the interbank market and the target rates. It may actually be said that the ECB was more successful in stabilizing short rates, even if this is explained to a good extent by the different severity of the crisis in the two zones. But here we have clearly an assignment problem: how much of this relative success was due to the action of fiscal authority (bailing out of the banking sector, deposit guaranty, recapitalization etc.) and how much was due to the action of the central banks? (This highlights the remarks made above about the Tinbergen-Mundell rule).

Figure 3 - Target rates and interbank short (1 week) rate. US-EMU

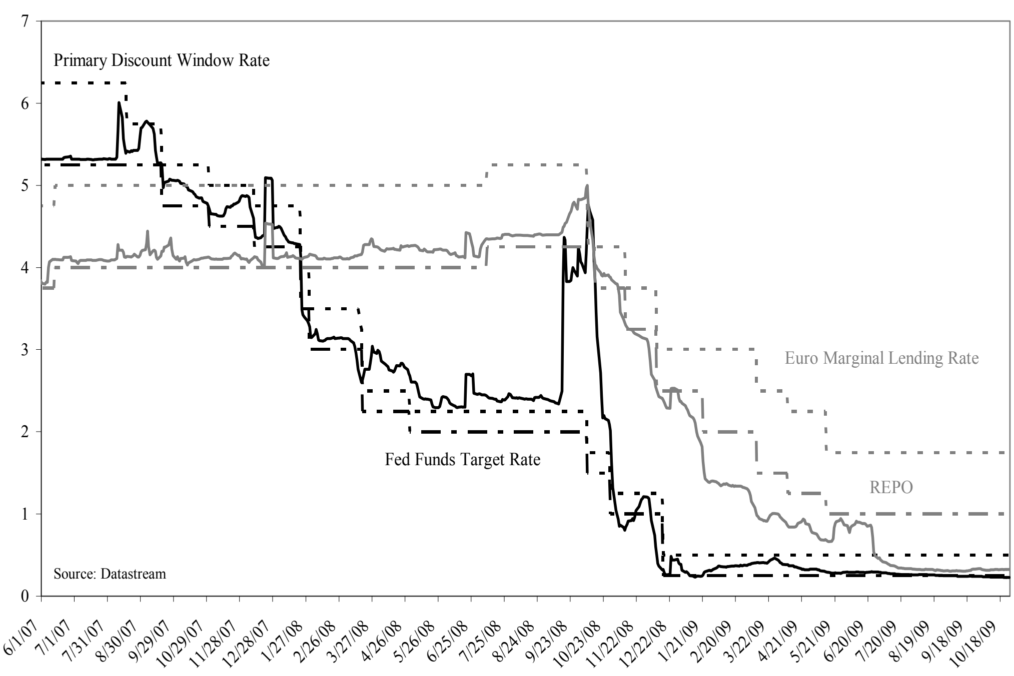
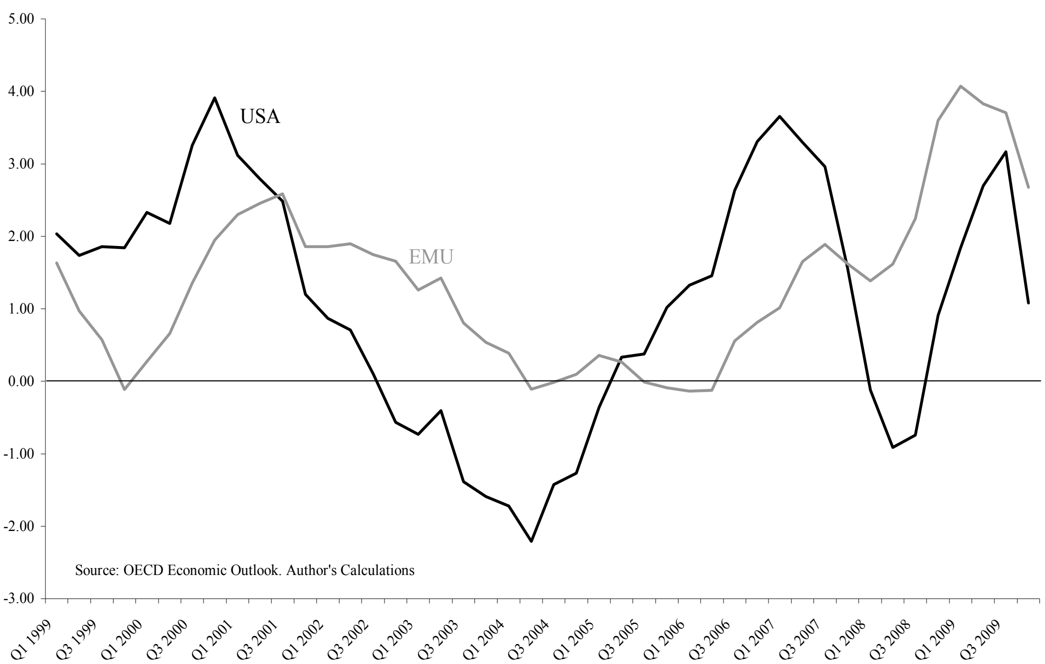


Figure 4 - Spread between short term rates and the Taylor Rule



We can further assess the relative tightness of monetary policy in the two zones by comparing short term rates with the rates that would be consistent with a Taylor rule taking into account inflation and the output gap.

Figure 4 shows that the ECB rates were consistently above the level that would have been implied by the Taylor rule, whereas in the US they were more variable[4]. In particular rate cuts were more aggressive both during the crisis of 2001, and the current global recession, while policy turned restrictive during recovery phases.

To summarize, monetary policy has been correctly praised as having been effective and timely in preventing a meltdown of the banking sector, even if it remained more restrictive in Europe than in the US. Nevertheless, as successful as it has been in avoiding a catastrophic event, monetary policy has not been able to restore confidence. The massive injections of liquidity into the system have been hoarded (or invested in safe public bonds) by banks in an attempt to restore more reasonable prudential ratios. The liquidity trap re-emerged from economic history books, and by the end of 2008 it was well installed in our economies. Monetary

[4] We assumed a potential growth rate of 2.5% in the EMU, and of 3% in the US, which are also the target real interest rates. The inflation target is assumed to be 2% and 2.5% respectively.

policy has run out of steam, at least as the main tool of macroeconomic policy intervention. As in a standard textbook case, from the spring of 2009, fiscal policy has taken the lead role in sustaining aggregate demand.

Fiscal Policy

In a situation of liquidity trap, private savings massively go into government securities, in a "flight to safety". The government has to transform these savings in order to curtail deflationary expectations, to restore the value of assets, and ultimately to escape the deflationary process. Three main principles and elements of an effective stimulus package should be highlighted:

1) A large part of it should take the form of public investment, to build and modernize infrastructures, to avoid rent seeking, "pork in the barrel" projects, and to lay the foundations for future growth.
2) The current crisis is leaving on the ground many casualties, like home owners, blue collar workers, and entire business sectors. An important part of the planned expenditure should be targeted at relieving their conditions and to sustain their income and capacity to spend.
3) As could be expected, even as GDP growth resumes, unemployment is increasing significantly in most countries, both in the existing workforce and among those who will enter in the workforce in the following months. Everything should be done to avoid them to become discouraged, and to provide them with safety nets. In particular, the extension of unemployment benefits would increase economic security and act as a powerful economic stabilizer at the same time. Employment subsidies, on the other hand, while they may enforce inclusion in normal time, should not be seen as substitute for unemployment insurance.

As for the size, estimates converged on the need of a fiscal stimulus of around 2% of GDP, if no country plays a free rider game. In fact, standard textbook analysis shows that the size of the multiplier is significantly increased by a joint (if not coordinated) effort. There is nevertheless a real difficulty in measuring the amplitude of the crisis, and the effects of macroeconomic policies aimed at dampening it. This difficulty is reflected by the repeated revisions of policies and forecasts by national governments, even before the plans are put in place. This makes it rather difficult to give a quantitative assessment of the needed stimulus. While it of course depends on the fact that the crisis is still unfolding, this uncertainty is at least in part an unavoidable consequence of the dismissal of tools that in the past allowed an evaluation of policy in the global economy. Today only a few institutions have multi-country models and use them for policy analysis and forecasting: their dismissal in the past as Keynesian and

DOI: 10.2202/1948-1837.1053

thus “out of fashion”, was a mistake that we are paying for today. This difficulty is compounded by the fact that due to the long-term structural changes in the world economy, the statistical indicators on which we rely (mainly GDP) are flawed with a series of measurement problems (Stiglitz, Sen and Fitoussi, (2009)).

It is worth noting that some developing countries may not be in a position to afford a fiscal stimulus of several points of GDP. It is therefore of foremost importance that the international community help these countries carry out the needed measures exactly as it needs to help them with the banking rescue packages. OECD countries should resist the temptation to cut foreign aid spending; ideally, foreign aid should be increased. But until now, the news from this front is wholly inadequate, as it appears that foreign aid has effectively been reduced.

Finally, a word should be said on sustainability. The concern about the long-term sustainability of current action, as is emerging in the statements of the heads of state and government around the world, is normal. While the issue is important, we should bear in mind that no long-term sustainability concern should appear, as long as the policy will effectively remain counter-cyclical. This means that as the economy will enter an expansion phase, fiscal policy should turn restrictive. It is very important that this does not happen too late, but it is even more important that it does not happen too early. Turning to budgetary restrictions before the crisis is over could undermine all the previous efforts to sustain growth. This is why the discussion about an exit strategy mentioned in the introduction looks extremely worrisome. Also, the importance of the composition should be underlined: public investment, if it succeeds in increasing the growth potential of the economy and hence future growth, may pose less sustainability problems.

Table 1 details the stimulus plans adopted by EU countries and by the major economies of the world, With a stimulus package of 5.6% of GDP spread over three years (2008 to 2010), the United States has adopted an aggressive fiscal policy stance to face the crisis. Fiscal stimulus in the EU 27 is 1.4% of GDP over the same period, four times less than in the US. The euro area, which totals 73% of GDP in the EU 27, contributes about the same percentage to the global stimulus in 2009, but nearly 90% in 2010. In fact, non-EMU European countries seem to be constrained by threats to the stability of their currency. This is the case of Hungary but also to a lesser extent the United Kingdom, whose stimulus is the size of the European average, but concentrated only in 2009.

Within the Eurozone, Germany, Spain, and Finland have recovery plans of around 3 percentage points of GDP. In contrast, France, Italy and Portugal appear inertial, while Ireland contributes negatively to the European stimulus by adopting a strongly pro-cyclical policy.

Since January 2009 no major element came to alter the picture, with the exceptions of a plan for tax cuts by the newly elected German government, which should account for about 1% of GDP (24 bn euros), and a plan by the French government to cut taxes to the business sector that is forecasted to cost around

Table 1 Stimulus Plans

	% of GDP	Effect				% of GDP	Effect		
		2008	*2009*	*2010*			*2008*	*2009*	*2010*
Austria	1.1	0	0.9	0.2	Czech Republic	3	0	2	1
Belgium	1.6	0	1	0.6	Denmark	2.5	0	0.8	1.7
Finland	3.1	0	1.5	1.6	Hungary	-4.4	-0.7	-1.9	-1.8
France	0.6	0	0.5	0.2	Poland	1	0	0.8	0.2
Germany	3	0	1.4	1.6	Sweden	2.8	0	1.5	1.3
Ireland	-4.4	-0.7	-1.9	-1.8	UK	1.4	0.2	1.3	-0.1
Italy	0	0	0	0	**UE 27**	**1.4**	**0.1**	**0.8**	**0.5**
Netherlands	1.5	0	0.8	0.7					
Portugal	0.8	0	0.8	0	**USA**	5.6	1	2.1	2.4
Spain	3.5	1.1	1.6	0.8	**Japan**	2	0	1.5	0.5
Eurozone	**1.6**	**0.2**	**0.8**	**0.6**					

Source: OECD - National Accounts - OFCE Forecasts, Spring 2009

0.4% of GDP (11.7 bn euros). Moreover the French Government is preparing a long run investment program that will be financed by borrowing ("le grand emprunt") around 35 billion euro, spread over several years. This program will mostly be devoted to financing higher education and research.

To summarize, the answer of EU governments to the crisis is significantly less aggressive than in the US and even in Japan, both on impact and over time. While this can be justified for smaller non-Eurozone countries, which face the risk of a currency crisis, it is much harder to find a rationale for the timidity of large Eurozone countries. If we read these facts together with the comparatively less expansionary stance of the ECB with respect to the Fed, we conclude that macroeconomic policy has been far more inertial in the EU than in the United States.

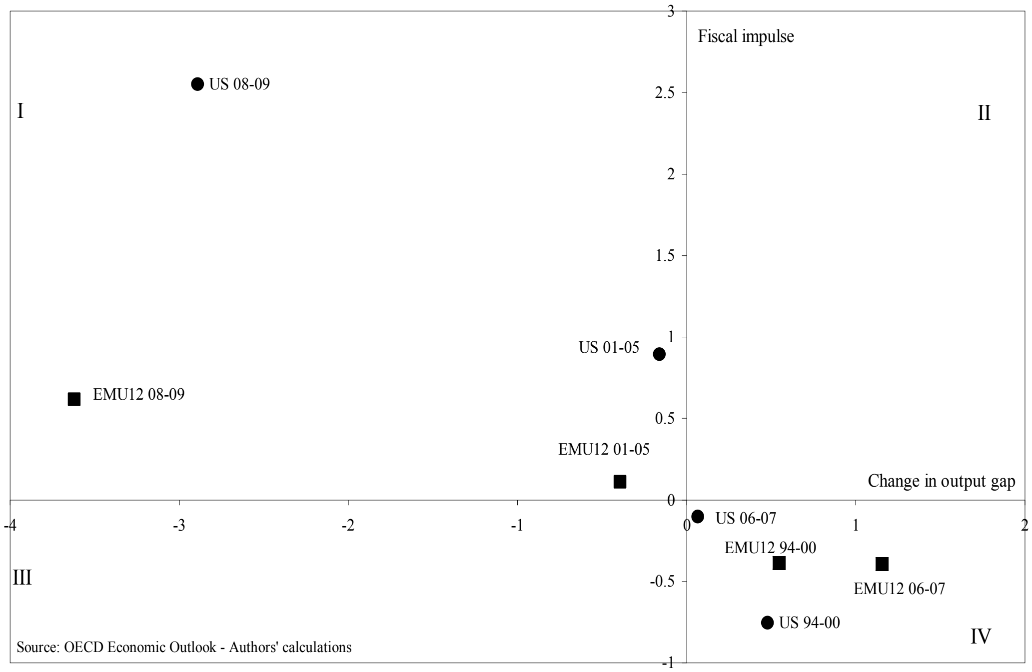
The reaction to the current crisis, furthermore, constitutes no exception, as in the past two decades macroeconomic policy in Europe has played a distinctive minor role. We saw in

Figure 4 how monetary policy has been less reactive than in the US. Similarly, discretionary fiscal policy in the past decade has not been as responsive to the cycle as it should have been.

The fiscal requirements of the Maastricht criteria and of the SGP had a deep influence on the pattern of public finances in European countries. shows

DOI: 10.2202/1948-1837.1053

Figure 5 - Change in output gap vs fiscal impulse



the scatter plot of changes in the output gap against the fiscal impulse[5] for the US and the Eurozone. In the US fiscal policy has been counter-cyclical (expansionary in 2001-05, and of course in 2008-09; contractionary during the expansion of the 1990s and in 2006-07). This pattern shows that fiscal policy has constantly been in the policy makers' toolbox, regardless of the administration (the sample spans the Clinton and Bush terms). In the Eurozone, the consistently restrictive fiscal stance happened to be counter-cyclical in the second half of the 1990s. It was slightly counter-cyclical during the difficult years at the beginning of this decade, and overall rather mild even in the current recession. If we look at the details of the correlation between fiscal impulse and output gap (figures are available upon request) we observe that all the large Euro zone countries, with the exception of Spain had a mildly pro-cyclical stance. Only Finland has a reactivity of fiscal policy comparable to the one of the US and of the UK.

The heterogeneity of the countries considered leads to link this restrictive stance to the efforts for entry in the EMU in the 1990s, and for trying to respect the SGP constraints since 1997.

[5] The fiscal impulse is computed as the negative of year on year changes in cyclically adjusted government net lending. It measures the discretionary fiscal stance of the country, and a positive number denotes an expansionary stance.

We argued elsewhere at length (Fitoussi and Saraceno, (2004; 2008)) that the inertia of macroeconomic policy has to be traced back at the institutions for the economic governance of Europe, notably the statute of the ECB, exclusively focused on inflation, and the Stability and Growth Pact that limits discretionary fiscal policy. As we said above, these institutions are not meant to consider the tradeoffs facing policy choices, and target nominal stability rather than growth.

4. What Helped France Smooth the Impact of the Crisis?

Within the European countries France seems to have been able to cushion the crisis better than its partners. We saw in Figure 2 that the growth performance of France in 2009 is forecasted to be similar to the one of the US, and significantly better than the Eurozone countries, a forecast that is confirmed by the latest (October 2009) IMF economic outlook. France looks more resilient than its large Eurozone partners also if we look at industrial production. What explains the better resilience of France with respect to other large Eurozone countries? We can point out two factors: The first is the relative strength of automatic stabilization in France. Creel and Saraceno, (2009) show that in France the trend towards lowering the strength of automatic stabilizers has been less marked than in other countries, while the weight of the government on the economy remains larger (see also Fatas and Mihov, (2001)). This has more than compensated the timidity of the discretionary stimulus, thus providing an overall support to aggregate demand larger than in Germany or in Italy.

The second element that could explain a relatively better performance of the French economy is more structural. We discussed above how increasing income inequality (widely documented: for a recent assessment of the US, look at Heathcote, Perri and Violante, (2009)) in the past three decades has weakened aggregate demand and increased aggregate savings in most countries. If we look at the most recent international comparisons, nevertheless (IMF, (2007), OECD, (2008)), we observe that according to most measures the trend of mounting inequality has been less pronounced in France than in other countries. Thus, this structural weakening of aggregate demand was less important. This effect may be felt especially during a recession, because low-income classes have a better capacity to sustain their consumption. The "French model", as branded recently by *The Economist* (2009), would then have been more resilient both because of the public (automatic stabilization) and the private performance.

5. Conclusion

This paper showed that, in spite of the severe crisis that hit the world economy, European macroeconomic policies have not been as active as expected, and certainly less than the ones followed by the United States. This is in our opinion

DOI: 10.2202/1948-1837.1053

the main reason for the better prospects of the US at the time of writing. In principle, a proactive macroeconomic (fiscal and monetary) policy is not a necessity. An economic system endowed with strong social safety nets and a well functioning system of automatic stabilizers would be able to cushion the negative effects of shocks without resorting to discretionary measures. On the contrary, the proactive macroeconomic policies followed in the US, by Republican and Democrat administrations alike, are necessary for a system that made the political choice of minimizing social safety nets. Macroeconomic policies have to be active where the social protection system is weak. Otherwise a slowdown of growth, not to say a recession, would have such far reaching consequences, that it will endanger the legitimacy of the economic system. Mass unemployment in the US is simply unbearable in view of its potentially destructive social consequences. In other words, the US system is the result of a political and democratic choice, and within that choice it is consistent. Equally consistent would be a system in which the restraint in macroeconomic policies went hand in hand with a strong welfare system and an important role for automatic stabilization. This issue seemed to be clear at the time of the debate on the SGP when, in response to criticism, the proponents of the Pact argued that constraining discretionary choice would not be a problem because room was left for automatic stabilization to operate (look for example at Buti and Giudice, (2002) who reflected not only the general view of European economists but the political position of France and Germany). The problem is that, as we said above, in the EU the constraints to macroeconomic policies were such as to make them structurally restrictive. As a consequence, unemployment increased and stayed at high levels. This explains the emphasis put on structural reforms and on the necessity of downsizing the welfare state. Creel and Saraceno, (2009) show how the role of automatic stabilization and of social protection has been constantly decreasing over time, both in the EU and in the US; but only in the latter has the role of macroeconomic policy been proactive, as would have been consistent with this trend. This fundamental inconsistency is in our opinion at the roots of the poor macroeconomic performance of the EU, when we compare it with the US.

References

Buti, M. and G. Giudice (2002), "Maastricht's Fiscal Rules at Ten: An Assessment," *Journal of Common Market Studies*, 40(5), 823-48.

Creel, J. and F. Saraceno (2009), "Automatic Stabilisation, Discretionary Policy and the Stability Pact", in *Current Thinking on Fiscal Policy*, J. Creel and M. C. Sawyer, Eds., Palgrave Macmillan, 112-44.

Fatas, A. and I. Mihov (2001), "Government Size and Automatic Stabilizers: International and Intranational Evidence," *Journal of International Economics*, 55(1), 3-28.

Fitoussi, J.-P. (2001), "Monetary Policy and the Macroeconomics of 'Soft' Growth", in *Monetary Theory as a Basis for Monetary Policy*, A. Leijonhufvud, Ed., Palgrave, IEA Conference Volume n°131, 215-44.

Fitoussi, J.-P. (2002), *La Règle Et Le Choix*, Paris, La république des idées, Seuil.

Fitoussi, J.-P. and E. Laurent (2009). "Macroeconomic and Social Policies in the Eu 15 : The Last Two Decades." OFCE, *Document de Travail*, 2009-20, August

Fitoussi, J.-P. and F. Saraceno (2004). "The Brussels-Frankfurt-Washington Consensus. Old and New Tradeoffs in Economics." OFCE, *Document de Travail*, 2004-02, January

Fitoussi, J.-P. and F. Saraceno (2008), "Fiscal Discipline as a Social Norm: The European Stability Pact," *Journal of Public Economic Theory*, 10(6), 1143-68.

Fitoussi, J. P. (1996), "Substitutabilities Vs Complementarities between Structural and Macroeconomic Policies," *OECD Proceedings*, 208-29.

Heathcote, J., F. Perri and G. L. Violante (2009). "Unequal We Stand: An Empirical Analysis of Economic Inequality in the United States, 1967–2006." NBER, *Working Papers*, 15483, November

IMF (2007). "World Economic Outlook: Globalization and Inequality." October

OECD (2008). "Growing Unequal? Income Distribution and Poverty in Oecd Countries." October

OFCE (2009), "Perspectives 2009-2010," *Revue de l'OFCE*, 111(October).

Stiglitz, J. E., A. Sen and J.-P. Fitoussi (2009). "Report on the Measurement of Economic Performance and Social Progress." September

The Economist (2009), *Vive La Différence!*, May 7th

United Nations (2009). "Report of the Commission of Experts of the President of the United Nations General Assembly on Reforms of the International Monetary and Financial System ", 21 September

DOI: 10.2202/1948-1837.1053