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Germany, France, two answers?

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1. A similar situation ?

2. The growth performances

3. Two strategies?

4. Why so poor performances

1. A similar situation ?

- At the beginning of the century, Germany and France face similar economic and social choices.
- Their economic and social structures are typical of the European social model in its continental version. This model is characterized by a high level of public spending and social transfers, important redistributions, important intervention of the State in the economy, close relationships between firms, banks and the State, an important role of trade unions both at the enterprise and at national level, a strong employment protection.
- This model is challenged by liberalism, by globalization and by European construction.
- The two countries must choose between defending their model or transform it in depth. The leading classes have chosen the strategy of transformation.

This strategy raises three issues :

1. Toward what model should European countries evolve? Are they obliged to move towards the liberal model? Could they try to maintain a specific system, compatible with the European Social Model? Is the Scandinavian model an alternative? The question arises regarding the labour market, industrial policy, financial structures, taxation or social policies.

2. This transition has social and economic costs which add to globalization costs.

3. The leading classes have to find allies and to overcome social classes opposed to change. They must cut social benefits, make jobs and wages flexible, increase social inequalities…They must destroy the old alliance - public and private sectors workers, welfare state recipients - to build a new alliance - entrepreneurs and workers of well-performing firms, new leading classes (financial sectors, medias), wealthy people. Social cohesion will be weakened.

- The year 1980 saw the 'renaissance' of liberal project at world scale. The Anglo-Saxon countries break with the Keynesian project (maintain full employment in an increasingly socialized society) to find again a renewed triumphant capitalism: to restore companies' profits, to develop financial markets, to accept widening inequalities, to make markets flexible, to lower public expenses and taxes.
- This model is spread by trade and financial globalisation and by European construction. It comes in conflict with the traditional governance of continental European Countries, which must accept to reform themselves, but these reforms lead to resistance, with varying importance depending on the country.
- Since 1980, continental countries have to undertake economic and social reforms. These are years of sluggish growth and mass unemployment, whose responsibility is hard to define. Is it to undertake liberal reforms ? Is it to undertake these reforms with not enough force? Is this the inevitable cost of transition?
- European institutions paralyse part of tools of States and at the same time it imposes the direction. Bigger countries have more difficulty that smaller ones to reform: the cost is greater, social consensus is more difficult to obtain, they can more easily resist the European pressures.

Germany and France, however, significant disparities:

1. Reunification whose economic weight was heavy for Germany.
2. The strength of its industrial sector allowed Germany to restore its situation recently.
3. France has more difficulty to adapt to European institutions, the ECB and the SGP, less in its tradition
4. The difference in the position and the strength of political parties and trade unions. France was involved in specific policies (nationalisation, 35 hour working week) and did not introduce liberal reforms before 2007 while these reforms met less resistance in Germany.

In 2008, France appears to have resisted more to the liberal wave, when Germany followed a strategy of labour market reforms and wage restraint.

In these two countries, the issues are similar: should people have to accept the liberal model and try to implement it as soon as possible? Would it be possible to maintain a specific model of society? Is a new compromise possible? Is the liberal model a solution with its inequalities and its instabilities ?

2. Growth performances

- The countries recording the best growth performances vary over time. Since 1998, the best performers are the liberal countries, some Mediterranean countries (Spain and Greece) and the Scandinavian countries. The losers are the 3 major countries of the euro zone and Portugal. Should we extend the results of the last 10 years to infer that the major continental countries or the Continental model countries are condemned to a slow growth?
- Each of these 3 countries have their specificities. Germany has experienced five years of very low growth (2001-2005), in a classic pressure on wages and weak domestic demand. German GDP growth rebounds in 2006-2007 with a huge external surplus and a public balance in equilibrium.
- On the contrary, Italy and France keep low growth, together with important public and external deficits for France, external deficit for Italy. Is the German strategy a model for France or Italy? Or has this strategy contributed to push the euro area economies into stagnation?

Table 1. Economic performance

Real GDP growth (percent p.a.)	1960/1973	1973/1980	1980/1990	1990/1998	1998/2007	1960/2007
EU-15	**4.7**	**2.3**	**2.4**	**1.9**	**2.3**	**2.9**
Euro Area	5,1	2,6	2,4	1.9	2.2	3,1
Continental Model	*4.8*	*2.4*	*2.3*	*2.0*	*1.8*	*2.9*
Germany	4.3	2.2	2.3	2.0	1.5	2.6
France	5.4	2.6	2.4	1.7	2.0	3.1
Belgium	4.9	2.7	2.0	1.8	2.3	2.9
Netherlands	4.9	2.5	2.3	2.9	2.3	3.2
Austria	4.9	2.9	2.3	2.4	2.3	3.1
Mediterranean Model	*6.2*	*3.7*	*2.5*	*1.8*	*2.4*	*3.6*
Greece	8.5	3.0	0.7	2.0	4.3	4.1
Italy	5.3	3.6	2.4	1.3	1.4	3.0
Portugal	6.9	4.0	3.3	2.7	1.7	4.0
Spain	7.2	3.8	2.9	2.3	3.7	4.3
Scandinavian Model	*4.4*	*2.0*	*2.4*	*1.9*	*3.0*	*2.9*
Denmark	4.4	1.7	2.1	3.0	2.4	2.9
Finland	5.0	2.8	3.0	1.5	3.4	3.3
Sweden	4.1	1.8	2.2	1.4	3.1	2.8
Liberal Model	*4.2*	*2.4*	*3.1*	*3.0*	*2.8*	*3.2*
Ireland	4.4	4.7	3.6	6.7	6.3	5.0
United Kingdom	3.2	1.0	2.6	2.2	2.8	2.5
United States	4.4	2.6	3.2	3.1	2.8	3.3

- Since 1980, French economic policy has oscillated between the Keynesian strategy and a neo-classical consolidation strategy.
- In 1981-83, the Keynesian expansionary policy launched by the left government fails. The increases in wages and taxes caused a decline in company profits and high inflation, which induced a strong external deficit obliging to devalue the French francs, thereby increasing inflation further. France has met a supply barrier.
- In 1983, the government had no choice but run a new strategy : ‘rigour’ and competitive disinflation. Fiscal and wage restraints reduced growth, increased unemployment but allowed for the restoration of profits and a strong disinflation. Growth resumed robustly from 1987 to 1989.
- In 1990, the German reunification has resulted in a sharp rise in interest rates which together with the world recession caused a sharp deceleration of growth. The Maastricht criteria imposed a restrictive fiscal policy. The slow growth persisted until 1996, in a situation of low inflation and external surplus. It is the lack of demand which slowed growth. France was paralyzed by an inadequate economic policy imposed by European construction.

- In 1997-2000, France has experienced a revival of growth allowed by the restoration of profits, the low level of the euro and an original economic policy (35 hour working week, reduction in employers' contributions).
- In 2001, France was hit by the world recession induced by the stock market crisis of September 11. In the absence of expansionary policy, growth did not resume. The French economy suffered from the German restrictive policy and the U.S. exchange rate. France had no inflation; the firm margins remained high, but the external deficit widened. France suffered from a lack of domestic and external demands.
- Over the period, the French economic policy failed to maintain a satisfactory growth, structural reforms were shy and did not succeed… Growth depended on miracles that were not present except in 87-89 and 97-00.
- Since 1983, slowing down of growth were not caused by supply constraints, but by internal or mainly external demand shocks, that economic policy were not able to offset

The EMU experience

- France and Germany have witnessed a sharp slowdown in growth in the years 1990. Despite a growth revival in 1997-2000 for France, EMU has not translated for them by the expected acceleration of growth. Like the whole area, both countries suffered from the Internet crisis, the rise of the euro and the weakness of European economic policy.
- From 1999 to 2005, euro area growth is only at 1.45%, while France is slightly higher, at1.65%, but Germany is only at 0.6%. In 2006-2007, the German growth is 2.7%, as in the euro zone and well above France, 2%.
- In terms of GDP per capita, their situation is deteriorating since 1991, both vis-à-vis the UE15, the United Kingdom or the US.

Table 2. GDP per head of population in PPS

Euro area =100

	France	Germany	United Kingdom	United States
1991	102.0	112.6	92.8	132.6
1998	99.9	106.3	100.6	139.2
2007	98.1	102.3	105.8	138.6

- Since 10 years, growth in domestic demand is much stronger in France than in Germany, but the gap has widened further since 2001.
- This comes especially from household expenditures. France has seen robust growth of household spending while Germany saw its consumption grow slowly and housing investment decline, reflecting both low growth of households income and stagnation of its population (against an increase of 0.8% per annum in France).
- On the other hand, foreign trade has greatly reduced French growth (0.5 points per year) while it supported German growth. This discrepancy has 3 causes which are difficult to distinguish: price-competitiveness, robustness of domestic demand, strength of the industrial sector.
- Since 8 years, Germany and France have chosen different strategies, France continues to support its growth through domestic demand, Germany has chosen a strategy of competitiveness.
- From 1995 to 2005, the French strategy was successful, but these last two years show a reversal.

Figure 1. FRANCE: Contribution to GDP growth

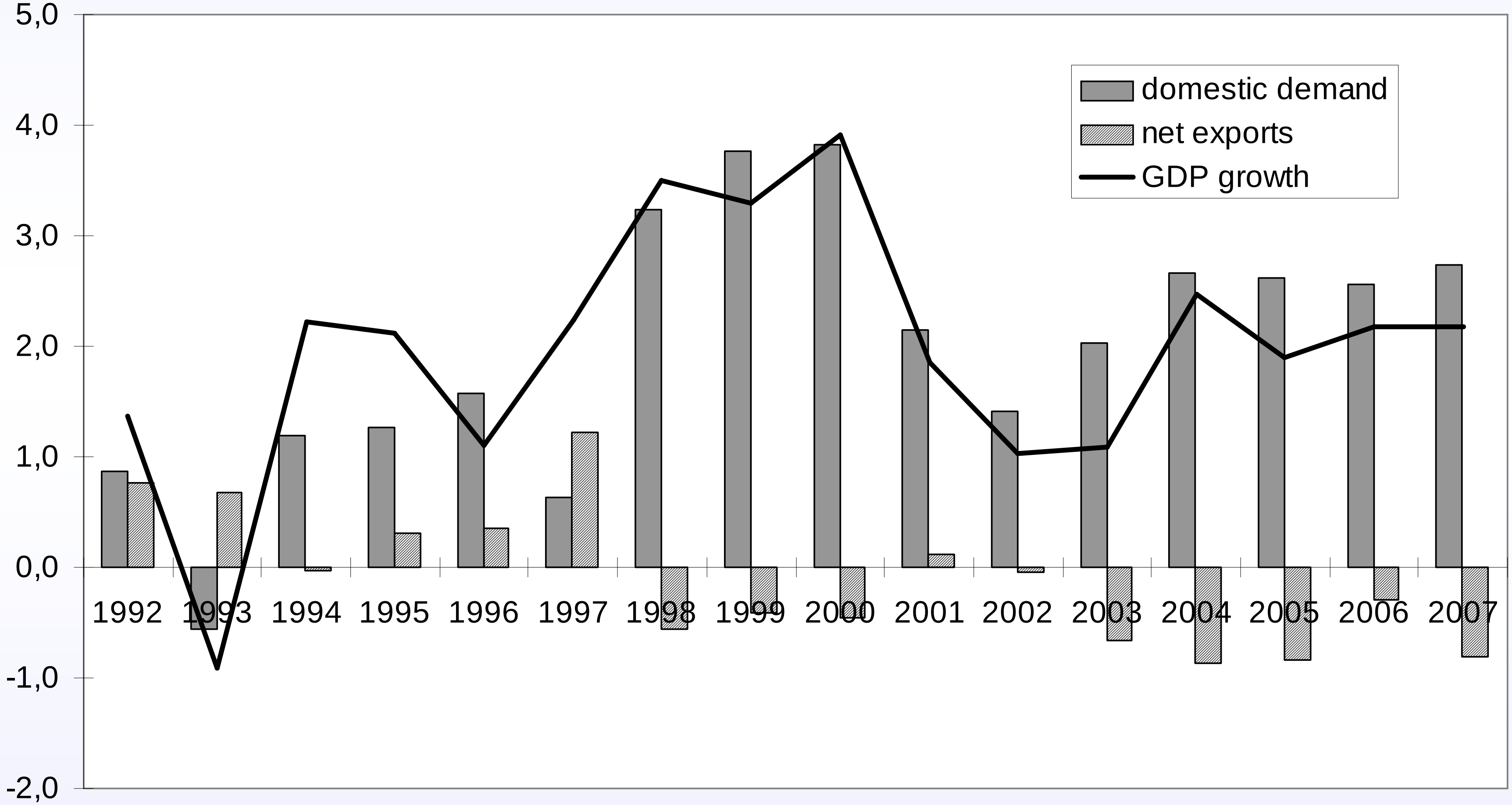


Figure 2. GERMANY: Contribution to GDP growth

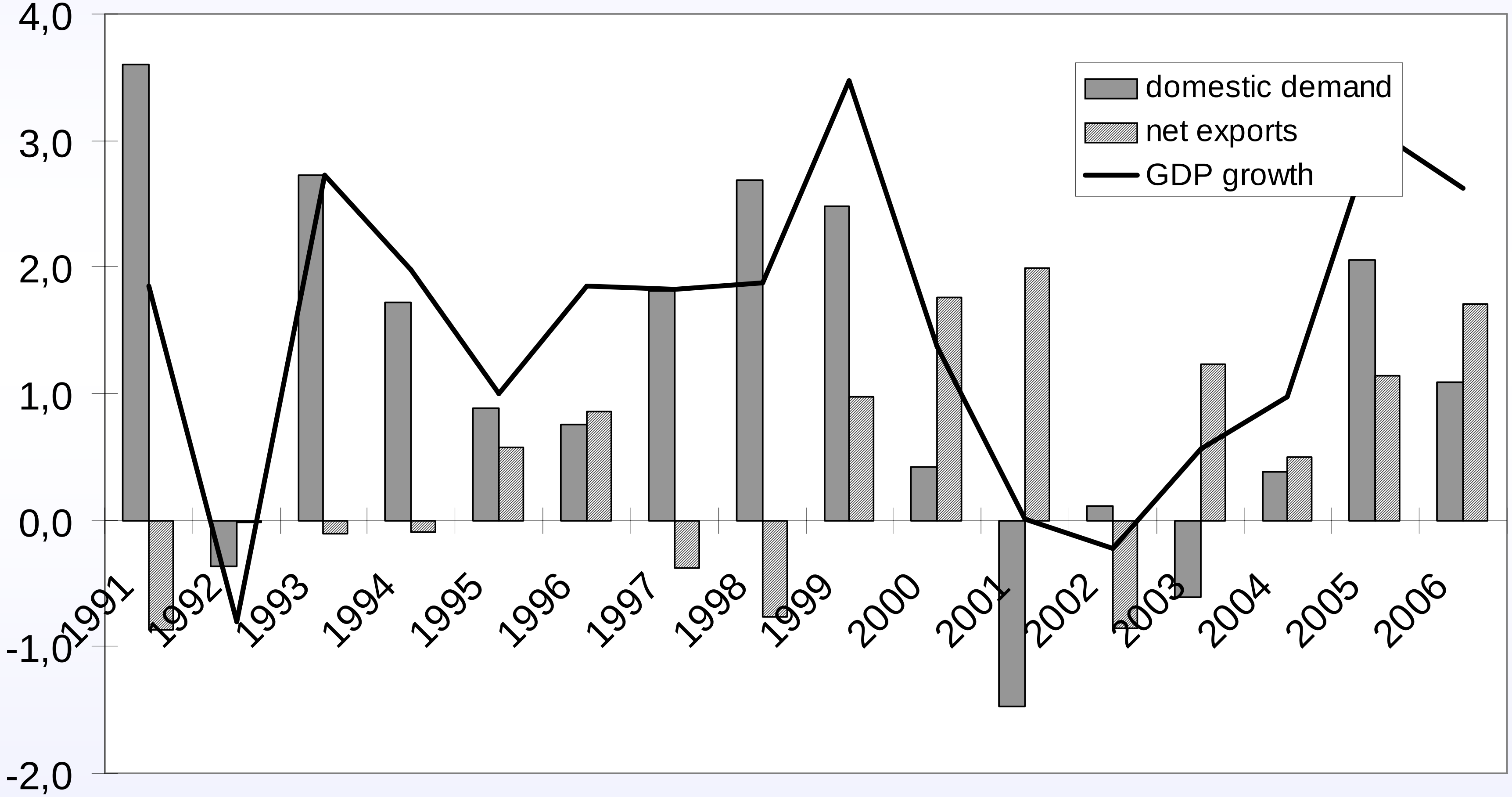


Table 3. Average annual growth 1999/2007

	France	Germany	Euro Area
GDP	2.1	1.5	2.1
Private consumption	2.5	0.6	1.7
Public consumption	1.6	0.7	1.9
Productive investment	3.9	2.8	3.3
Residential Investment	3.2	-1.6	3.3
Exports	3.9	8.1	7.2
Imports	5.6	5.8	7.5
Domestic demand	2.5	0.6	1.9
Foreign balance*	-0.5	1.1	0.0

*** Contribution**

3. Difference in the required growth ?

- From 1993 to 2006, the working age population has continued to grow in France (+6.3%), but begun to fall in Germany. Activity rates increase more rapidly in Germany but the growth of German potential population has remained below the French one (0.4% by year against 0.8% for France).
- In 2006, the employment rate in full-time equivalent is 58% in France, 60% in Germany against 64% in the United Kingdom, 67.5% in the USA, 69.5% in Sweden. France and Germany have a margin of increase of about 10% before to face a labour supply constraint. In both countries, this implies an increase of female participation (and more full-time in Germany) and an important increase in older workers employment (which has already started in Germany, but not in France).

Table 4. Unemployment variation 1993/ 2006

In %

	United Kingdom	France	Germany	Italy
Unemployment variation	-5.0	-2.0	2.5	-3.2
Population 15/64 contribution	7.6	6.3	-1.0	-0.2
Activity rate contribution	0.8	4.4	6.1	7.4
Employment contribution	-14.5	-12.2	-2.2	-11.1

Table 5. Activity rates in 2006

	France	Germany	Sweden	United-Kingdom
Males				
Activity rate 25-55	93.8	93.8	92.5	91.7
Activity rate 55-65	46.8	64.1	76.2	68.3
Part time rate	5.1	7.6	8.4	9.9
Females				
Activity rate 25-55	81.2	80.3	86.2	79.9
Activity rate 55-65	40.5	46.7	69.8	50.2
Part time rate	22.5	39.2	19.0	38.8
Unemployment rate	8.3	8.4	6.1	5.2

- Until 2020, the working age population would remain stable in France, while it would decrease at the rate of 0.4% per annum in Germany.
- In Germany, the rate of activity is likely continue to increase, particularly for 55-65, at a rate of 0.4% per annum. To obtain an unemployment rate of 5% in 2020 against 8.4% in 2007, Germany needs an employment growth of around 0.4% per annum.
- France lags behind Germany as regards older workers' activity rates. To succeed its pension reform, it would have to achieve an increase of its activity rate of 0.6% per annum. To obtain an unemployment rate of 5% in 2020 (against 8.3% in 2007), France needs a employment growth of 1% per annum. So there is a differential of 0.6% between the growth rate required in France and in Germany.
- From 1997 to 2007, the unemployment rate has sharply declined in the euro area (3.2 points), but Germany remains the worst performer (- 0.9 points), while France is in the average (3, 2 points).
- Employment grew by 1.4% per annum in the euro area, against 1.25% in the USA. In France, employment growth was 1.1% by year against 0.6 % In Germany.

- France and Germany have seen the growth of labour productivity eroded from 1973 to 1990, although the performance of France have always been better. Since 1990, France takes behind the USA and Germany.
- The period 1999-2005 saw the gap between productivity of the US and Europe widened, because of a better integration of ICT and of discrepancies between the labour market situations. In under-employment context, public policy incentive firms to maintain employment. Both countries have sought to increase employment by gains in competitiveness in industry, Germany has been a little more successful than France (3.8% against 3.2%).
- France has chosen to encourage non-industrial firms to reduce gains in labour productivity gains and to hire unskilled workers. This strategy was successful in terms of employment in the short term, even if it reduce the growth potential growth.
- From 2001 to 2007, France has experienced an employment growth of 0.7% by year against 0.2% for Germany. But the situation was reversed in 2007 (1.2% in France, 1.7% in Germany).

Table 6. Labour productivity growth

	61-73	74-85	86-90	91-95	96-00	01-07
France	4.7	2.4	1.8	1.5	1.5	0.9
Germany	4.2	2.1	1.3	2.8	2.2	1.5
United States	2.4	1.0	1.3	2.1	2.1	1.7

Table 7. Labour cost 2000-2007

	France	Germany
All economy		
Wage	3.0	1.1
Productivity	0.9	1.3
Unit labour cost	1.9	-0.2
Industry		
Wage	2.7	2.2
Productivity	3.2	3.8
Unit labour cost	-0.6	-1.5

- During the 1997-2007 period, 8 countries in the area remained in mass unemployment. As they represent 90% of the area, it is hard to understand why they have not tried to undertake more dynamic policies as inflation was very low and the current account in surplus In fact, the leading classes of these countries consider that the priority is not to support growth and achieve full employment, but rather to implement structural reforms.
- One explanation for this passivity could be the need to fight against inflation. But, in both countries studied, inflation was extremely low since 1987, even if an increase was registered in Germany in 1990-93, during reunification. Over the period 1999-2007, inflation was only 1.3% in Germany and 1.5% in France. In the euro zone, countries with high inflation are catching up and rapid growth countries (Ireland, Greece, Spain) and not countries with slow growth and high public deficit.

About the Nairu

- Another explanation could be the constraint that would impose a high level of equilibrium unemployment rate (NAIRU). If the unemployment rate goes below this limit, economic policy could be forced to become restrictive. Unfortunately, estimates of NAIRU are extremely variable and not reliable for European countries.
- For example, OECD considers that NAIRU is 8.7% for France in 2003 (when the unemployment rate to 8.5%) and 7.8% in 2007 (when the unemployment rate is 8%). The NAIRU therefore fall as the effective unemployment rate and France was during this period above the EUR, which is not credible.
- From 2001 to 2007, the real wage growth in Germany was 0.5% per year (using the GDP deflator) or 0.1% (using the consumer price). It was 0.9% or 1.25% in France. In the two countries, we did not see excessive wage increases due to too high tensions on the labour market.

3. Two strategies?

- In the 1999-2007 period, the wages shares in GDP decreased in the euro area as a whole. The decrease was particularly strong in Austria, Spain, Germany, on the contrary, France and Italy have not experienced such reductions. The wages share stands in 2007 below the 1970 level by 7 points in France and the euro zone, Germany 6 points, 4 points in the USA. This transfer, which has benefited dividends, is the price to pay for ensuring a satisfactory return to shareholders.
- Increasing company profitability and price competitiveness through downwards pressure on wages became a major strategy in several countries, like in Germany and Austria.
- It was the only instrument of economic policy remain to countries who could not or depreciate their exchange rate or lower their interest rates or employ fiscal policy.
- Firms were able to threaten to relocate their production abroad, particularly in the NMS if wages were not reduced.

Table 8 . Adjusted wage share in GDP, 1998/2007

	Change in percentage point, 1998-2007
Euro area	**-2.0**
Belgium	-2.4
Germany	-3.0
Greece	-1.5
Spain	-5.5
France	- 0.2
Ireland	0.4
Italy	-0.2
Netherlands	1.5
Austria	-6.9
Portugal	1.2
Finland	- 0.9
Denmark	*-0.3*
Sweden	*-0.6*
UK	*0.6*
US	**-1.2**

Source: European Commission.

Germany, France, two answers ?

- This strategy of low wage growth has been accepted by salaries in Germany but not in France, where unions do not believe in the trade-off between wage and employment.
- This strategy boosted exports but put a drag on private consumption in these countries, thus dampening demand in the whole euro area.
- Other countries had the choice between two painful strategies :

1. To follow the German example which will induce a costly race to the bottom.
2. Not to follow and to suffer from an unsustainable external deficit

Wage competition: A non-cooperative game

- Winners: Germany which succeeded to support domestic GDP growth by a positive contribution of net exports (by around 0.9 percentage point of GDP each year).
- Losers: Spain and France (both 0.7 percentage point per year).

- Considering **patterns of domestic and foreign demand**, euro area countries can be divided into 4 groups:
- ‘Winners’: Ireland, Spain, Greece - with both strong domestic and foreign demand
- ‘Bad guys’: Germany, Austria, Netherlands - offsetting weak domestic demand by strong gains in export demand
- ‘Losers’: Italy, Portugal - suffering from both low domestic and external demand
- ‘victims’: France, Belgium, Finland - where a weak external demand partly offsets a satisfactory domestic demand.

French households in a better situation…

- The slowdown in the German households disposable income compared to the previous decade contrasts with its acceleration in France. The contribution of wages and social benefits has been lower in Germany, where property and independent income have contributed more to disposable income growth,
- From 2000 to 2007, the real income of French households increased by 2.4% in France (more than the GDP, 2%) against 0.5% in Germany (less than GDP, 1.5%). Household consumption grew by 2.35% by year in France, 0.4% in Germany. Housing investment increased by 3.2% by year in France against a decline of 1.6% by year in Germany.
- France and Germany are characterized by relatively high household savings rate with little decrease in the recent years. German households have not offset the decline in the progression of their real income by a fall in their savings rate. On the contrary, rising uncertainty linked to reforms led them to save more. On the contrary, the household savings rate has fallen sharply in the UK and the USA, thus contributing to strongly support the activity.

Figure 3: Contributions to growth of the gross disposable income

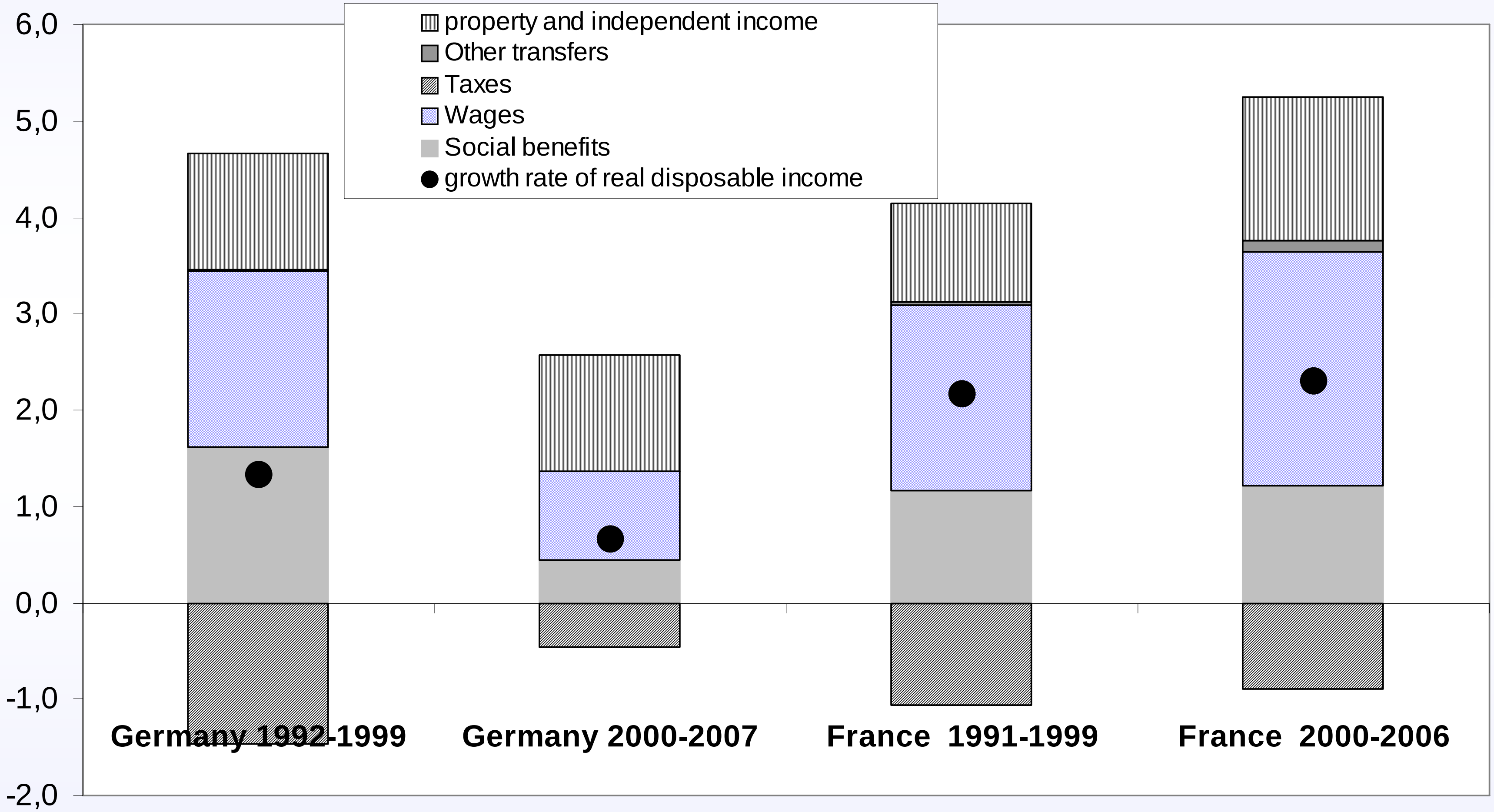


Figure 4. Households savings rate

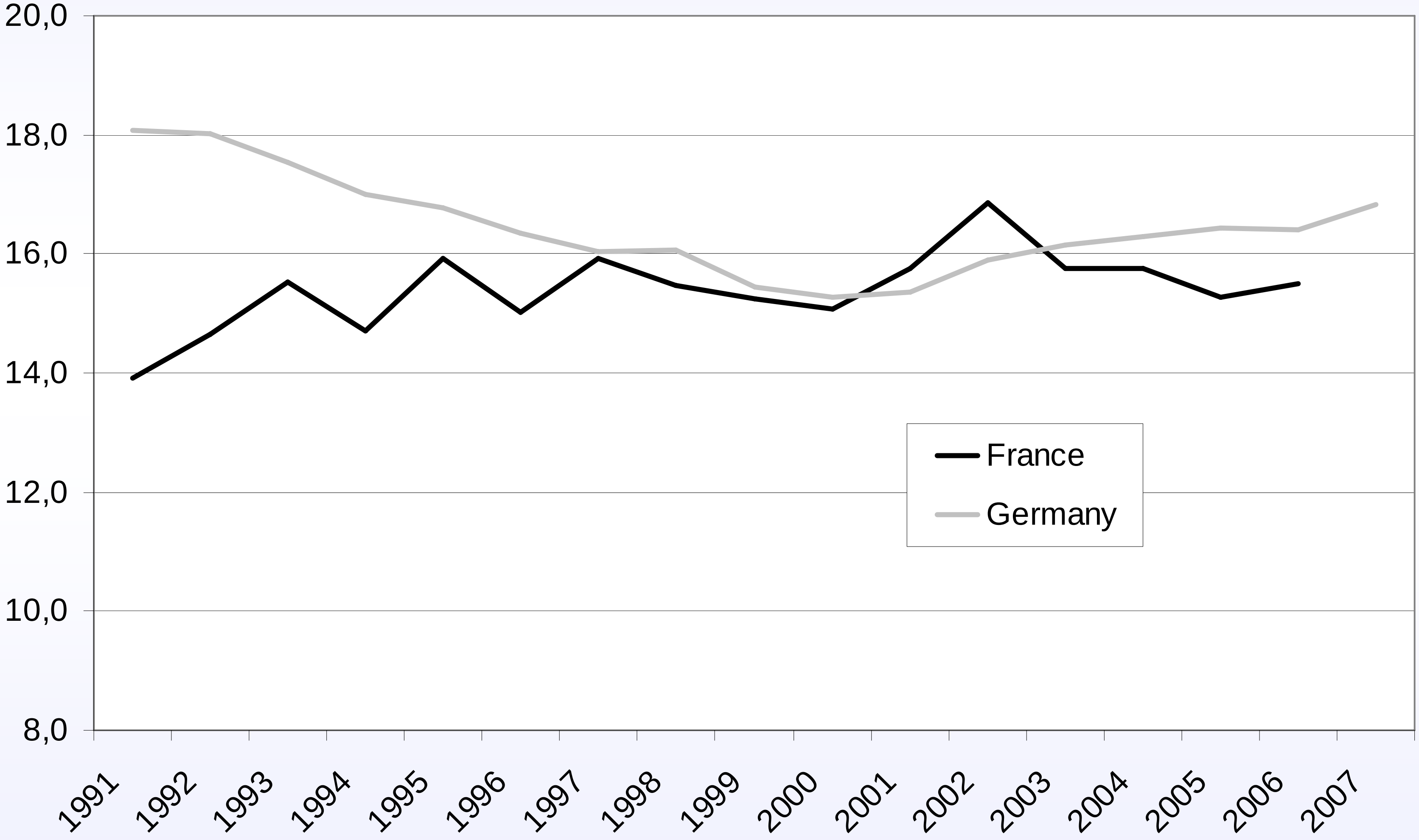


Table 9. Households saving rate

	1995	2007
France	12,8	13,1
Germany	11,0	11,1
United Kingdom (brut)	10,2	3,3
United States	4,6	0,7

Germany, France, two answers ?

Two paradoxes…

- It is paradoxical that countries with the pay-as-you-go pension system are higher saving rates than countries with capitalisation pensions system, but capitalisation systems go with a strong development of financial markets, which allows an high level of household debt, which induces a low saving rate.
- Output growth is strong in Greece, Spain, the UK and in the US too, while both national and households saving rates are very low. On the contrary, Belgium, Germany, Austria and France suffer from too high saving rates. Low saving rates seem necessary to have high GDP growth and low public debt. Virtue is dangerous in Europe, since the weakness of domestic demand resulting from a high savings ratio cannot be offset by low interest rates or substantial government deficits.

Table 10. Households wealth (in annual disposable income)

	Germany		France		United Kingdom		United States	
	1995	2005	1995	2005	1995	2005	1995	2005
Non financial assets	3.7	3.9	3.1	5.5	2.8	5.0	2.1	2.8
Financial assets	2.2	2.9	2.2	2.9	3.9	4.4	4.0	4.3
Liabilities	1.0	1.1	0.7	0.9	1.1	1.5	0.9	1.3
Net wealth	5.0	5.8	4.6	7.5	5.7	7.9	5.1	5.7

German Firms did not invest their high profit…

- After increasing their rate of return on capital and their profitability in the second half of the nineties, the French and German firms have been affected by a fall in their mark-up in the first three years of the Monetary Union, in part due to the fall in Euro exchange rate.
- Since then, the improvement in the economic situation of German firms has been spectacular: a sharp increase in the mark-up and in the return on capital allowing for an improvement in profitability in spite of a monetary retrenchment. In France return on capital has deteriorated negatively affecting profitability.
- The increase in the return rate of German firms since 2001 contrasts with its uninterrupted fall in France. In spite of a more rapidly increase in the net outflows of dividends, the rapid decrease in the debt ratio of German firms has allowed for a fall in the interest paid. Interest payments were already much lower for German firms as the fall in the debt ratio was twice more important. The debt ratio was however 50% higher in the mid-nineties.

German Firms did not invest their high profit…

- After the tax reform, which induce an acceleration of investment, German firms have massively reduced their investment rate in 2001. Since 2001, the investment rate of French firms is higher, which is surprising historically. High profit does not induce a strong investment when the growth is low.
- The combination of a higher savings rate and of a falling investment rate has generated a net lending for German firms since 2002. Strong profits had not yet induced a strong investment rate. Savings of French firms have been insufficient to finance the improvement in the investment rate, thus increasing net borrowing, notably since 2005.

Figure 5. Mark-up for non-financial entreprises

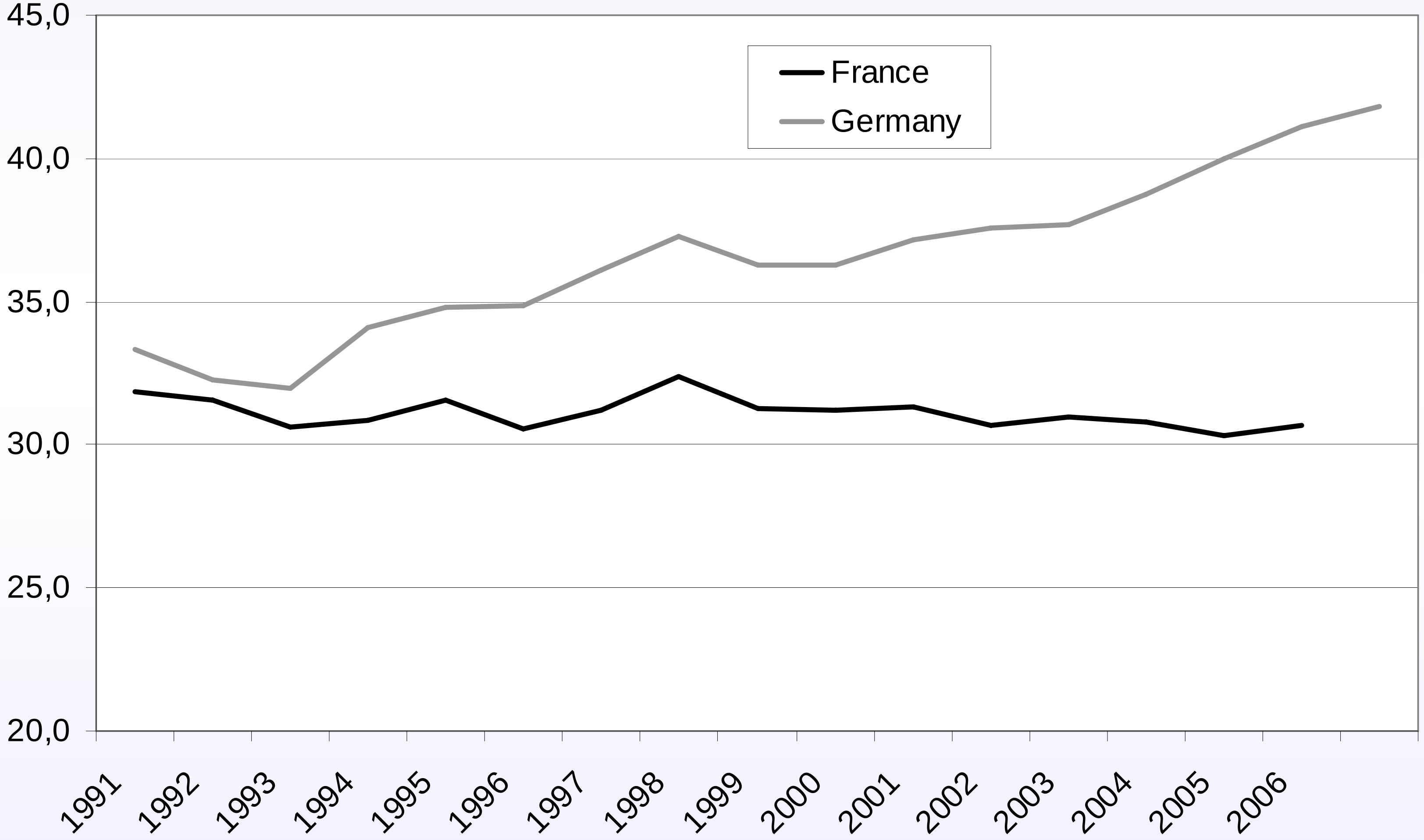


Figure 6. Business sector return on capital (Gross operating surplus/capital stock)

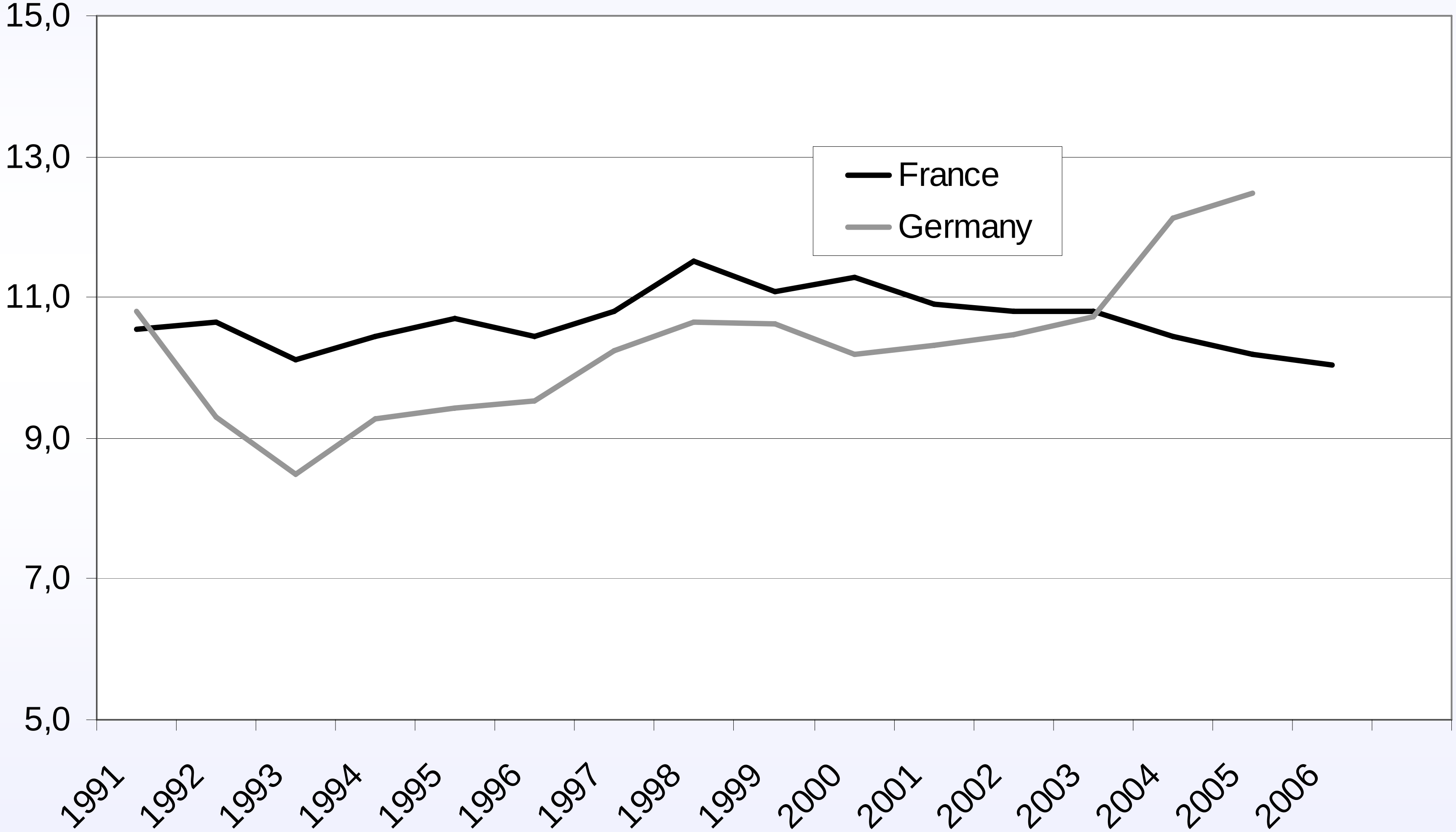
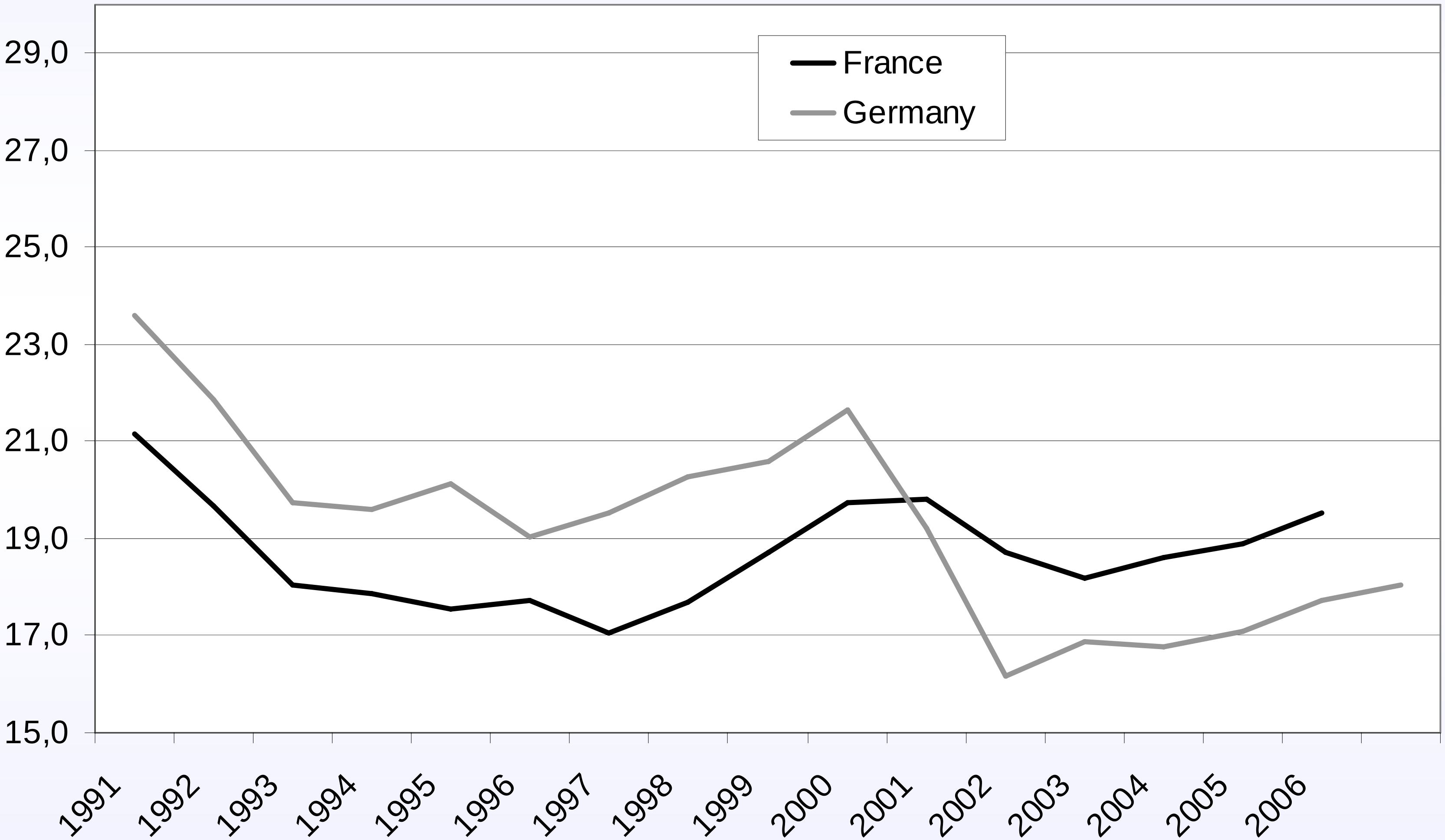


Figure 7. Investment rate



- In France, the deterioration of the company situation, the public deficit and the decline of households financial saving rate result in an increase in the external deficit.
- In Germany, by contrast, firms have improved their situation, households have increased their financial saving rate inducing a strong external surplus.

Table 11. Financing Capacity

	France		Germany	
	2000	2007	2000	2006
Enterprises	-2.0	-4.1	-4.1	0.0
Financial sector	0.3	0.6	0.4	0.8
Households	4.3	3.5	3.7	6.0
Administrations	-1.5	-2.6	-1.2	-1.6
External balance	1.2	-2.8	-1.3	5.2

External balances : return to old habits

- The euro area as a whole won competitiveness from 1996 to 2001 thanks to the fall in the euro vis-à-vis the US dollar. A weak euro together with the NTIC bubble induced strong GDP growth (3% per year from 1997 to 2000) and employment (8.7% in five years). The competitiveness gains were more than cancelled by appreciation of the euro vis-à-vis the US dollar and Asian currencies from 2002 to 2007.
- The euro area needs a weaker exchange rate in the light of the high level of unemployment. The euro area has been able to have a low exchange rate only when domestic demand was strong in the US, because the US then also had an interest in a high dollar. But the euro is high vis-à-vis the dollar is always high when US domestic demand is relatively weak. The euro area suffers from a less active monetary policy than in the US. Last, the euro area suffers from exchange rate policies in Asian countries, where exchange rates are kept low to support a fragile GDP growth (Japan), to support exports growth (China, new industrial economies) and to accumulate foreign currencies reserves.

External balances : return to old habits

- The French competitiveness improved significantly from 1981 to 1988 (competitive disinflation), then from 1995 to 2001 (fall of the euro). It then deteriorates (rise of euro, German strategy).
- The German competitiveness deteriorates until 1995, then improved due to the fall of Euro. From 2002, the wage restraints compensate the rise of Euro and the improvement continues.

Table 12. Competitive positions (relative unit labour costs)

	1981	1988	1995	2001	2007
France	108	102	100	89	96
Germany	69	85	100	84	80
United States	138	112	100	119	85

External balances : return to old habits

- France has had important external deficits until 1991. France had surpluses from 1993 to 2003. The return to external deficits came in 2004, with the euro over-evaluation and the high energy prices. France is likely to implement a restrictive policy to reduce them while they are normal considering the international context.
- Germany has experienced external deficits from 1991 to 2000, which is not its habit. Since 2004, Germany has large surpluses (5 points of GDP). These surplus compensate for the high households saving rate, the equilibrium of public balance and the low level of firms new indebtness (high profit, low investment)
- These surpluses finance excessive deficit South countries (Spain, Greece, Portugal) as desirable deficits of NMS. But they also have a depressing impact on all partners of Germany.
- The international role of the euro makes it necessary that the euro zone has a external deficit. Its distribution among member countries should be coordinated in Europe.

About monetary policy

- From 1960 to 1980, strong growth and high inflation of France had helped to maintain real interest rate adjusted for growth relatively low, relatively to Germany or the USA.
- Since 1980, France, virtuous in terms of inflation, was obliged to maintain relatively high rates, as markets fear a devaluation against the mark. The high level of interest rate increased public debt and obliged firms to increase their profit, which has been considered as one main causes of the slow growth.
- After 1996, France found again relatively low rates, while Germany suffers from low growth. At the end of the period, the long-term rates are again low relatively to growth rates. The period of high interest rates, launched by the USA in 1980, has lasted 20 years for France and the USA, 25 years for Germany.

Table 13. Long term interest rate less GDP growth rate

	61-73	74-79	80-85	86-90	91-95	96-00	01-05	06-07
France	-4.2	-3.7	2.5	2.5	4.8	1.5	1.0	-0.2
Germany	-1.4	0.9	3.6	1.1	1.9	3.0	2.5	0.1
United States	-2.7	-2.0	2.7	1.6	2.0	2.0	-0.4	-0.8

About policy mix

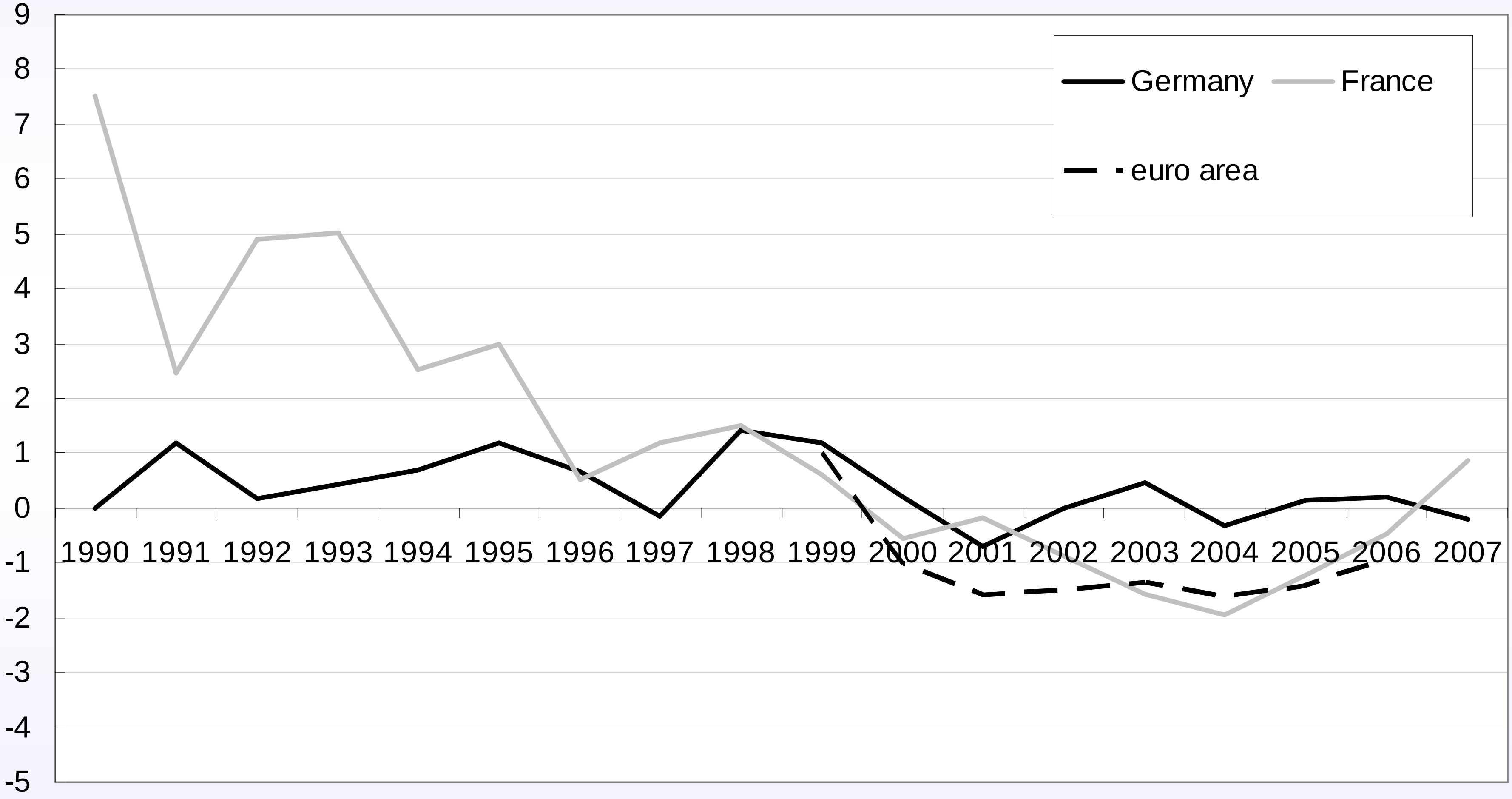
- In a heterogeneous monetary union like the euro zone, catching-up countries have structurally higher growth rates and inflation rates higher the mature countries, and a single monetary policy is problematic. Countries with low growth and low inflation as Germany may suffer from too high interest rates.
- Since 2001, monetary policy was clearly more expansionary as suggested by a Taylor rule in the USA; more expansionary also in the euro area, but to a lesser degree. During the period 1999-2007, the ECB' interest rate was 3% on average, while a Taylor rule, based on an inflation target of 2% and on output gaps estimated by the OECD, would have given averages of 3.2% for Germany and France, 3.9% for the area. The policy of the ECB has therefore not too much suffering Germany.
- However, the inflation target of 2% may be considered too low: the euro zone needs a growth recovery which could be accompanied by some temporary tensions in some markets. The estimates of the output gap by OECD are very conservative: The OECD estimated that the output gap in the euro area was zero in 1999 (for an unemployment rate of 9.2%) or 2002 (for an unemployment rate of 8.3%).

Table 14. Interest rate: Taylor rule and actual CB objective rate

	1999	2000	2001	2002	2003	2004	2005	2006	2007
Euro Area									
Taylor rule EA	2.55	4.95	5.3	4.45	3.5	3.5	3.3	3.7	3.95
Taylor rule F	1.5	4.15	3.95	3.55	3.55	3.75	2.9	3.05	2.6
Taylor rule G	1.7	4.0	4.75	3.2	1.8	2.7	2.65	3.25	4.5
Actual rate	2.7	4.05	4.3	3.2	2.25	2.0	2.0	2.8	3.85
United States									
Taylor rule	4.9	6.95	5.1	2.75	3.7	4.85	6.15	6.15	5.15
Actual rate	5.0	6.25	3.9	1.7	1.15	1.35	3.2	5.0	5.0

Germany, France, two answers ?

Figure 8. Difference between the ECB rate and the Taylor rule



- France and Germany have joined in EMU in 1997 with deficits close to 3% (3.3% for France, 2.6% for Germany). From 1998 to 2000, fiscal policies have been neutral: both countries have refused to run restrictive policies, not wanting to jeopardise the revival of growth. In 2000, public deficits are 1.5 % of GDP in France, 1.2 in Germany. The two countries were far from the limit of 3%, but they have garnered little room for manoeuvre.
- In 2001-2003, following the global economic slowdown and the German tax reform, the two countries implement expansionary policies (1.5 percentage points of GDP in France and Germany), in addition to the cyclical deficit, so that their deficit reached 4 points of GDP in 2003, inducing the SGP the crisis in November 2003. In the Euro area, the fiscal stimulus during those 3 years was only 1.2 points of GDP, while it was 6 points in the USA or 5.4 points in the United Kingdom.
- From 2004 to 2007, in a situation of negative output gap, the two countries implemented restrictive policies, at a larger extent in Germany (3.1 points) than in France (1.6 points), Germany taking advantaged of its renewed growth and more favourable monetary conditions. Finally, Germany succeed to equilibrate its public balance with an effort of 1.4 point of GDP from 1997 to 2007 while France undertook no effort globally on the period.

Table 15. France and Germany. Output Gap and Fiscal impulse

	90	91	92	93	94	95	96	97	98	99	00	01	02	03	04	05	06	07
F																		
OG	1.8	1.0	1.0	-1.5	-1.8	-1.8	-2.7	-2.6	-1.6	-0.8	0.9	0.5	-0.6	-1.5	-1.4	-1.9	-1.6	-1.3
FI	1.0	0.1	1.2	0.2	-0.9	-0.1	-1.9	-1.0	0.1	-0.2	0.6	0.3	1.1	0.4	-0.6	-0.7	-0.2	0.0
G																		
OG	3.9	1.7	1.5	-1.6	-1.0	-0.5	-1.2	-1.0	-0.8	-0.4	1.8	1.8	0.2	-1.4	-2.0	-2.4	-0.9	0.4
FI	3.0	0.1	-0.8	-1.0	-0.8	0.8	-0.1	-0.7	-0.3	-0.2	0.7	1.9	0.2	-0.6	-0.5	-0.6	-0.9	-0.3

Figure 9. France: pro-cyclical fiscal stance 1991-2007

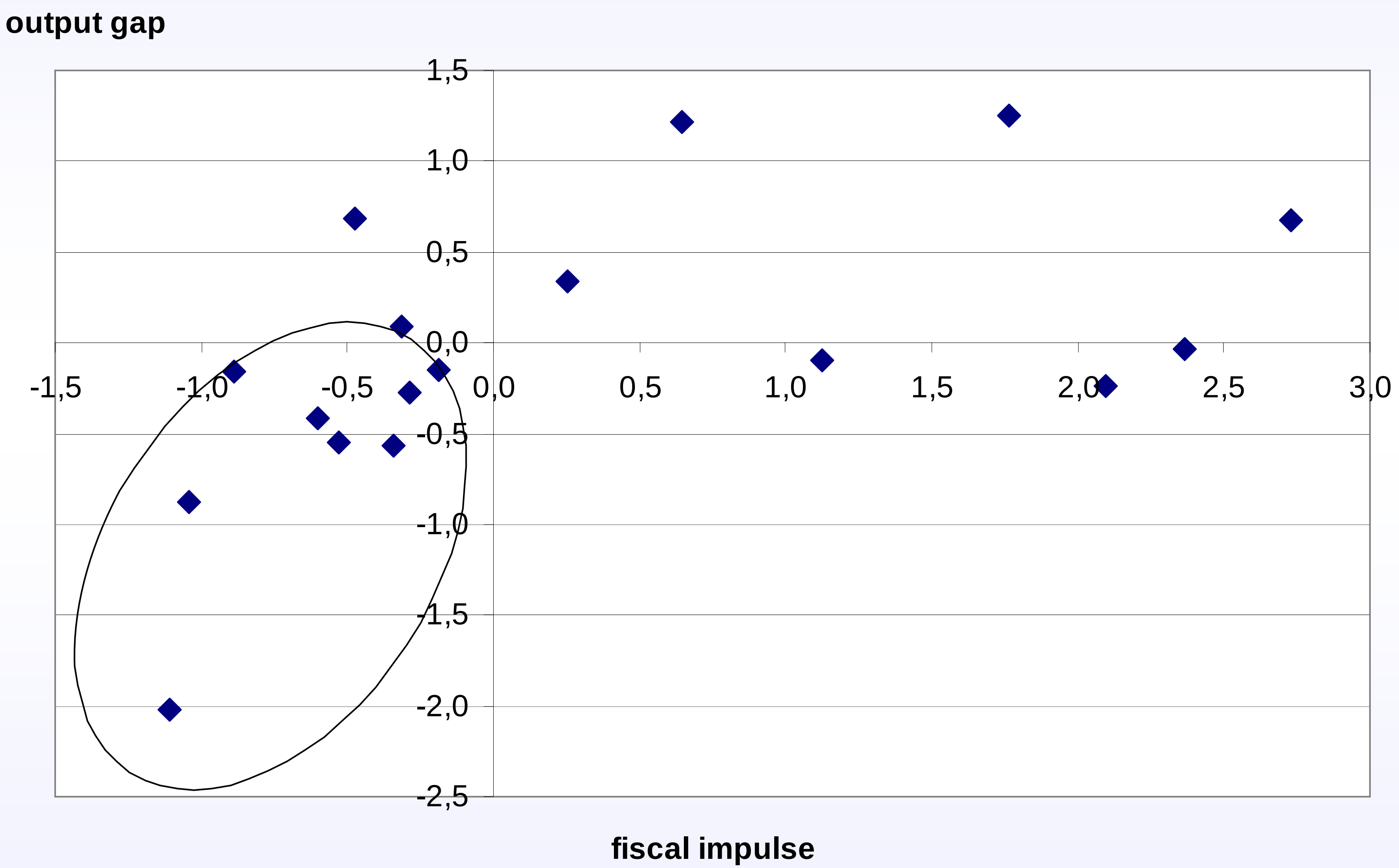


Figure 10. Germany: pro-cyclical fiscal stance 1992-2007

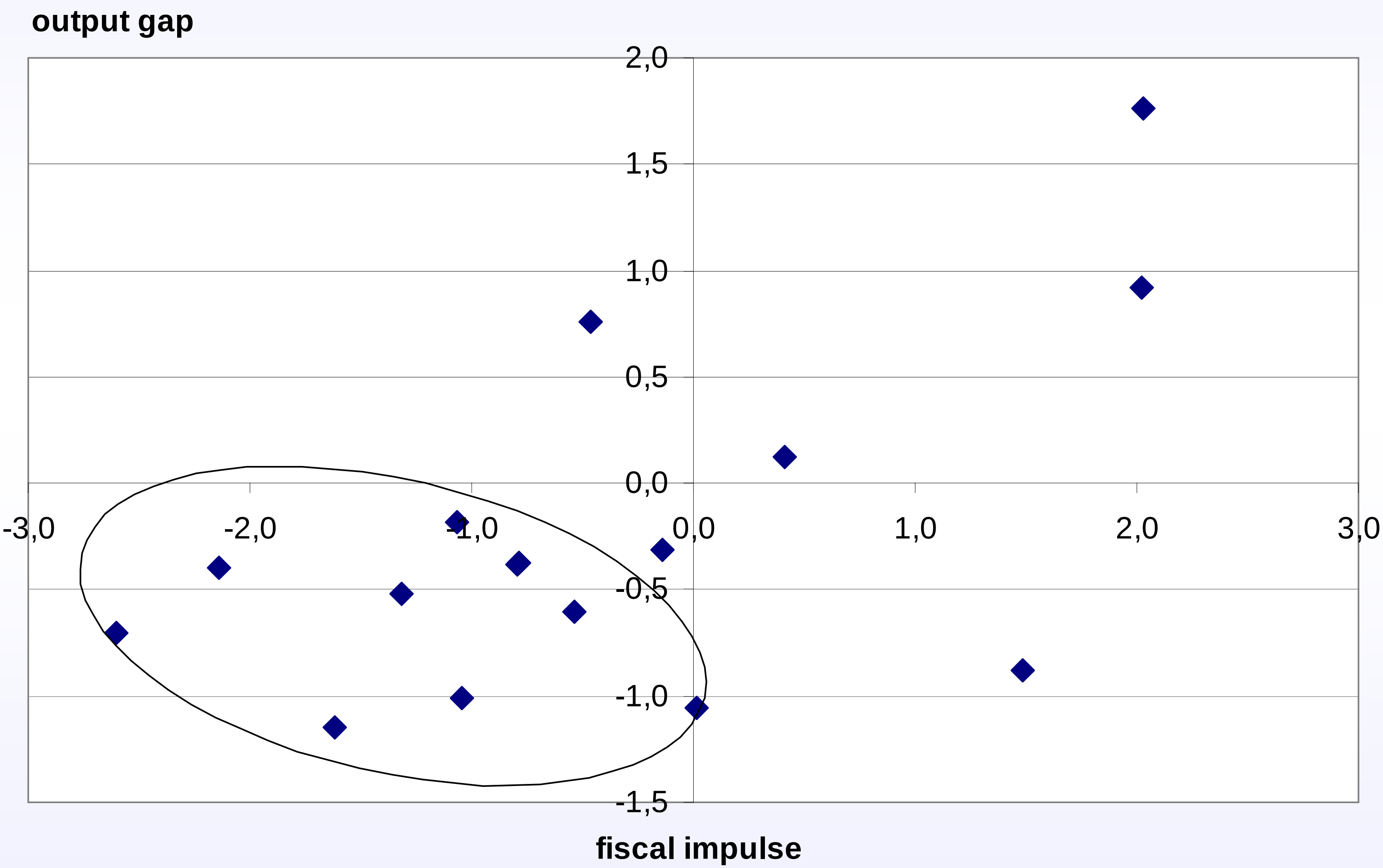
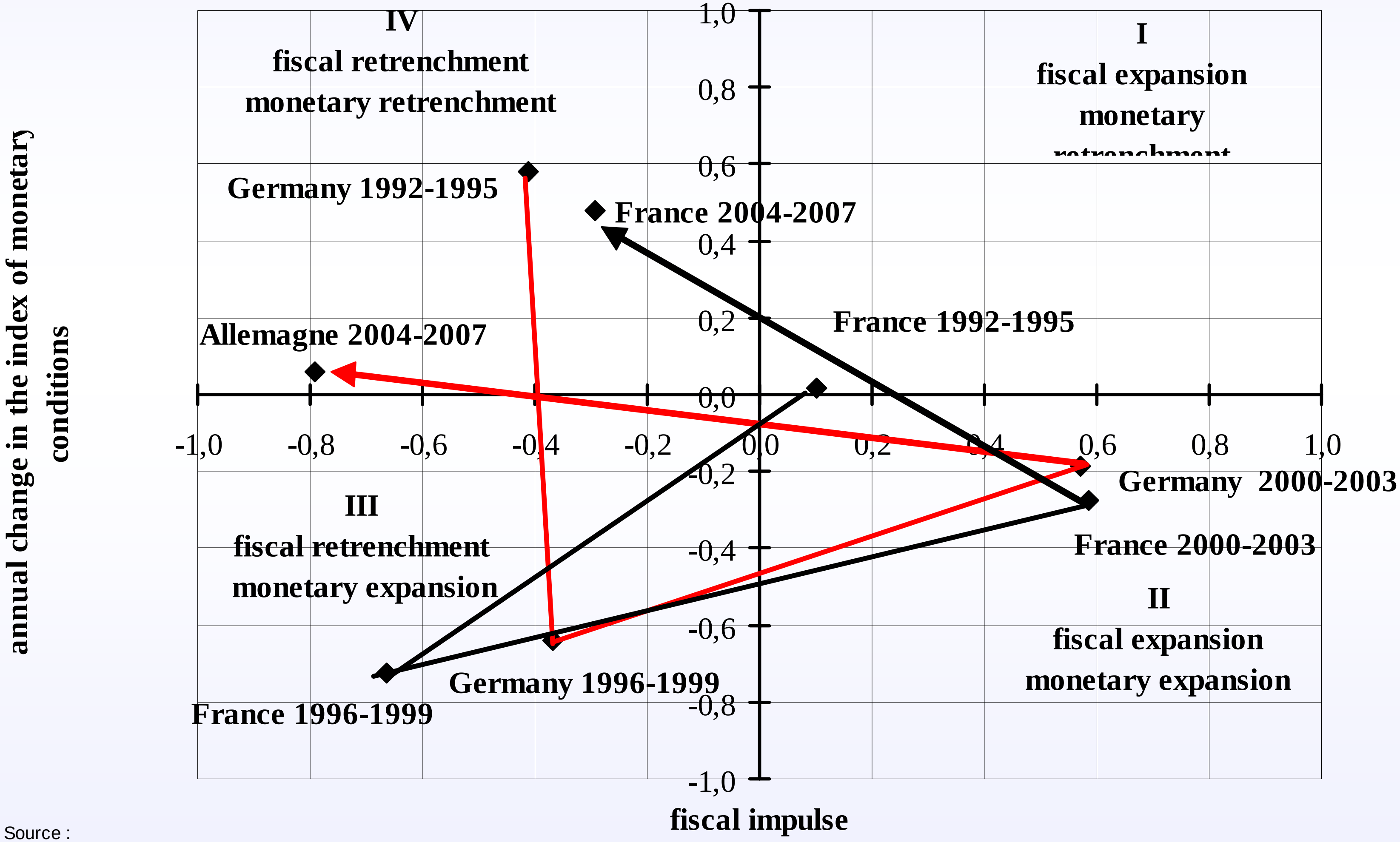


Figure 11. Index of monetary and budgetary stance



Source :

About policy mix

- In terms of taxation, France is in 2007 at the same level as 1997, while Germany has been able to reduce its tax to GDP ratio by 1.5 points. This gap is reflected at the level of primary public spending, which fell by 0.7 point in France, 3.8 points in Germany. Germany has implemented a restrictive expenditure policy that France has never been able to implement at the same scale in terms of social benefits (-1.8 point of GDP against stability), public wages (-1.6 points of GDP against -0.7 point), public consumption (-1 point in the 2 countries), subsidies (-0.7 point against stability) and public investment (-0.4 against +0.3).
- Germany has lowered its tax burden in 2001-2002 and used the budget deficit as an argument to reduce its expenses. The French government seems to want to follow the same strategy, after the decline in taxation in 2007.

Two strategies for poor growth performances

Three explanations for so poor growth performances :

- France and Germany were in average at their level of potential production, but this corresponds to a high level of equilibrium unemployment rate, due to the bad functioning of their labour market. This vision is hardly compatible with the low inflation and the declining share of wages in GDP.
- Demand constraints were the more stringent. It reflects the weakness of domestic demand and constraints on economic policies in Europe. The two countries have not found any engine for growth: neither the dynamism of investment, nor the fall in the savings rate of households.
- The leading classes of these countries have chosen to maintain a strategy of slow growth to control salaries, to restore profits, to improve competitiveness. They refuse to take the risk of important expansionary policy as in the past and as US does. The consolidation strategy induces low growth for some years and then allows for a strong recovery (France: 1983-86 then 1987-1990, 1991-1996 then 1997-2000; Germany 2001-2005 then 2006-07). But no tools are used to resist to external shocks.

- The period 1997-2007 saw France and Germany implement different economic and social policies. Germany and France have been under heavy pressure from the EU to reform their economies in a liberal direction. Germany did more than France in this way.
- France has done little to change its labour institutions. Major reforms have been the 35 hour working week, the reduction of contributions on low-wage and the Prime *pour l'emploi*, then tax exemption for overtime. They are not really liberal reforms. The French Government did not consider such reforms before 2008. Germany, with the Hartz reforms, did faster.
- In tax matters, France has chosen to reduce the cost of unskilled work rather than use tax competition by reducing the rate of corporate tax and the taxes on the wealthiest. France did not reduce its public expenditures. Here too, a turning point is taken in 2007. German use tax competition by reducing its corporate tax rates.

Table 16. Product and labour market regulation

	Product market regulation		Employment protection legislation		
	1998	2003	1990	1998	2003
Austria	1.8	1.3	2.2	2.4	2.2
Belgium	1.9	1.4	3.2	2.5	2.5
France	2.4	1.6	2.7	2.8	2.9
Germany	1.8	1.3	3.2	2.6	2.5
Netherlands	1.8	1.4	2.7	2.3	2.3
***Continental*(1)**	**2.0**	**1.4**	**2.9**	**2.6**	**2.6**
Italy	2.7	1.8	3.6	3.1	2.4
Greece	2.7	1.7	3.6	3.5	2.9
Portugal	2.2	1.7	4.1	3.7	3.5
Spain	2.1	1.5	3.8	3.0	3.1
***Mediterranean*(1)**	**2.4**	**1.7**	**3.7**	**3.1**	**2.8**
Denmark	1.4	1.1	2.3	1.8	1.8
Finland	2.1	1.3	2.3	2.2	2.1
Sweden	1.8	1.1	3.5	2.6	2.6
***Scandinavian*(1)**	**1.8**	**1.2**	**2.9**	**2.3**	**2.2**
Ireland	1.4	1.0	0.9	1.2	1.3
UK	1.1	0.9	0.6	1.1	1.1
***Liberal*(1)**	**1.1**	**0.9**	**0.6**	**1.1**	**1.1**
US	1.3	1.0	0.2	0.7	0.7

(1) Weighted averages
Source: OECD.

- Germany has chosen a classical strategy of wage restraints to restore company profits and competitiveness while France remained committed to a Keynesian active fiscal policy, low exchange rate and low interest rates which it is in fact not able to undertake.
- Germany has experienced a long period of low growth, which is just over. Its strategy was painful for the other euro zone MS in terms of demand and competitiveness.
- France has experienced a higher growth, but its external and public deficit remains.
- France failed to find allies in Europe for another policy, so it must now accept an austerity fiscal policy with the hope to compensate it by a strategy aiming to change the labour laws and to increase work incentives. But can such a strategy work if growth remains slow?
- The two countries have similar social systems and similar problems but different political configurations. They suffers from the absence of fiscal harmonisation, from the absence of industrial policy, from the excess of financial liberalisation. Can they agree to drive a common economic strategy in Europe? This seems unlikely today.

Franco-German Conference

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Roundtable

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France and Germany were confronted to three issues

- The European economic framework was not satisfying.
- The non-cooperative strategies are harmful especially for larger economies albeit allowing smaller economies to take advantage of it.
- There is a crisis of continental countries, not prepared to address globalisation, having chosen neither a liberal strategy nor a Scandinavian one.

Weaknesses in the economic policy framework

- Euro area economic policy framework based on three pillars: a single monetary policy, targeting price stability; domestic fiscal policies under the surveillance of European procedures, requesting medium-term budgetary positions in balance, allowing only economic stabilizers to play and no discretionary policy; a strategy of structural reforms assumed to raise medium-term growth.
- No common strategy at the area level to support output in the short term. Divergences between countries are not taken into account, since there are no criteria in terms of domestic inflation or external deficits; public finance targets are not set according to national economic situations.
- No consensus in the EU on the strategy to follow at the macroeconomic level: some countries would favour a growth strategy supported by demand, while the Commission and some other countries recommend a growth-strategy based on supply reforms.

Weaknesses in the economic policy framework

- No authority in Europe aims at supporting growth, which would be needed to allow continental countries to leave mass unemployment.
- Monetary policy aims at maintaining the inflation rate below 2%; this leads interest rates to be increased too early in the cycle, as soon as growth rebounds, like we could see in 2006-2007. It let Euro exchange rate appreciate, which destroy European competitiveness.
- Similarly, European authorities request the implementation of restrictive fiscal policies as soon as some growth is back.
- Criteria lacking economic rationale (2% inflation, 3% of GDP limit for deficits, objective of budgetary position in balance) have the preference compared to growth or employment.
- This is all the more detrimental that demand tends to be relatively weak in the Euro area: households wish to save taking into account uncertainties on the future level of pensions, companies hesitate to invest taking into account the growth weakness and being tempted to produce in emerging countries, due to low costs and rapidly developing markets.

Non-cooperative national policies

- Fiscal policy is relatively effective in large countries and conversely restrictive fiscal policy is particularly costly. Large countries may also use their political weight to oppose Commission's requests reducing their domestic fiscal autonomy. Fiscal policy is less powerful in smaller countries. These countries also have less political weight.
- Smaller countries can be tempted to improve their competitiveness through wage moderation or tax competition, because the resulting negative impact on domestic demand will be more than offset by gains from external demand. For large countries, such strategies are more painful. Moreover, smaller countries have more often practices of centralized wages negotiations between social partners. Thus, they can more easily implement wage restriction strategies.
- The result is a non-optimal outcome, with too restrictive fiscal policies and too restrictive wages policies, especially in the small countries There is too much competition and not enough cooperation in the area. This coordination default is harmful for the area as a whole, but the larger countries are in a more unfavourable situation than the smaller.

Non-cooperative national policies

- The bigger euro area economies initially opposed the non-cooperative strategies, but they were victims and obliged to follow like Germany since 2001, which depresses demand in the euro area and increases the search for competitiveness gains or like many countries who decreases their tax rates on firms.
- Large countries (Germany, France, Italy) account for 65% of the euro area population (71% with Greece and Portugal). They could thus try to impose a more satisfying strategy. However, they have never firmly taken a common position. For instance, in the SGP reform debate in 2005, they have not imposed that capital expenditures should be deducted from public deficits in the assessment of the 3% of GDP threshold. Is this a sacrifice in favour of European construction? Or is this a strategic choice of their dominant classes and technocratic authorities in order to implement at home unpopular structural reforms in the name of Europe?

The crisis of the European Social Model

- Tensions are exacerbated by the difficulties for the European Social Model in the current phase of globalisation.
- Continental Europe countries had certain specificities in terms of the role of the state in the economy, industrial policies, relationship between firms, banks and the State, size of financial markets. They implicitly agreed to give up these specificities in the context of financial globalisation and European construction, but the coherence of the new regime of growth has not been settled.
- Globalisation puts continental Europe workers more or less directly in competition with those of the NMS and Asia. What strategy does Europe wish to follow in face of industrial employment losses?

The crisis of the European Social Model

- Can Europe choose a two-hands strategy: in one hand subsidizing higher education, R&D to make developing an innovative and highly performing sector; in the other, subsidizing a less-productive sector of service for the persons? Is it possible without a dramatic rise in inequalities, which also means reducing the social protection system? Does Europe wish the winners of globalisation to compensate for the losses for the losers (but, this requires that the winners agree or are constrained to pay, more national solidarity or more tax harmonization, two strategies which Europe does currently oppose)?
- Could the Scandinavian strategy, combining efforts on innovation and on re-qualification and social support of the unemployed, be applied in open, heterogeneous and large countries?
- Without long run coherent strategy, the Continental countries were the losers of the European construction, when Scandinavian and liberal countries performed better.

A liberal strategy

- For many economists, like for the Commission, increasing flexibility on all markets will increase groth and reduce disparities in Europe. The EU has been is unable to organize a satisfactory coordination of economic policies. Instead of making suggestions on how to improve the framework, the mainstream view in Europe refers to a Walrasian myth: if each economy was fully flexible (prices, wages, workers), there would be no need for economic policy, so no coordination problem. But the US example shows that it is an illusion: even a flexible country needs an economic policy.
- More flexible labour markets are not the *panacea*. Contrary to today's mainstream opinion, wage flexibility is not the solution to any demand shock as it may increase the lack of demand and the uncertainty (but Keynes already said this).

A market oriented view

- The market oriented view condemns the European social model to move towards the liberal one. It refuses any tax harmonization, which will oblige each country to strongly reduce the field of redistribution. If a firm can make profits in Germany but pay (reduced) taxes in Switzerland, who will pay for the public equipment and infrastructure in Germany?
- The European dominant classes did not try to protect the Social European Model but took the opportunity of globalisation and of the single market to impose structural reforms, in particular public and welfare expenditures cuts and labour market flexibility. Supporting output by an active macroeconomic policy is unproductive: people should understand that they have only the choice between accepting a liberal functioning of the economy or seeing capitals flows leaving towards more capital-friendly skies. It is the TINA (There Is No Alternative) strategy.

More Europe?

- Economic policy could not be decided at the area level. Europe is not a nation: there is no unification of the political and social lives. Taxation and social protection systems are not unified. Economic situations remain different. No consensus on economic policies, institutions, reforms, strategy exists among the area; divergence can only be decided by a democratic election. But European peoples would probably not agree with a economic, political and social unification decided at the European level. It is difficult to imagine a single organization able to manage different national situations.
- Europe governance will need national policies coordination. The euro area seems more appropriate for such co-operation than the EU-25 because it includes more homogenous economies. But this supposes that countries agree to share a common "European social model", that will need to be defined, protected, and be able to evolve.

More Europe?

- However, the policy to be followed and the governance remain a delicate issue. **Economic policy should combine Keynes, Colbert and social democracy.**
- In a mass-unemployment situation, the euro zone needs a growth-oriented policy mix. It would be desirable to set up a real economic policy coordination in the framework of the Eurogroup, with whom the ECB would have to dialogue. This co-ordination should not focus on public finance balances, but should aim at supporting economic activity and achieving a 3% annual growth target, as in the Lisbon strategy. The process will have to take into account countries disparities. The task is not so easy.

More Europe?

- Europe must try to design a specific model of European firms, caring about employment, growth in the area where they are located and by durable growth. Companies have a social role to play. They must take account of the interests of their employees and customers, not only of that their shareholders. This supposes that Member States maintain relatively high company taxation, and subsidize firms locating their activities in lagging areas and to help the economic sectors in difficulty, as to provide them incentives to innovation and research. States should have an active industrial policy, aiming both at developing Large European Companies and at supporting the development of innovating SME and Research Centers networks. European authorities should plan the future of productive activities and industrial employment in Europe; reduce the weight of competition policy and promote a European industrial policy within the framework of the Lisbon strategy.

More Europe?

- The objective would be to maintain the European social model, characterized by a significant level of transfers, public expenditure and thus of taxation. The system will have to be preserved from tax and social competition by harmonisation in Europe that will have to include the prohibition of unfair competition but also the introduction of minima rates for taxation (corporate taxation, tax on wealth and on higher incomes) and for benefit (minimum income, minimum pension replacement ratio) and by strong measures against tax havens at a worldwide scale.
- The European Social Model will have to rely on its comparative advantages (free education and health for all, public infrastructures, social security benefits) to remain competitive in spite of globalisation. With a more dynamic growth, the decrease of unemployment rate would allow to extent in Continental countries a “flex-security system” inspired by the Scandinavian model, which should included a more precise follow-up of the unemployed.

More Europe?

- Improving the European economic framework is not a technical issue; it requires a major change in the economic policy thinking, a new alliance between social classes concerned about full employment and social cohesion, the willingness to depart from the financial markets and globalised firms point of view. This move would be easier to undertake at the European than at a National level, but it would require an agreement between people of each EMU Member State, which would be difficult to reach.