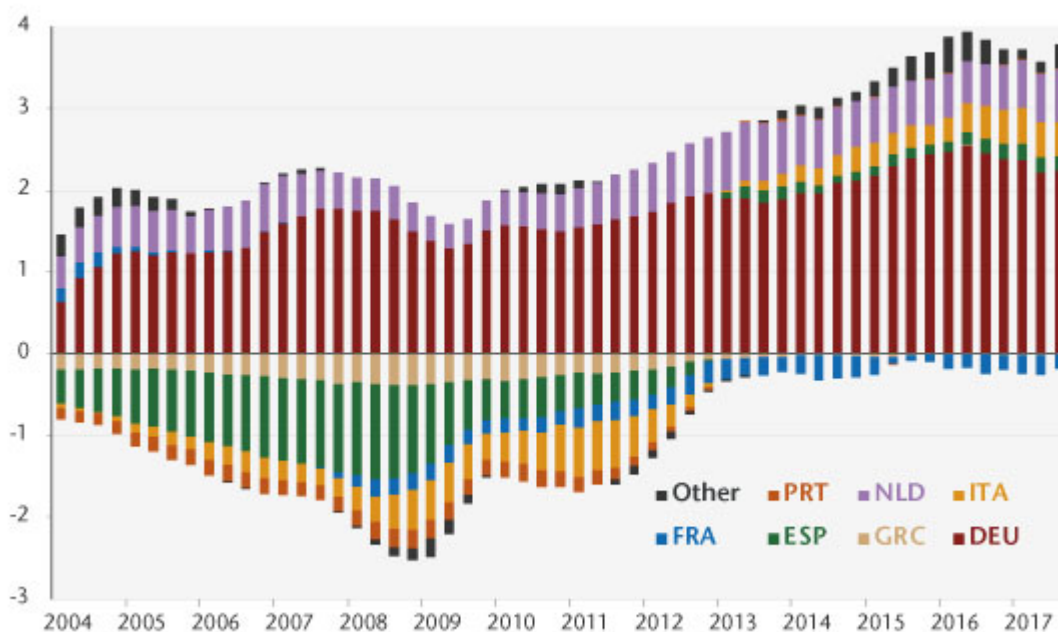


# Major adjustments are awaiting the euro zone

By [Bruno Ducoudré](#), [Xavier Timbeau](#) and [Sébastien Villemot](#)

Current account imbalances are at the heart of the process that led to the crisis in the euro zone starting in 2009. The initial years of the euro, up to the crisis of 2007-2008, were a period that saw widening imbalances between the countries of the so-called North (or the core) and those of the South (or the periphery) of Europe, as can be seen in Figure 1.

Figure 1. Current account balances (moving average over four quarters) in % of GDP of the euro zone



Source: Eurostat.

The trend towards diverging current account balances slowed sharply after 2009, and external deficits disappeared in almost all the euro zone countries. Despite this, there is still a significant gap between the northern and southern countries, so there cannot yet be any talk about reconvergence. Moreover, the fact that the deficits have fallen (Italian and Spanish) but not the surpluses (German and Dutch) has radically changed the ratio of the euro zone to the rest of the world: while the

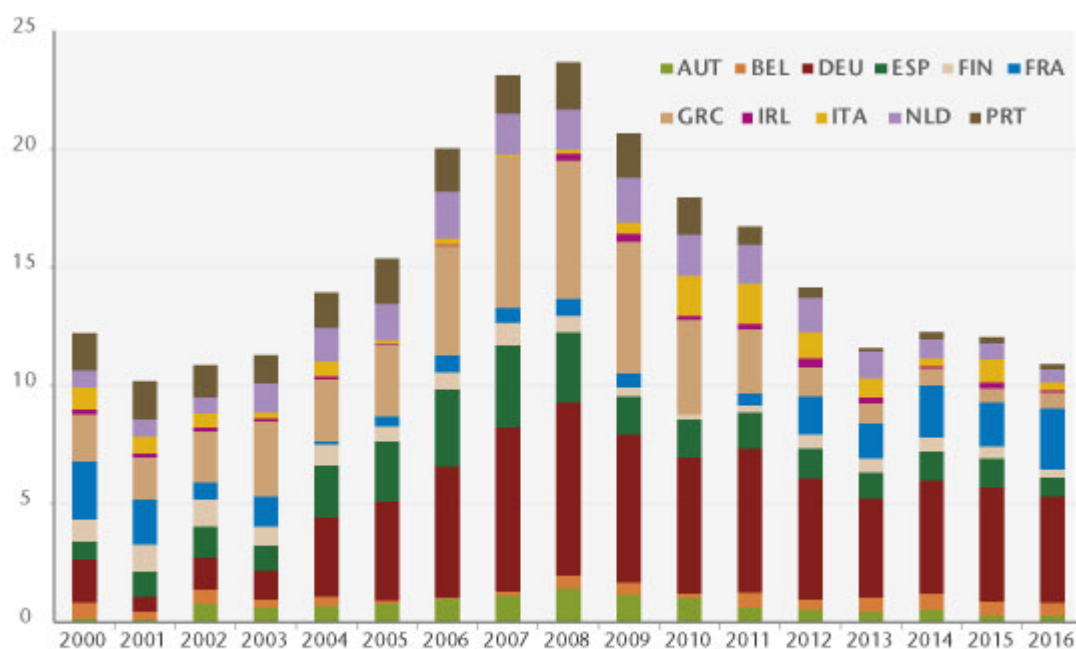
zone's current account was close to balanced between 2001 and 2008, a significant surplus has formed since 2010, reaching 3.3% of GDP in 2016. In other words, the imbalance that was internal to the euro zone has shifted into an external imbalance between the euro zone and the rest of the world, in particular the United States and the United Kingdom. This imbalance is feeding Donald Trump's protectionism and putting pressure on exchange rates. While the nominal exchange rate internal to the euro zone is not an adjustment variable, the exchange rate between the euro and the dollar can adjust.

It seems unlikely that the euro zone can maintain a surplus like this over the long run. Admittedly, the pressures for the appreciation of the euro are now being contained by the [particularly accommodative monetary policy of the European Central Bank](#) (ECB), but when the time comes for the normalization of monetary policies, it is likely that the euro will appreciate significantly. In addition to having a deflationary impact, this could rekindle the crisis in the zone by once again deepening the Southern countries' external deficits due to their loss in competitiveness. This will in turn give new grounds for leaving the euro zone.

[In a recent study \[1\]](#), we seek to quantify the adjustments that remain to be made in order to resolve these various current account imbalances, both within the euro zone and vis-à-vis the rest of the world. To do this, we estimate equilibrium real exchange rates at two levels. First, from the point of view of the euro zone as a whole, with the idea that the adjustment of the real exchange rate will pass through an adjustment of the nominal exchange rate, notably the euro vis-à-vis the dollar: we estimate the long-term target of euro / dollar parity at USD 1.35 per euro. Next, we calculate equilibrium real exchange rates within the euro zone, because while the nominal exchange rate between the member countries does not change because of the monetary union, relative price levels allow adjustments in the real exchange rate. Our

estimates indicate that substantial misalignments remain (see Figure 2), with the average (in absolute terms) misalignment relative to the level of the euro being 11% in 2016. The relative nominal differential between Germany and France comes to 25%.

Figure 2. Indicator of nominal intra-euro zone adjustments with countries' contributions



Note: Figure 2 relates the average (weighted by GDP) of the absolute value of the nominal adjustments. The contribution of each country to this average is shown. The nominal disadjustments correspond to the changes in price of the added value that must be made simultaneously so that all the countries hit their current account target. This figure can be interpreted as a summary measure of the level of the internal disadjustments of the euro zone, with the contribution of each country.  
Source: OFCE calculations.

In the current situation, claims by some euro zone countries are not accumulating on others in the zone, but there is accumulation by some euro zone countries on other countries around the world. This time the exchange rate (actual, weighted by accumulated gross assets) can serve as an adjustment variable. The appreciation of the euro would therefore reduce the euro zone's current account surplus and depreciate the value of assets, which are probably accumulated in foreign currency. France however now appears as the last country in the euro zone running a significant deficit. Relative to the zone's other countries, it is France that is contributing most (negatively) to the imbalances with Germany (positively). If the euro appreciates, it is likely that France's situation

would further deteriorate and that we would see a situation where the net internal position accumulates, but this time between France (on the debtor side) and Germany (creditor). This would not be comparable to the situation prior to 2012, since France is a bigger country than Greece or Portugal, and therefore the question of sustainability would be posed in very different terms. On the other hand, reabsorbing this imbalance by an adjustment of prices would require an order of magnitude such that, given the relative price differentials that would likely be needed between France and Germany, it would take several decades to achieve. It is also striking that, all things considered, since 2012, when France undertook a costly reduction in wages through the CICE tax credit and the Responsibility Pact, and Germany introduced a minimum wage and has been experiencing more wage growth in a labour market that is close to full employment, the relative imbalance between France and Germany, expressed in the adjustment of relative prices, has not budged.

Three consequences can be drawn from this analysis:

1. The disequilibrium that has set in today will be difficult to reverse, and any move to speed this up is welcome. Ongoing moderation in rises in nominal wages in France, stimulating the growth of nominal wages in Germany, restoring the share of German added value going to wages, and continuing to boost the minimum wage are all paths that have been mentioned in the various iAGS reports. A reverse social VAT, or at least a reduction in VAT in Germany, would also be a way to reduce Germany's national savings and, together with an increase in German social security contributions, would boost the competitiveness of other countries in the euro zone;
2. The pre-crisis internal imbalance has become an external imbalance in the euro zone, which is leading to pressure for a real appreciation of the euro. The order of

magnitude is significant: it will weigh on the competitiveness of the different countries in the euro zone and will lead to the problems familiar prior to 2012 resurfacing in a different form;

3. The appreciation of the euro caused by the current account surpluses in certain euro zone countries is generating an externality for the euro zone countries. Because their current accounts respond differently to a change in relative prices, Italy and Spain will see their current account balance react the most, while Germany's will react the least. In other words, the appreciation of the euro, relatively, will hit the current accounts of Italy and Spain harder than Germany's and will lead to a situation of internal imbalance much like what existed prior to 2012. This externality together with the reduced sensitivity of Germany's current account to relative prices argues for a reduction in imbalances by boosting Germany's internal demand, i.e. by a reduction in its national savings. The tools to do this could include boosting public investment, lowering direct personal taxes, or raising the minimum wage more quickly relative to productivity and inflation.

[\[1\]](#) Sébastien Villemot, Bruno Ducoudré, Xavier Timbeau: "Taux de change d'équilibre et ampleur des désajustements internes à la zone euro" [Equilibrium exchange rate and scale of internal misalignments in the euro zone], *Revue de l'OFCE*, 156 (2018).

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## Shut down: America in the

# spotlight

By Christine Rifflart

A State that asks a third of its civil servants to stay home because it can't pay them is in a critical situation. When it's the United States, it's the whole world that worries.

The absence of an agreement on the 2014 budget, which was to take lawful effect as of Tuesday, 1 October 2013, shows the standoff in Congress between Democrats and Republicans. This kind of contention over the budget is not new: no budget has been passed since 2011, and the federal government has worked up to now through "continuing resolutions" that are used to release the funds needed for the government to function and operate, on a provisional basis. Today's blockage is on a different scale, and parts of the administration have had to close their doors due to lack of funds. This exceptional situation is not unprecedented: 17 shutdowns have occurred since 1976, the last two under the Clinton administration, lasting, respectively, one week (from 13 to 18 November 1995) and three weeks (from 15 December 1995 to 6 January 1996).

According to the Office of Management and Budget, of a total of 2.1 million federal government employees, more than 800,000 have been prohibited from working, while others have come to work with no guarantee that they will be paid. For example, those being told not to work include 97% of NASA employees, 93% of the Environmental Protection Agency, 87% of the Department of Commerce, 90% of the IRS, etc. Each of these received [a letter from the President](#) expressing his bitterness. In practice, this also means that some social services are no longer assured, some government call centres are closed, and the national monuments and 368 national parks are no longer open to the public. Applications for subsidized loans, housing grants, and loan guarantees are no longer being taken, and some government services are closed:



U.S. Department of Commerce

# Bureau of Economic Analysis

Due to the lapse in government funding,  
[www.bea.gov](http://www.bea.gov) will be unavailable until further  
notice. This includes access to all data and the e-  
File system.

We sincerely regret this inconvenience.

Additional information can be found at [link to PDF](#).

Updates regarding government operating status and resumption of normal operations  
can be found at [www.usa.gov](http://www.usa.gov).

Vital services and programs for which funding is not linked to the vote on the annual budget (so-called mandatory spending), which account for over 60% of pre-interest expenditure and represent 12.7% of GDP, have nevertheless been spared. Some social security programs (Medicare, Medicaid), the postal service, national security, and military operations have thus been protected from shutdown, at least in so far as they are not affected by restrictions on staff whose salaries are covered in the 2014 budget.

Another political and fiscal crisis is looming: the US government could go into default from October 17 if the authorized debt ceiling is not raised. The uncertainty surrounding this situation is fraying nerves on the financial markets, and the frozen political climate in Congress does not seem to herald an honourable end to what the media are calling a “game of chicken” [\[1\]](#). In 1995, however, Clinton emerged victorious from this crisis with the Republicans, and was re-

elected in 1996, despite the Republican majority in Congress.

The economy could be seriously affected while awaiting an end to this crisis. If the salaries and benefits of federal civil servants are not paid, the loss in earnings would come to an average of 1500 dollars per week for each family affected. Given the total of 2.1 million federal employees, this would represent 0.08% of quarterly GDP. In three weeks, this would amount to a loss of 0.25% of GDP for the economy in the 4<sup>th</sup> quarter. Congress could, however, approve retroactive payment of the salaries, which is what generally took place during previous shutdowns.

But this still does not take account of the more important issue of the disorganization of the economy. Considering that on an annual basis half of the federal government's discretionary spending (*i.e.* 37% of federal spending, or 7.6% of GDP) [\[2\]](#) is affected by the shutdown, since it is financed out of the 2014 budget, this loss in expenditure represents 0.15 GDP point per week. Given the disorganization represented by the government closures (and using a fiscal multiplier of 1.5), the impact on growth could then come to at least 0.22 GDP point per week. If the crisis lasts 3 weeks, then the impact on 4<sup>th</sup> quarter GDP would be at least 0.7 GDP point – which would mean a recession for the US economy by the end of the year!

Other estimates do exist. The Office of Management and Budget evaluated the [cost of the 1995 shutdowns](#) (from 13 to 18 November 1995 and then from 15 December to 6 January 1996) at 1.4 billion in 1995 dollars (*i.e.* 0.5 % of quarterly GDP). Based on the 1995 shutdowns, [Goldman Sachs](#) evaluates the current weekly cost to the US economy at 8 billion dollars, equivalent to an impact of 0.2% of 4<sup>th</sup> quarter GDP. Moody's Analytic Inc. estimates that the shutdown will have an impact of 0.35% of quarterly GDP per week.



If the budget crisis lasts only a few days, its repercussions on the French economy will be minimal, *i.e.* a reduction in US growth of 1 percentage point would cut French growth by 0.17%. But if the crisis lasts several weeks and overlaps with a crisis over the ceiling on the government debt, which is quickly approaching, then the consequences could be very different. The two crises (the blocked budget and the failure to pay the public debt) would combine and fuel one another, as is emphasized by this [New York Times post](#). It is difficult to imagine the panic this could cause on the financial markets, as interest rates soar and the dollar collapses. This would be a very different story indeed...

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[1] In game theory, a game of chicken is a game of influence between two players in which neither must yield. When for example two cars are racing towards a head-on collision, the “chicken” is the driver who veers off course in order to avoid dying.

[2] A major part of spending by the Department of Defence is approved on a multiyear basis and is not subject to being blocked due to the shutdown. Over half of DoD spending is composed of this discretionary expenditure. Furthermore, mandatory outlays are not financed out of credits subject to the vote on the Budget.

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**Competitiveness** **and**

# industrial demand: The difficulties facing the French-German couple

[Jean-Luc Gaffard](#)

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

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

It would, nevertheless, be a mistake to ignore that this development is also the product of an adverse change in price competitiveness. This reflects labour market reforms in Germany, which lowered the relative cost of labour, as well as strategies that are based on the segmentation of production and the outsourcing of intermediate segments, which have also

contributed to lowering production costs.

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

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

There are two requirements for restoring the competitiveness of French companies and thereby encouraging the country's re-industrialization. The first is to allow immediate control of labour costs and the restoration of profit margins; this could

be helped in particular by tax measures that would adjust the financing of a portion of social protection. The second requirement is to promote the reorganization of industry through the creation of a network of stable relationships between all those involved in the industrial process, especially by the use of aid that is conditioned on cooperation between large and small firms in "competitiveness clusters".

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