The euro zone: A general recovery

By Christophe Blot

This text is based on the 2017-2019 outlook for the global economy and the euro zone, a full version of which is available here.

The euro zone has returned to growth since mid-2013, after having experienced two crises (the financial crisis and the sovereign debt crisis) that led to two recessions: in 2008-2009 and 2011-2013. According to Eurostat, growth accelerated during the third quarter of 2017 and reached 2.6% year-on-year (0.6% quarter-on-quarter), its highest level since the first quarter of 2011 (2.9%). Beyond the performance of the euro zone as a whole, the current situation is marked by the generalization of the recovery to all the euro zone countries, which was not the case in the previous phase of recovery in 2010-2011. Fears about the sustainability of the debt of the so-called peripheral countries were already being reflected in a sharp fall in GDP in Greece and the gradual slide into recession of Portugal, Spain and a little later Italy.

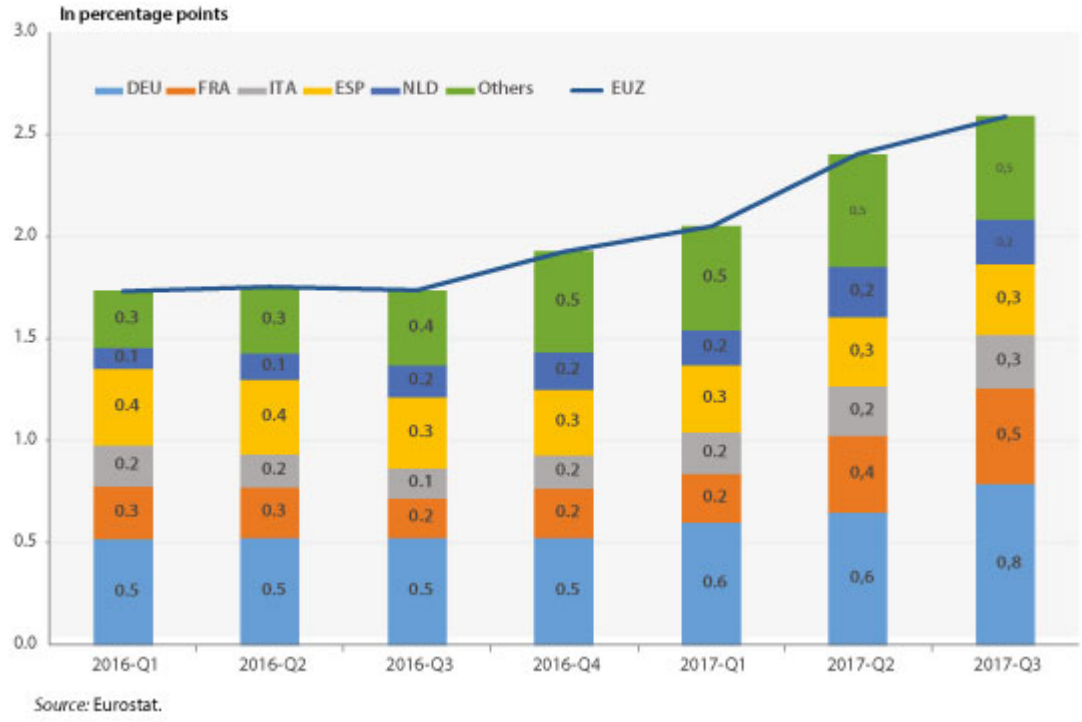
Today, while Germany remains the main engine of European growth, all of the countries are contributing to the accelerating recovery. In the third quarter of 2017, Germany's contribution to euro zone growth was 0.8 point, a faster pace than in the previous two quarters, reflecting the vitality of the German economy (see the Figure). However, this contribution was even greater in the first quarter of 2011 (1.5 points for growth of 2.9% year-on-year). This catching-up trend is continuing in Spain, which in the third quarter of 2017 had quarterly growth of 3.1% year-on-year (0.8% quarter-on-quarter), making a 0.3 point contribution to the euro

zone’s overall growth. Above all, activity is accelerating in the countries that up to now had been left a little bit out of the recovery, particularly in France and Italy, which contributed respectively 0.5 and 0.3 points to the growth of the zone over the third quarter[1]. Finally, the recovery is taking root in Portugal and Greece.

This renewed dynamism of the European economy is due to several factors. Monetary policy is still very expansionary, and the securities purchases being carried out by the Eurosystem help to keep interest rates low. Credit conditions are favourable for investment, and the access to credit for SMEs is being loosened up, especially in the countries that were hit hardest by the crisis. Finally, fiscal policy is generally neutral or even slightly expansionary.

The current optimism must not nevertheless hide the scars left by the crisis. The euro zone unemployment rate is still higher than its pre-crisis level: 9% against 7.3% at the end of 2007. The level still exceeds 10% of the active population in Italy, 15% in Spain and 20% in Greece. The social consequences of the crisis are therefore still very visible. These conditions justify the need to continue to support growth, particularly in these countries.

Figure. The contributions to growth in the euro zone



Source: Eurostat.

The European economy in 2017 – or, the post-Brexit EU

By Jérôme Creel

The just released *L'économie européenne 2017* provides a broad overview of the issues being posed today by the European Union project. Brexit, migration, imbalances, inequality, economic rules that are at once rigid and flexible… the EU remains an enigma. Today it gives the impression of having lost the thread of its own history or to even to be going against History, such as the recent international financial crisis or in earlier times the Great Depression.

A few months after the bankruptcy of Lehman Brothers, the G-20 Summit of the heads of State and Government held in London in

April 2009 drew up a list of recommendations to revive the global economy. These included implementing active fiscal and monetary policies, supporting the banks and improving banking regulation, rejecting the temptation of protectionism, fighting against inequality and poverty, and promoting sustainable development.

These recommendations were in contrast to the policies implemented shortly after the Great Depression back in the 1930s. At that time, economic policies started with restrictive measures, thereby fueling the crisis and rising inequality. Protectionism in that epoch became not just a temptation but a reality: tariff and non-tariff barriers were erected in an effort to protect local business from international competition. We know what happened later: the rise of populism and extremism that plunged Europe, and then the world, into a terrible war. The economic lessons learned from the catastrophic management of the 1930s crisis thus contributed to the recommendations of the London G-20 Summit.

What now remains of these lessons in Europe? Little, ultimately, other than a resolutely expansionary monetary policy and the establishment of a banking union. The first is meant to alleviate the current crisis, while the second is intended to prevent a banking crisis in Europe. While this is of course not nothing, it is based on a single institution, the European Central Bank, and is far from sufficient to answer all the difficulties hitting Europe.

Brexit is one of these: as the first case of European disintegration, the departure of the United Kingdom poses the issue of the terms of its future partnership with the European Union (EU) and re-raises the question of protectionism between European states. The temptation to turn inwards is also evident in the way that the refugee crisis has been managed, which calls for the values of solidarity that have long characterized the EU. Differences between EU Member States in terms of inequality, competitiveness and the functioning of

labour markets require differentiated and coordinated policies between the Member States rather than the all-too homogeneous policies adopted up to now, which fail to take an overall view.

This is particularly true of the policies aimed at reducing trade imbalances and those aimed at cutting public debts. By applying fiscal rules to manage the managing public finances, even if these are not perfectly respected, and by imposing quantitative criteria to deal with economic and social imbalances, we lose sight of the interdependencies between the Member States: fiscal austerity is also affecting our partners, as is the search for better price competitiveness. Is this useful and reasonable in a European Union that is soon to be the EU-27, which is seeing rising inequalities and struggling to find a way to promote long-term growth?

L'économie européenne 2017 takes stock of the European Union in a period of severe tensions and great uncertainty, following a year of average growth and before the process of separation between the EU and the UK really begins. During this period, several key elections in Europe will also serve as stress tests for the EU: less, more or better Europe – it will be necessary to choose.

The ECB is extending its QE programme but mixes up its

communications

By Paul Hubert

On Thursday, March 10, after the meeting of its Governing Council, the European Central Bank (ECB) announced a series of additional measures for the quantitative easing of monetary policy. The aim is to prevent the onset of deflation and to boost growth in the euro zone. The key innovation lies in the measure for bank financing at negative rates. While the measures were well received by the markets at the time of the announcement, a lapse in Mario Draghi's communications during the press conference following the Board of Governors meeting greatly undercut some of the impact expected from the decisions taken.

What decisions were taken?

– The three key rates set by the ECB were lowered. The main refinancing rate went down from 0.05% to 0%, while the marginal lending rate was cut from 0.30% to 0.25%. Finally, the deposit facility rate, which compensates the excess reserves that banks hold on the ECB's balance sheets, is down from -0.30% to -0.40%. It thus now costs a bank more to have cash on the ECB's balance sheet.

– Quantitative easing (QE) has been extended in terms of its scale – securities purchases rose from €60 bn to €80 bn per month – but especially in terms of the types of securities eligible for purchase. While heretofore the ECB has bought government bonds (sovereign and/or local authority bonds), it will now buy high-quality corporate bonds, based on rating agency criteria. This measure is a direct response to the drying up of the supply of government securities and is expected to directly influence the conditions for corporations active on the bond markets.

– The most significant innovation concerns the new Targeted

Longer-Term Refinancing Operations (TLTRO), which are intended to reboot the channels of bank lending and to provide financing to banks *on the condition that* they finance the real economy. These loans to banks will be at a zero or even negative rate, based on various criteria, including the amount of loans that the banks provide to households and businesses. In other words, the ECB will pay banks meeting these criteria, so that they in turn lend.

What is the expected impact?

The effect to be expected from these measures depends on the situation of the credit market. Numerous studies show that in normal times these measures have a positive effect on the economy. However, this holds true only if it is the *supply* of credit that is currently constricted in the euro zone. Conversely, if the problem lies in the demand for credit on the part of consumers and businesses who have poor prospects in terms of income and profits, then these measures will have little effect. In granting banks such favourable conditions, it is easy to imagine that the ECB is betting on increasing the solvent demand for credit, that is to say, that the ECB is providing banks with strong incentives to lend to households and individuals that might have appeared non-creditworthy in previous conditions. Another expected effect of the lower deposit facility rates and the increase in QE will pass through the channel of a lower exchange rate for the euro, which will promote euro zone exports and increase imported inflation, and therefore overall inflation in the euro zone. This channel is potentially even more important given that the US Federal Reserve has initiated a period of monetary tightening.

Nevertheless, a more relevant economic policy would be to make use of fiscal policy to support demand, especially as the conditions for State financing are at historically low levels: the French state in 2016 is earning money from issuing debt of less than 4 years. Monetary policy would then have all the

more effect.

Why announce that there's no manoeuvring room left?

At the press conference following the meeting of the Governing Council, Mario Draghi announced that the ECB didn't expect "to reduce rates further", which had the effect of completely changing the financial markets' interpretation of the decisions announced just before that. While the aim of these very expansionary decisions is to further ease monetary and financial conditions and to lower the exchange rate for the euro, the announcement that future changes in the ECB's monetary policy could only be in a more restrictive direction transformed investor expectations.

As one of the main channels for the transmission of monetary policy involves expectations, several studies conducted on data from the US [1], Britain [2] and the euro zone [3] show that a central bank's communications need to be consistent with its decisions, otherwise the impact expected from monetary policy will be limited. This is called the "signal effect" of monetary policy. Mario Draghi's short statement is one such example. The following graph shows the exchange rate of the euro vis-à-vis the dollar during the course of 10 March. The sharp drop at mid-day corresponds to the publication of the decisions taken by the Board of Governors, while the equally sharp rise corresponds to the contradictory message issued a few minutes later at the press conference. We thus see that as a series of highly expansionary measures – one of whose goals is to push down the euro – was announced, the euro eventually rose vis-à-vis the US dollar as if restricting measures had been put in place.

This does not necessarily mean that these decisions will have no effect, but that some of the effect will be lessened, or even disappear. Some transmission channels other than the signal effect remain operative. While the exchange rate channel has now been limited by the restrictive effect

generated by the channel of expectations, we will see in the weeks and months to come whether capital movements induced by the decisions taken will have the effect expected on the euro exchange rate.

Figure. Euro-dollar exchange rate, day of 10 March 2016.

Source: Boursorama.

[1] Hubert, Paul (2015), "The Influence and Policy Signalling Role of FOMC Forecasts", *Oxford Bulletin of Economics and Statistics*, 77(5), 655-680.

[2] Hubert, Paul, and Becky Maule (2016), "Policy and Macro Signals as Inputs to Inflation Expectation Formation", *Bank of England Staff Working Paper*, No. 581.

[3] Hubert, Paul (2015), "ECB Projections as a Tool for Understanding Policy Decisions", *Journal of Forecasting*, 34(7), 574-587, or Hubert, Paul (2016), "Disentangling Qualitative and Quantitative Central Bank Influence", *OFCE Working Paper*, No. 2014-23.

Do QE programmes create bubbles?

By Christophe Blot, Paul Hubert and Fabien Labondance

Has the implementation of unconventional monetary policies since 2008 by the central banks created new bubbles that are now threatening financial stability and global growth? This is a question that comes up regularly (see here, here, here or here). As Roger Farmer shows, it is clear that there is a strong correlation between the purchase of securities by the Federal Reserve – the US central bank – and the stock market index (S&P 500) in the United States (Figure 1). While the argument may sound convincing at first glance, the facts still need to be discussed and clarified. First, it is useful to remember that correlation is not causation. Secondly, an increase in asset prices is precisely a transmission channel for conventional monetary policy and quantitative easing (QE). Finally, an increase in asset prices cannot be treated as a bubble: developments related to fundamentals need to be distinguished from purely speculative changes.

Higher asset prices is a factor in the transmission of monetary policy

If the ultimate goal of central banks is macroeconomic stability [1], the transmission of their decisions to the target variables (inflation and growth) takes place through various channels, some of which are explicitly based on changes in asset prices. Thus, the effects expected from QE are supposed to be transmitted in particular by so-called portfolio effects. By buying securities on the markets, the central bank encourages investors to reallocate their securities portfolio to other assets. The objective is to ease broader financing conditions for all economic agents, not just those whose securities are targeted by the QE programme. In

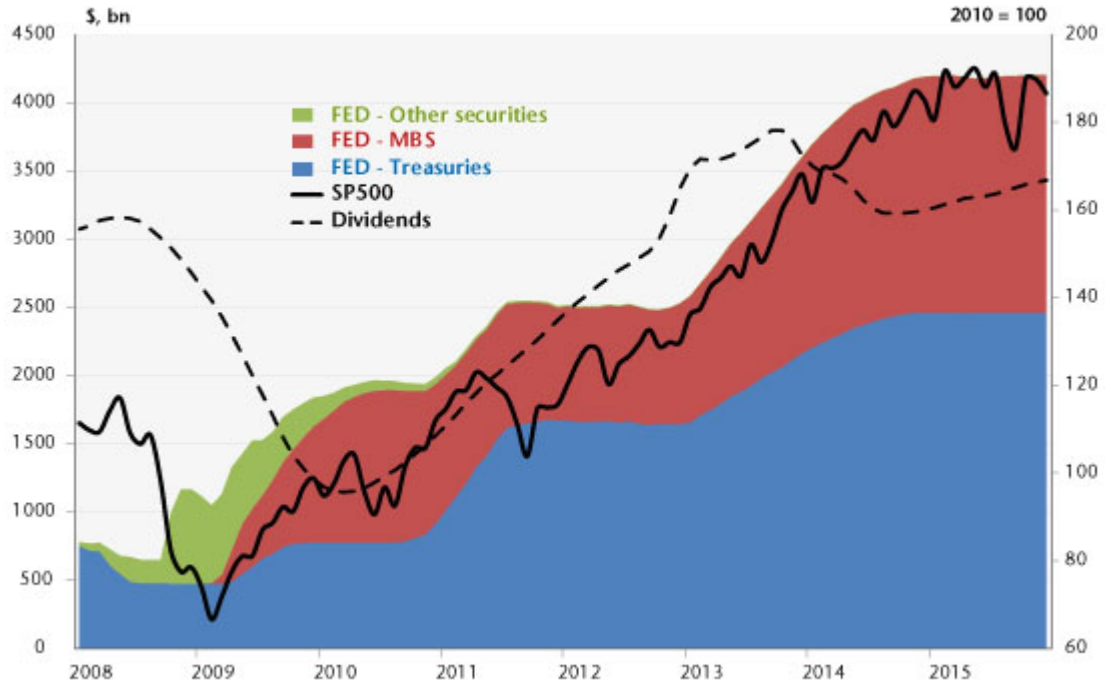
doing this, the central bank's actions push asset prices up. It is therefore not surprising to see a rise in equity prices in connection with QE in the US.

Every increase in asset prices is not a bubble

Furthermore, it is necessary to make sure that the correlation between asset purchases and their prices is not just a statistical artefact. The increase observed in prices may also reflect favourable fundamentals and be due to improved growth prospects in the United States. The standard model for determining the price of a financial asset identifies its price as equal to the present value of anticipated income flows (dividends). Although this model is based on numerous generally restrictive assumptions, it nevertheless identifies a first candidate, changes in dividends, to explain changes in stock prices in the United States since 2008.

Figure 1 shows a clear correlation between the series of dividends [2] paid and the S&P 500 index between April 2010 and October 2013. Part of the rise in equity prices can be explained simply by the increase in dividends: the usual determinant of stock market prices. Looking at this indicator, only the period starting at the beginning of 2014 could then indicate a disconnect between dividends and share prices, and thus possibly point to an over-adjustment.

Figure 1. Quantitative easing and stock market prices in the US



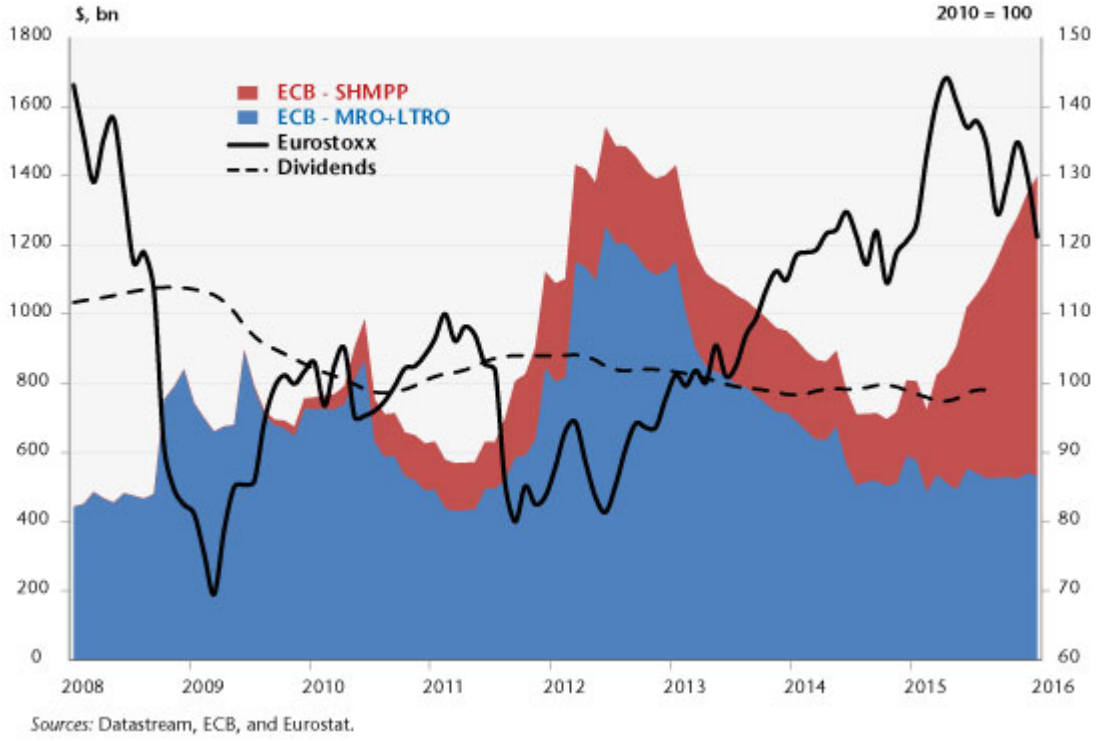
Sources: Datastream, Federal Reserve, and Bureau of Economic Analysis.

A correlation that isn't found in the euro zone

If the theory that unconventional monetary policies create bubbles is true, then it should also be observed in the euro zone. Yet performing the same graph as the one for the United States does not reveal a link between the liquidity provided by the European Central Bank (ECB) and the Eurostoxx index (Figure 2). The first phase in the increase in the size of the ECB's balance sheet, via its refinancing operations starting in September 2008, came at a time when stock markets were collapsing, following the bankruptcy of Lehman Brothers. Likewise, the very long-term refinancing operations carried out by the ECB at the end of 2011 do not seem to be correlated with the stock market index. The rise in share prices coincides in fact with Mario Draghi's statement in July 2012 that put a halt to concerns about a possible breakup of the euro zone. It is of course possible to argue that the central bank has played a role, but any link between liquidity and asset prices is simply not there. At the end of 2012, the banks paid back their loans to the ECB, which reduced the cash in circulation. Finally, the recent period is once again

illustrating the fragility of the argument that QE creates bubbles. It is precisely at a time when the ECB is undertaking a programme of large-scale purchases of securities, along the lines of the Federal Reserve, that we are seeing a fall in world stock indices, in particular the Eurostoxx.

Figure 2. Quantitative easing and the stock market index in the euro zone



Sources: Datastream, ECB, and Eurostat.

So does this mean that there is no QE-bubble link?

Not necessarily. But to answer this question, it is necessary first to identify precisely the portion of the increase that is due to fundamentals (dividends and companies' share prospects). A bubble is usually defined as the difference between the observed price and a so-called fundamental value. In a forthcoming working paper, we endeavour to identify periods of over- or undervaluation of a number of asset prices for both the euro zone and the United States. Our approach involves estimating different models of asset prices and thereby to extract a component that is unexplained by fundamentals, which is then called a "bubble". We then show that for the euro zone, the ECB's monetary policy broadly speaking (conventional and unconventional) does not seem to

have a significant effect on the “bubble” component (unexplained by fundamentals) of asset prices. The results are stronger for the United States, suggesting that QE might have a significant effect on the “bubble” component of some asset prices there.

This conclusion does not mean that the central banks and the regulators are impotent and ignorant in the face of this risk. Rather than trying to dissect every movement in asset prices, the central banks should focus their attention on financial vulnerabilities and on the ability of agents (financial and non-financial) to absorb sharp fluctuations in asset prices. The best prevention against financial crises thus consists of continuously monitoring the risks being taken by agents rather than trying to limit variations in asset prices.

[1] We prefer a broad definition of the end objective that takes into account the diversity of institutionalized formulations of the objectives of central banks. While the mandate of the ECB is primarily focused on price stability, the US Federal Reserve has a dual mandate.

[2] The series of dividends paid shows strong seasonality, so this has been smoothed by a moving average over 12 months.

The potential headache of measuring economies in public expenditure

By Raul Sampognaro

Since 2009, the French budget deficit has been cut by 3.3 GDP

points, from 7.2 percent of GDP in 2009 to 3.9 points in 2014, even though the economic situation has been weighing heavily on the public purse. This improvement was due to the implementation of a tighter budget policy. Between 2010 and 2013, most of the consolidation effort came from higher taxes, but since 2014 the effort has largely involved savings in public expenditure. In 2014, public expenditure excluding tax credits[1] recorded its weakest growth since 1959, the year when INSEE began to publish the national accounts: in value, spending excluding tax credits increased by 0.9%, though only 0.3% in volume terms (deflated by the GDP deflator).

At first glance it may seem counter-intuitive to talk about savings on spending even though the latter has been rising constantly. This rise is, however, well below potential growth, which reflects a real long-term effort to reduce the ratio of spending to GDP. Indeed, the formula usually used to calculate the effort on spending depends on the hypothesis adopted on potential growth:

To understand why the extent of the effort on public expenditure is dependent on potential growth, one must understand the underlying concept of the sustainability of the debt. There is a consensus on the theoretical definition of the sustainability of the public debt: it is sustainable if the current stock of debt could be repaid by the anticipated future stream of the State's net revenues[2]. While the concept is clear, its practical application is more difficult. In practice, fiscal policy is deemed sustainable when it makes it possible to stabilize the ratio of public debt to GDP at a level deemed consistent with maintaining refinancing by the market.

Thus, changes in spending that are in line with that goal should make it possible to stabilize the share of public expenditure to GDP over the long term. However, as public spending essentially responds to social needs that are

independent of the economic situation (apart from certain social benefits such as unemployment insurance), stabilizing its share in GDP at any given time (which would imply it changes in line with GDP) is neither assured nor desirable. In order to deal with this, changes in the value of public expenditure are compared to the nominal growth rate of potential GDP[3] (which depends on the potential growth rate and the annual change in the GDP deflator).

An increase in expenditure that is above (respectively below) the potential reflects a positive (negative) impulse, because in the long run it leads to an increase (decrease) in the ratio of public spending to GDP. While the application of this concept may seem easy, potential growth is unobservable and uncertain because it is highly dependent on the assumptions made about demographic variables and future changes in productivity. In the 2016 Budget Bill (PLF), the government revised its potential growth assumptions for the years 2016 and 2017 upwards (to 1.5% instead of 1.3% as adopted at the time of the vote on the LPFP supplementary budget bill in December 2014).

This revision was justified on the basis of taking into account the structural reforms underway, in particular during the vote on the Macron Act. This was the second revision of potential since April 2014 when it was estimated at 1.6% (2014-2017 Stability Programme). The government is not the only one to repeatedly revise its assessments of potential growth. When the European Commission published its latest projections[4], it revised its assessment of potential growth even though its previous assessment had been issued only in May[5]. It is not easy to see what new information could change its assessment now. These recurring revisions generally complicate the economic debate[6] and cloud discussion of the budget.

Hence using identical sets of hypotheses about the public

finances, a measurement of savings on spending, and thus of the structural adjustment, would depend on the potential growth adopted (Table). Assuming a value for the growth in public spending (excluding tax credits) of +1.3% in 2016 and in 2017, the scale of the effort on spending was evaluated at 0.7 GDP point in October 2015 (using the hypotheses in the 2016 PLF) but 0.6 point in December 2014 (2014-2019 LPFP).

Table 1. Evaluation of the effort on public expenditure based on different hypotheses for potential growth

In %

	Potential growth			Effort on spending		
	2015	2016	2017	2015	2016	2017
2016 PLF, October 2015	1,1	1,5	1,5	-0,6	-0,7	-0,5
2014-2019 LPFP, December 2014	1,1	1,3	1,3	-0,6	-0,6	-0,4
2015 PLF, October 2014	1,1	1,3	1,3	-0,6	-0,6	-0,4
2014-2017 Stability Programme, April 2014	1,5	1,6	1,6	-0,8	-0,7	-0,5
2014 PLF, September 2013	1,5	1,6	1,6	-0,8	-0,7	-0,5
2012-2017 LPFP, January 2013	1,5	1,6	1,6	-0,8	-0,7	-0,5
November 2015 forecast	1,0	1,1	1,2	-0,5	-0,4	-0,3
May 2015 forecast	1,0	1,1	—	-0,5	-0,4	—
Ageing Working Group*, May 2015	1,1	1,1	—	-0,6	-0,4	—
Ageing Working Group**, May 2015	1,6	1,6	1,6	-0,8	-0,7	-0,5

* simple average of the potential growth of 2013 and of 2020 published in *The 2015 Ageing Report*.
** average of the 2013-2060 potential growth published in *The 2015 Ageing Report*.
Sources : PLF, LPFP, European Commission forecasts, *The 2015 Ageing Report*.

While the differences identified above may seem small, they can have significant consequences on the implementation of fiscal rules, which can lead the various players to act on their assumptions in order to change the effort shown [7]. Even though this notion should guide the vision of the future trajectory of Europe's economies, the debate winds up being hijacked. Recurrent revisions in potential growth focus discussion on the more technical aspects, even though the method of estimating potential growth is uncertain by definition and there is not even a consensus among economists. Thus, the European Semester, which should set the framework for discussion and coordination between Member States in determining the economic policy that best suits the macroeconomic context, for France and for the euro zone as a whole, gets lost amidst technical discussions that are of no

particular interest.

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[1] Reimbursable tax credits – essentially the CICE and the CIR credits – are recognized in public expenditure on the basis of the 2010 national accounts. In order to remain closely in line with economic concepts, public spending will be analyzed excluding tax credits, which will be considered as a component of taxation.

[2] This definition is accepted both by the academic literature (see for example, D'Erasmo P., Mendoza E. and Zhang J., 2015, "What is a Sustainable Public Debt?", *NBER WP*, no 21574, September 2015, and by international organizations (see IMF, 2012, "Assessing Sustainability").

[3] It can also be compared to an underlying trend in public expenditure which itself takes into account the changing needs to which spending responds.

[4] The European Commission expects France to grow by 1.1% in 2015, 1.4% in 2016 and 1.7% in 2017.

[5] The evaluation has changed to the second decimal.

[6] For this debate, see H. Sterdyniak, 2015, "Faut-il encore utiliser le concept de croissance potentielle?" [Should the concept of potential growth still be used?], *Revue de l'OFCE*, no. 142, October 2015.

[7] The revisions of potential growth may have an impact on the implementation of procedures. These revisions cannot give rise to penalties. At the sanctions stage, the European Commission's hypothesis on potential growth, made at the recommendation of the Council, is used in the discussion. However, it is likely that a difference of opinion on an unobservable variable could generate friction in the process,

reducing the likelihood of sanctions and making the rules less credible.

The official introduction of the euro in Lithuania: does it really make no difference?

Sandrine Levasseur

On 1 January 2015, Lithuania adopted the euro *officially*, becoming the 19th member of the euro zone. The adoption was in reality formal, as the euro was already (very) present in Lithuania. For example at the end of 2014, over 75% of loans to Lithuanian businesses and households were denominated in euros, as were 25% of bank deposits.

The use of the euro alongside Lithuania's national currency, as a currency for loans, a means of savings and for invoicing, is neither an anomaly nor simply an anecdote: this practice concerns or concerned a number of countries in the former communist bloc. "Euroization" [1] is the result of economic and political events that, at one time or another in these countries' histories, have led them to use the euro in addition to their own currency. So given this context, will the official introduction of the euro in Lithuania really not change anything? Not exactly. Lithuania will see some changes, admittedly minor, as will the decision-making bodies of the ECB.

The euroization of loans and deposits: the case of Lithuania, neither anomaly, nor anecdote …

If we exclude the principalities, islands and States (Andorra, San Marino, the Vatican, etc.) that have negotiated the adoption of the euro with the European authorities but without joining the European Union together with the countries that have adopted the euro unilaterally (Kosovo and Montenegro), there is in addition a whole set of countries that use the euro alongside their own currency. These countries are mostly from Central and Eastern Europe, the Balkans or the Commonwealth of Independent States (CIS). For example, in 2009, before Estonia and Latvia officially joined the euro zone (in 2011 and 2013, respectively), lending by private agents in the three Baltic states was mainly denominated in the euro, reaching a level of almost 90% in Latvia (Figure 1). Countries such as Croatia, Romania, Bulgaria, Serbia and Macedonia were not far behind, with over 50% of their loans denominated in euros. The figures for deposits in euros are somewhat less striking (Figure 2), but still raise questions as to the attraction that the euro exerted in some countries as a payment or reserve currency or for precautionary savings.

Figure 1. Share of loans to the private sector denominated in euros (emerging Europe, 2009)

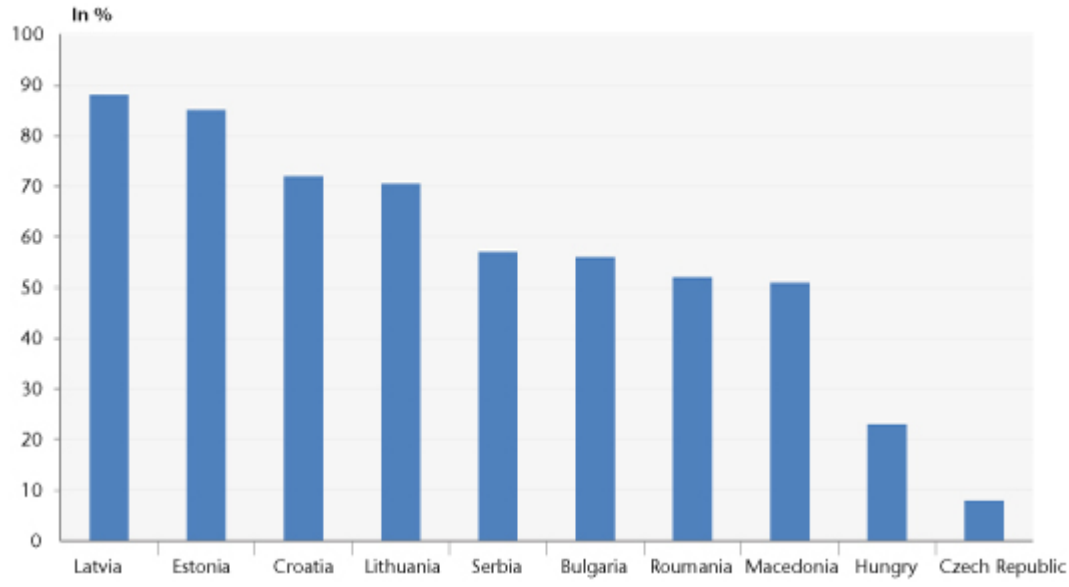
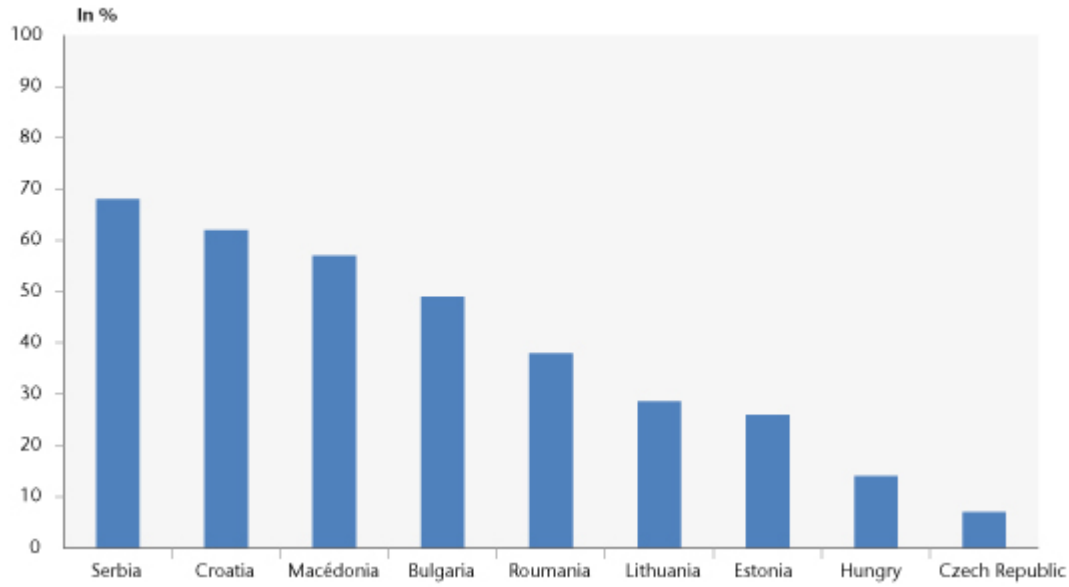


Figure 2. Share of private sector deposits in euros (emerging Europe, 2009)



There are a number of reasons why these countries have used the euro in addition to their own currency:

– **The existence of fixed** (or relatively fixed) **exchange rates** against the euro, which protects borrowers against the risk that their euro-denominated debt will grow heavier (since the likelihood of a devaluation / depreciation of the national currency is considered to be low);

– **A lower interest rate on loans denominated in euros** than when the loans are denominated in the national currency;

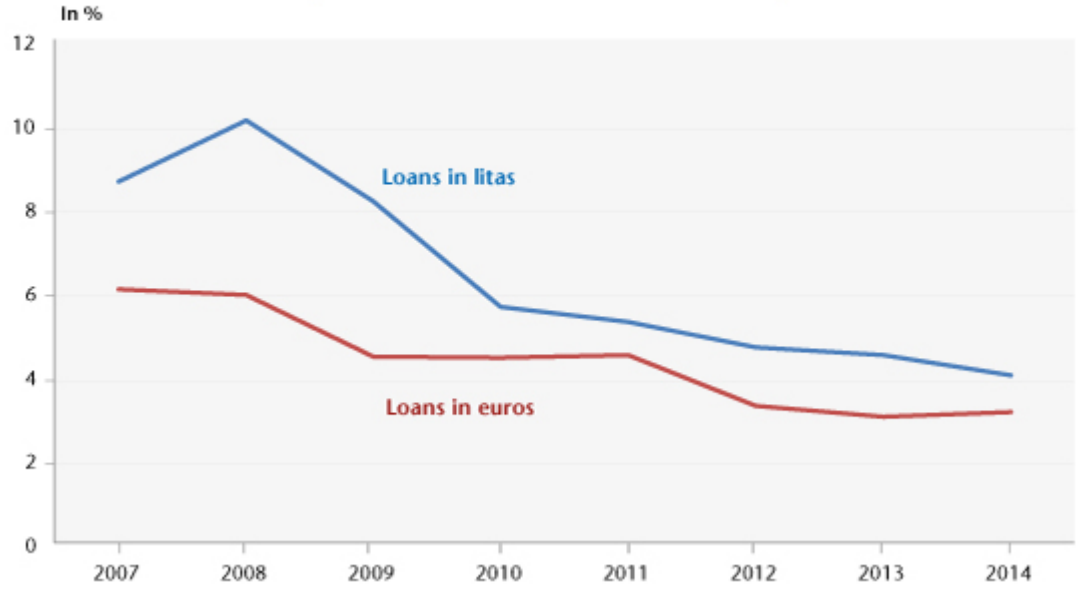
– **A strong presence of multinational companies (particularly in the banking sector)** that have not only funds in euros but also the "technology" to lend / borrow in euros;

– For loans in euros, **the ex ante existence of bank deposits in euros**, which is itself linked to multiple factors (e.g. the credibility of the monetary authorities, a strong presence of multinationals, revenue from migration coming from countries in the euro zone) .

These factors have been present to a greater or lesser extent in the different countries. In Lithuania, the existence of a *Currency Board* [2] vis-à-vis the euro since 2002 has generally

contributed to the economy's "euroization". This system of fixed exchange rates has enjoyed great credibility, prompting the country's businesses and consumers to borrow in euros, particularly since these benefited from very low interest rates (Figure 3). The presence of multinational companies in a number of sectors strengthened the use of the euro as a benchmark currency for different functions (billing, deposits and savings). The importance to Lithuania of banks from the euro zone should nevertheless not be overestimated: the three largest banks operating in Lithuania are from Sweden and Norway. The risk of loans in euros thus involves, beyond the risk associated with the value of the Lithuanian lita, a risk associated with the value of a third currency. … This risk will obviously not disappear with Lithuania's formal adoption of the euro.

Figure 3. Interest rates on loans to the private sector
(based on the denomination of the loan)



What changed on 1 January 2015?

Four changes can be highlighted:

(1) The euro now circulates in Lithuania in the form of notes and coins, whereas previously it existed primarily in the form of bank money (bank deposits and euro-denominated loans); the euro is the legal tender and will be used for all

transactions; and the lita will disappear after dual circulation for a fortnight.

(2) Changes to the price labels for goods will result in additional inflation, due to more frequent rounding off upwards rather than downwards. However, this phenomenon, which has been seen in all countries during the transition (official) to the euro, should have only a minor impact. Experience shows that in general perceived inflation is higher than actual inflation.

(3) Lithuania is adhering *de facto* to the banking union, which can provide benefits in the financial sector (e.g. opportunities for additional collaboration in a common monetary and banking space, existence of an orderly resolution mechanism in case a bank runs into difficulty).

(4) The Governor of Lithuania's Central Bank is now a member of the ECB Governing Council and therefore participates in decision-making on euro zone monetary policy, whereas previously, under its Currency Board system[3], Lithuania's Central Bank had no choice but to "follow" the decisions taken by the ECB in order to maintain parity with the euro. It could be argued that in any case Lithuania will not carry much weight in the ECB's choice of monetary policy due to the size of its economy. Note, however, that Lithuania's entry into the euro zone is bringing changes to the way decisions are made by the ECB Governing Council. The principle of "one country, one vote" that prevailed until now is being abandoned in accordance with the Treaties, due to the entry of a 19th member into the euro zone. Henceforth, the five "major" countries in the euro zone (defined by the weight of their GDP and their financial system) havenow four voting rights, while the other fourteen countries have eleven votes. The vote in each group is established according to a rotation principle, which displeases the Germans, but not just them. In practice, however, it is not certain that this change in the voting system will affect many decisions. For example, while the

governor of Germany's central bank now has only 80% of its voting right, it still has 100% of its right to speak… Will not voting one month out of five really mean that it loses its power of persuasion?

On 1 January 2015, the official adoption of the euro by Lithuania was thus not at all amount to a Big Bang. However, it is very symbolic for Lithuania, further demonstrating how much it is anchored in both Europe and the euro zone. This shows once again that despite all the turmoil the zone has experienced, it still has its supporters. The most striking result of Lithuania's accession to the euro zone is probably the change in the ECB's system of voting rights: here too the symbolic meaning is heavy, as it sounds the death knell of the principle, "one country, one vote".

For more on the issue of euroization, readers can see:

Sandrine Levasseur (2004), Why not euroization ? *Revue de l'OFCE*, Special Issue "The New European Union Enlargement", April 2004.

For more on the system of rotating voting rights in the ECB, see:

Silvia Merler (2014), Lithuania changes the ECB's voting system, *Blog of Bruegel*, 25 July 2014.

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[1] Strictly speaking, euroization refers to the adoption of the euro as legal tender by a country without its being given permission by the issuing institution (i.e. the European Central Bank) or the decision-making authorities (i.e. the heads of State of the European Union member countries). Euroization is then said to be unilateral. It differs from the

phenomenon discussed here, where the euro is used in conjunction with the national currency, but only the national currency constitutes legal tender.

[2] A currency board involves a system of fixed exchange rates in which the central bank simply converts foreign exchange inflows and outflows into the local currency at the pre-defined parity. A central bank that adopts this system gives up the tool of autonomous monetary policy: its role is reduced to that of a "cashier".

[3] See footnote 2.

Recovery aborted

By Christophe Blot

This text draws on the article "Le piège de la déflation: perspectives 2014-2015 pour l'économie mondiale" [The deflation trap: the 2014-2015 outlook for the world economy], written by Céline Antonin, Christophe Blot, Amel Falah, Sabine Le Bayon, Hervé Péléraux, Christine Rifflart and Xavier Timbeau.

According to a Eurostat press release published on 14 November 2014, euro zone GDP grew by 0.2% in the third quarter of 2014, and inflation stabilized in October at the very low level of 0.4%. Although the prospects of a new recession have receded for now, the IMF evaluates the likelihood of a recession in the euro zone at between 35% and 40%. This dismal prospect reflects the absence of a recovery in the euro zone, which is preventing a rapid reduction in unemployment. What lessons can be drawn?

In the short term, this sluggishness is due to three factors that have held back growth. First, fiscal consolidation, although less extensive than in 2013, has been continued in 2014 in a context where the multipliers remain high. Second, despite the reduction in long-term public interest rates due to the easing of pressure on sovereign debt, financing conditions for households and businesses in the euro zone have worsened, as the banks have not consistently passed on the reduction in long-term rates and lower inflation is leading to a tightening of real monetary conditions. Finally, the euro appreciated by more than 10% between July 2012 and early 2014. Even though the currency's rise reflects the winding down of pressure on euro zone bond markets, this has hurt exports. In addition to these short-term factors, recent data could herald the beginnings of a long phase of moderate growth and low inflation or even deflation in the euro zone.

Indeed, after a period of sharply increasing debt (see Figures), the financial situation of households and firms in the euro zone has deteriorated since 2008 due to a series of crises – financial, fiscal, banking and economic. This deterioration in the financial health of the non-financial sector has weakened its thirst for credit. Furthermore, households may be forced to cut down on their spending on consumption, and firms investment and their need for employment in order to reduce their debt. Adding to this is the fragility of certain banks, which need to absorb a high amount of bad debt; this is leading them to restrict the supply of credit, as is evidenced by the latest SAFE survey conducted by the ECB on SMEs. In a context like this where private agents prefer deleveraging, fiscal policy should play a crucial role. But this is not happening in the euro zone due to the desire to consolidate the trajectory of public finances at the expense of the goal of growth[1]. Furthermore, while many countries could get out of the excessive deficit procedure in 2015 [2], fiscal consolidation is expected to continue because of the rules in the Treaty on Stability,

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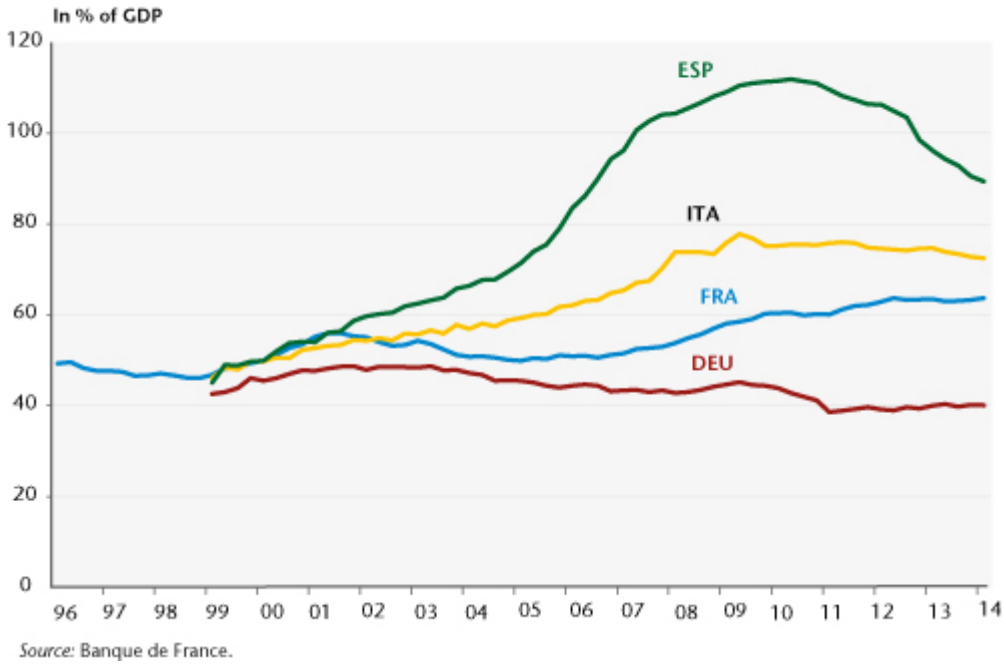
(TSCG) requiring Member countries to make fiscal adjustments to bring public debt down to the 60% threshold within 20 years[3].

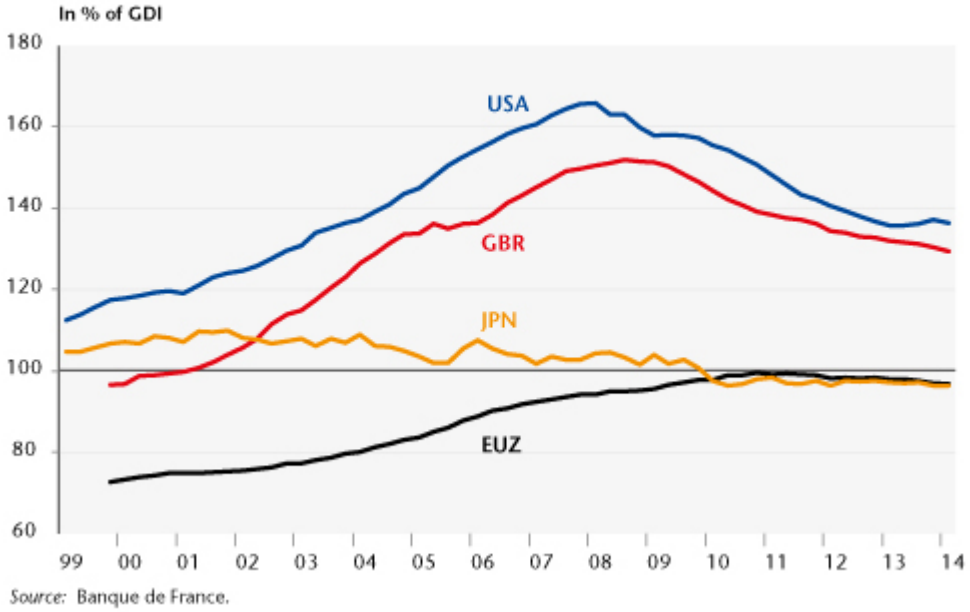
These conditions could push a recovery further down the road, and the euro zone could wind up locked in the trap of deflation. A lack of growth and high unemployment are creating downward pressure on prices and wages, pressure that is being exacerbated by internal devaluations, which are the only solutions being adopted to improve competitiveness and regain market share. This reduction in inflation is making the deleveraging process even more protracted and difficult, thus undercutting demand and strengthening the deflationary process. The Japanese experience of the 1990s shows that it is not easy to pull out of this kind of situation.

Figure 1. Debt of non-financial corporations



Source: Banque de France.

Figure 2. Household debt



Source: Banque de France.

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[1] The costs of this strategy were evaluated in the two preceding iAGS reports (see here).

[2] France and Spain would, however, constitute two major exceptions, with budget deficits of, respectively, 4% and 4.2% in 2015.

[3] See the post by Raul Sampognaro for more on the specific case of Italy.

Unemployment insurance for the euro zone?

By Xavier Timbeau

In the latest publication of France's Treasury Department, *Lettre Trésor-Eco*, no. 132, June 2014 (Ministère des Finances et des Comptes publics and Ministère de l'Économie du Redressement productif et du Numérique), Thomas Lellouch and Arthur Sode develop the operating methods and the merits of a common unemployment insurance for the euro zone. They specify the main steps of how it would be applied, which would ensure neutrality between the Member States. They argue for harmonized employment and labour market policies, leading in the long term to a single contribution rate in the euro zone:

– "Harmonization at the euro zone level of an unemployment insurance component would provide the euro zone a new solidarity instrument capable of giving a social Europe real substance while ensuring greater stability of the zone as a whole…

– This common base could compensate *e.g.* those who are unemployed less than one year (the most cyclical component) at 50% of their past salary, with financing determined on a harmonized base (*e.g.* payroll). It would be supplemented by national compensation in accordance with the preferences of each state, thus ensuring the continuation of the current level of compensation…

– Modulating the contribution rate of each member according to its unemployment level, with regular updates based on past trends, would ensure *ex ante* budget neutrality between the Member States…

– In the longer term, and after the unemployment rates of the various Member States converge, a system marking greater

solidarity between the Member States could be considered, with financing through a single contribution rate …”.

New solidarity, but posing three problems …

Unemployment insurance functions as an important automatic stabilizer. Having a common system for the euro zone members would have made possible significant transfers during the crisis we have just been through. Based on the scheme proposed by the authors (pooling the most cyclical component), Spain could have benefited from almost 35 billion euros by end 2012, mainly from Germany and France. This would not be sufficient to cancel Spain’s public deficit, but it would have kept down its level.

A system like this could play a major role in avoiding the sovereign debt crises that dry up a State’s credit. It would introduce solidarity and neutral transfers during cycles, but would be responsive to the state of the cycle.

However, this proposal raises three problems: the first is that unemployment insurance systems are the fruit of a national social compromise that has won general acceptance and is consistent with the rest of the country’s labour market policies, whether these are active policies or not. A European unemployment insurance component built on top of national systems could lead to confusion and to questions about the national balance. This could disrupt the social dialogue, since the social partners would have a potential resource for which they are not responsible, in addition to the issue of whether the European authorities or partner countries might also wish to have a say. Furthermore, unemployment insurance is often a sensitive subject, as was seen by the issue of entertainers and artists (*intermittents*) in France in early summer 2014.

This could be solved by limiting the sharing to macroeconomic transfers, independent of national arrangements. But, and this

is the second problem, to ensure that transfers between states do not become permanent, the transfers need to be balanced over the business cycle. This requires a procedure for identification of the cycle that the stakeholders agree on. The recent experiences of the crisis and the calculation of structural deficits show that this is far from the case today. Another option would be to "replenish" the system prior to using it by accumulating contributions over a number of years before a major downturn. It would suffice to limit use to what has been accumulated to resolve discrepancies. But then the system would be bereft of value in the face of a systemic crisis. The day the buffer collapses, the Kings would be as naked as before. At best the crisis is delayed, at worst it is aggravated.

A final option would be to give up balancing the transfers *a priori* (or by the mechanics of the way it operates), leaving it to polarize gradually one way or another and to ensure an asymptotic convergence. But in this case the system could lead to undesired structural transfers that could very well call it into question.

Spain for instance has high unemployment, well above its structural rate; entering into a transfer system based on the differences between current unemployment and structural unemployment could be done only on an equilibrium basis, or would run the risk of a long-lasting initial transfer.

This then raises the third issue, governance. It is difficult to design such a system without implying, at least potentially, significant transfers between States. How could such transfers be justified without a legitimate common representation? Furthermore, what could be done to avoid these transfers becoming an instrument for control of macroeconomic policy as a whole? The establishment of a banking union is a reminder of how key this problem is. Likewise, Spain's refusal to submit to the conditions set for a conventional assistance program (EU / IMF) clearly indicates that in the absence of

legitimate and sincere solidarity, the beneficiaries of transfers will be as suspicious as the payers.

The French fiscal devaluation, or the French Achilles strives to catch the German tortoise

By Sarah Guillou

In the 1980s, under the European Monetary System (EMS), France repeatedly carried out currency realignments – in 1981, 1982, 1983 and 1986 – that were tantamount to devaluations. For its part, Germany had – already! – adopted a rigorous strategy of competitive disinflation, which, it was said at the time, led to disciplining its companies, which could not rely on the temporary advantages gained by currency devaluations rendering its exports more competitive. They were compelled instead to make investments so as to build up their future non-price competitiveness. Which they did…

During this same period France's devaluations left it with imported inflation and companies that had less incentive to invest in non-price competitiveness. The peg to the deutsche mark and then the Monetary Union were presented as ways to break out of this endless strategy of inflationary devaluations. France belatedly wound up adopting Germany's strategy of competitive disinflation and renouncing currency devaluations, with a strong franc strategy characterizing the 1990s.

Today, the terms of the debate seem reversed, even though France is still in the position of Achilles chasing the German tortoise. A new form of competitive devaluation is in favour: not based on the exchange rate, since the euro is part of a market mechanism that determines its value, but one that involves a reduction of the labour costs borne by business, funded in part by an increase in Value Added Tax (VAT). This is called a fiscal devaluation. In an article entitled "Changer de Modèle", P. Aghion, G. Cette and E. Cohen defend this on the grounds that it is necessary to "think differently"[1]. The government is also implementing this through the Competitiveness and employment tax credit (CICE) and its plans in the 2015-2017 Stability Pact to cut social security charges.

How is a reduction in the cost of labour comparable to a "fiscal" devaluation? A devaluation, it should be recalled, leads to lowering domestic prices relative to foreign prices as the value of the domestic currency is decreased relative to a unit of foreign currency. A devaluation of the euro, if it were possible, would mean a higher amount of euros to buy a dollar; consequently, a European car at 10,000 euros would go for fewer dollars and thus become more attractive to an American buyer who would still be holding the same amount in dollars in his wallet. More generally, a devaluation ensures that the production cost of domestic firms becomes cheaper relative to their foreign competitors, so that the former have a cost advantage and become more competitive. Hence the term "competitive devaluation".

By lowering companies' labour costs, it is assumed that the prices of exported products (and the goods and services included) will be lowered – despite the fact that labour costs do not cover the full cost of production. By increasing VAT on all products, the price of imported products increases as well. The devaluation effect – that is to say, the reduction in domestic prices relative to foreign prices – will take

place only if the competitors' prices remain constant – in other words, only so long as the competitor does not implement the same policy at the same time! Furthermore, this will really have an impact on competitiveness if the price differential existing prior to the fiscal devaluation is more than offset by the reduction in labour costs.

Two further questions arise. First, we do not know the price elasticity of the labour costs. In other words, we do not know the extent to which firms pass lower employer costs onto prices. Second, labour market studies show that wages have a positive elasticity to labour costs. In other words, in the medium term and especially for higher wages, cutting payroll taxes on wages will result in increases in pay.

The medium-term effects are then drawn on to defend the fiscal devaluation policy. The reduction in employer contributions initially gives some manoeuvring room, or rather a cash flow, that then leads companies to invest, precisely because of the recovery in their margins. Incidentally, this excludes the previous effect, *i.e.* a reduction in prices, or in any case will have a maximum impact if the price drop does not occur. It is possible however that higher margins are a side effect of a reduction in prices, which pushes up sales, while increasing the profit per unit in a cost structure with increasing returns to scale, even if this affects only a few companies. Now suppose that the margins generated translate into investments. This could improve the companies' non-price competitiveness (the intrinsic product quality) in the future. This second aspect of fiscal devaluation is often put forward in parallel with the observation that French companies, in particular manufacturers, suffer both from crippling tax and regulatory conditions that handicap their international competitiveness and from a lack of product quality. But here macroeconomic analysis can no longer be invoked, and with respect to non-price competitiveness we know much less about the microeconomic dynamics due to the reduction of charges.

Let's conclude by considering the effects expected over the longer term. As pointed out by Aghion *et al.* in a footnote on page 58, the effects of a fiscal devaluation are temporary. Indeed, as with a currency devaluation, a fiscal devaluation will lead to an increase in wages due to the dynamics described above. Moreover, if the financing of the reduction in charges results in reducing households' purchasing power due to the VAT hike, then the latter could also demand an increase in their nominal wages. The initial reduction in relative prices will be wiped out over the longer-term by the rise in wages. The authors could draw on the quasi-deflation in Europe to deal with this side effect of a devaluation. They argue instead that the interval will give a new impetus to business. In fact, what the authors defend is not the direct effect of the devaluation but its indirect effect on the level of investment due to the increase in margins.

However, this is also undoubtedly the aim of the CICE tax credit, as it targets taxes and not employer charges directly, unlike the Responsibility Pact which is aimed primarily at employment. By granting a tax credit, the CICE seeks to generate margins for investment in order to develop non-price competitiveness. The problem is that an improvement in competitiveness is far from guaranteed (see Guillou and Treibich, *Note de l'OFCE, no. 41 of 19 June 2014* [in French] on the CICE and competitiveness), while the dual objective of this tax credit (employment and competitiveness) will complicate companies' decision-making.

To pick up on the suggestion by Aghion *et al.*, the memory of the French competitive devaluations of the 1980s could lead us to "really think differently", that is to say, to stop applying policies that others have already applied. To think otherwise would mean to anticipate future competition rather than to replicate a policy that other countries have already implemented, which is obviously not so simple. And the interest of the work of Aghion *et al.* is in embracing a set of

reforms that, taken **simultaneously**, could put France on a **different** trajectory.

But to undertake a fiscal devaluation while all the countries of Europe potentially will do or actually have done the same would generally be insufficient and even dangerous if it leads to a race to social dumping. It would be justified only because European integration requires a certain alignment of companies' cost conditions, and thus due to fiscal competition. Repeatedly lagging behind fiscally in an integrated European market is very costly, it is true, but the French Achilles will not catch the German tortoise that has set off early in the field of competitiveness by using the weapon of a fiscal devaluation.

A better strategy would be to get ahead of the game. In the absence of being able to harmonize companies' fiscal conditions, it is necessary to anticipate. Germany anticipated competition from the emerging countries and implemented social VAT, or a fiscal devaluation. A policy that would change the "model" should anticipate future competition in Europe and around the world. However, this competition will not be over the cost of labour. Proof of this lies in the approach of countries with a low relative cost of labour that are more and more replacing labour with capital. China for instance has already become the world's largest purchaser of industrial robots (*Financial Times,* 1 June 2014). Future competition will be structured around the pursuit of two trends already taking place: the division of the production process as it is being accelerated by technological possibilities, and the replacement of labour by technology. Most value added will be focused upstream of production in design and / or downstream in related services. In other words, the government also needs to take an interest in the cost of capital, particularly in terms of the opportunity cost of investment.

The question of labour costs concerns the employment of less-skilled workers (obviously of great importance *per se*), but it

is not at the heart of the problem of competitiveness. In attempting to solve the problem of the day, the cost of labour, there is a risk of not making the investments that ensure the future. Could France stop being the Achilles that chases the German tortoise? One way to resolve Zeno's paradox would be to invent a government that maintains continuity. Otherwise, we need to do away with a strategy of catching-up and opt for a more winning "model".

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[1] This is in fact the title of the first chapter of the book by P. Aghion, G. Cette and E. Cohen, *Changer de modèle*, Ed. Odile Jacob, 2014.

What Reforms for Europe?

by *Christophe Blot [1], Olivier Rozenberg [2], Francesco Saraceno [3] et Imola Streho [4]*

From May 22 to May 25 Europeans will vote to elect the 751 Members of the European Parliament. These elections will take place in a context of strong mistrust for European institutions. While the crisis of confidence is not specifically European, in the Old Continent it is coupled with the hardest crisis since the Great Depression, and with a political crisis that shows the incapacity of European institutions to reach decisions. The issues at stake in the next European elections, therefore, have multiple dimensions that require a multidisciplinary approach. The latest issue of

the *Debates and Policies Revue de l'OFCE* series (published in French and in English), gathers European affairs specialists – economists, law scholars, political scientists – who starting from the debate within their own discipline, share their vision on the reforms that are needed to give new life to the European project. Our goal is to feed the public debate through short policy briefs containing specific policy recommendations. Our target are obviously the candidates to the European elections, but also unions, entrepreneurs, civil society at large and, above all, citizens interested by European issues.

In the context of the current crisis, the debate leading to the next European elections seems to be hostage of two opposing views. On one side a sort of self-complacency that borders denial about the crisis that is still choking the Eurozone and Europe at large. According to this view, the survival of the euro should be reason enough to be satisfied with the policies followed so far, and the European institutions evolved in the right direction in order to better face future challenges.

At the opposite, the eurosceptic view puts forward the fundamental flaws of the single currency, arguing that the only way out of the crisis would be a return to national currencies. The different contributions of this volume aim at going beyond these polar views. The crisis highlighted the shortcomings of EU institutions, and the inadequacy of economic policies centered on fiscal discipline alone. True, some reforms have been implemented; but they are not enough, when they do not go in the wrong direction altogether. We refuse nevertheless to conclude that no meaningful reform can be implemented, and that the European project has no future.

The debate on Europe's future and on a better and more democratic Union needs to be revived. We need to discuss ways to implement more efficient governance, and public policies adapted to the challenges we face. The reader nevertheless

will not find, in this volume, a coherent project; rather, we offer eclectic and sometimes even contradictory views on the direction Europe should take. This diversity witnesses the necessity of a public debate that we wish to go beyond academic circles and involves policy makers and citizens. Our ambition is to provide keys to interpret the current stakes of the European debate, and to form an opinion on the direction that our common project should take.

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