

# Euro zone: Recovery or deflation?

By [Céline Antonin](#), [Christophe Blot](#), Sabine Le Bayon and Danielle Schweisguth

*This text summarizes the [OFCE's forecast for 2014-2015 for the euro zone economy](#)*

Will the euro zone embark on the road to recovery, or will it sink into a deflationary spiral? The latest macroeconomic indicators are sending out conflicting signals. A return to growth is being confirmed, with three consecutive quarters of rising GDP. However, the level of unemployment in the euro zone remains at a historically high level (11.9% for the month of February 2014), which is fuelling deflationary pressures, as is confirmed by the latest figures on inflation (0.5% yoy for March 2014). While this reduction in inflation is partly due to changes in energy prices, the fact remains that underlying inflation has fallen under 1% (Figure 1). In these conditions, a turnaround in inflationary expectations cannot be excluded, which would undoubtedly push the euro zone into deflation. The ECB has been concerned about this situation for several weeks and says it is ready to act (see [here](#)). However, no concrete proposal for a way to ease monetary policy and ensure that expectations are not anchored on a deflationary trajectory has been set out.

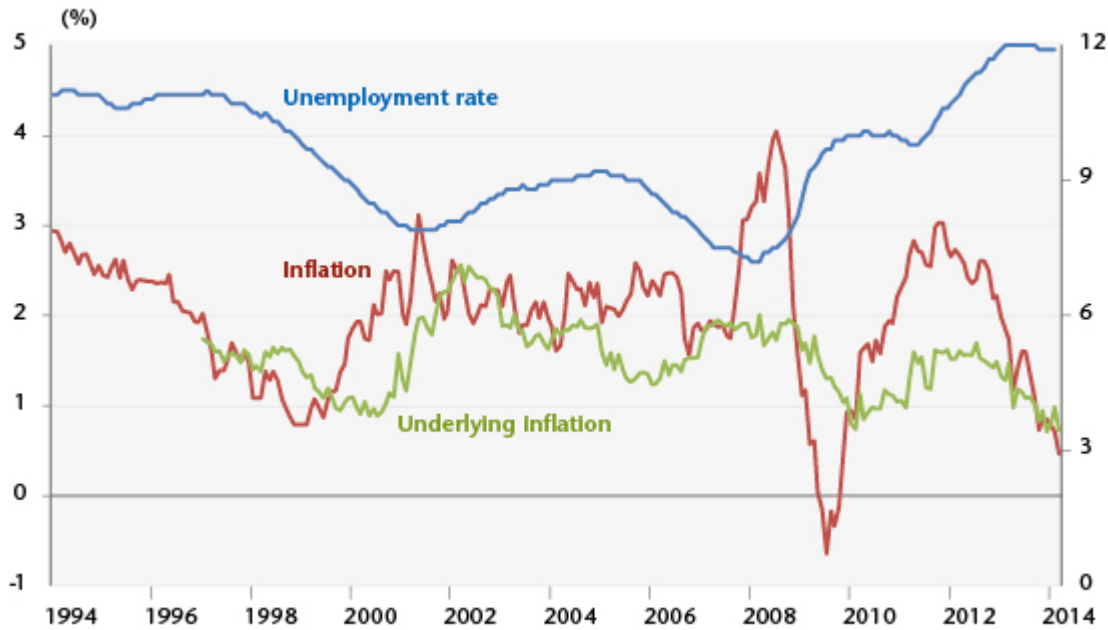
After a fall in GDP of 0.4% in 2013, the euro zone will return to positive growth: 1.3% in 2014 and 1.6% in 2015. Even so, at this rate of growth, there will still be an open output gap in most of the euro zone countries, reflecting the idea that the euro zone is only slowly pulling out of the crisis. Indeed, although efforts to reduce deficits will be curtailed, fiscal policies will still be pro-cyclical. Furthermore, financing conditions will continue to improve. The end of the sovereign

debt crisis, thanks in particular to the announcements by the ECB in July and September 2012 [\[1\]](#), has reduced the risk premiums on the market for government bonds. The impact of lower long-term market rates has been partly reflected in bank interest rates, and credit supply conditions are generally less restrictive than they were between early 2012 and mid-2013. But there will still not be sufficient growth to trigger a recovery strong enough to lead to a rapid and significant reduction in unemployment. Indeed, the level will fall only very moderately, from 11.9% in the first quarter of 2014 to 11.3% at year end 2015. While Germany will enjoy almost full employment, mass joblessness in Spain and the other countries of southern Europe will persist (Figure 2). Unemployment should stabilize in Italy and continue to grow in France.

However, this continuing underemployment is giving rise to the risk of deflation. It is holding back growth in wages and contributing to the weakness of underlying inflation, which was in fact zero in Spain in March 2013 and negative in Greece and Portugal. For the euro zone as a whole, we do not expect deflation in the short term, but the weakness of growth is increasing the likelihood that private agents' expectations are not anchored in a deflationary scenario.

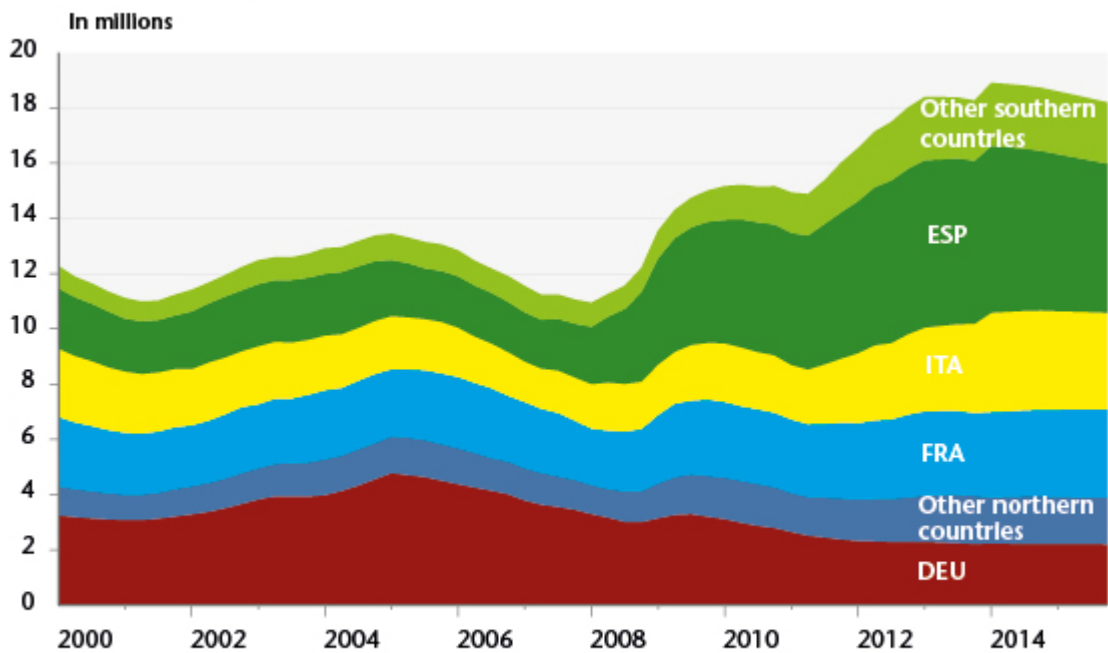
The situation in the euro zone is reminiscent of Japan in the 2000s. The country began to experience deflation in 1999 [\[2\]](#) following the recession associated with the Asian crisis. At that point, despite average growth of 1.4% between 2000 and 2006, prices failed to pick up, and the country's central bank did not find a way out of this trap, despite trying expansionary monetary policies. This is precisely the dynamic threatening the euro zone today, making it crucial to use all possible means to avoid this (monetary policy, fiscal policy and the coordination of wage policy [\[3\]](#)).

**Figure 1. Unemployment rate and inflation rate in the euro zone**



Source : Eurostat.

**Figure 2. Unemployment in the euro zone countries**



Note : The other southern countries are Portugal and Greece. The other northern countries are the Netherlands, Belgium, Ireland, Austria and Finland.

Sources : Eurostat, OFCE forecast April 2014.

[1] In July, ECB President Mario Draghi declared that the central bank would save the euro “whatever it takes”. In

September, the ECB announced the creation of a new mechanism called Outright Monetary Transactions (see the post by [Jérôme Creel and Xavier Timbeau](#)), which enables it to engage in unlimited purchases of sovereign debt.

[2] It should be pointed out that there was an initial period of deflation in 1995 following three years of economic stagnation.

[3] All these elements are discussed in detail in the previous [iAGS](#) report (2014).

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## **And what if the ECB respected its mandate!**

By [Christophe Blot](#)

Article 127 of the Treaty on the Functioning of the European Union (TFEU), *i.e.* former Article 105 of the Maastricht Treaty, states clearly that “the primary objective of the European System of Central Banks ... shall be to maintain price stability”. However, no precise quantification of this goal is given in the Treaty. The European Central Bank has interpreted this by stating that it would target inflation that is below, but close to, 2% over the medium term. Furthermore, Article 127 of the TFEU adds that, “without prejudice to the objective of price stability , the [European System of Central Banks ] shall support the general economic policies in the Union, as laid down in Article 3 ...”, which includes in particular the sustainable development of Europe based on balanced economic growth and price stability, full employment and social progress. It is therefore clear that the goal of growth and employment is not abandoned but subordinated to the

goal of price stability. Starting from this review of the definition of the ECB's objectives, what conclusion can we draw on the orientation of monetary policy in the euro zone?

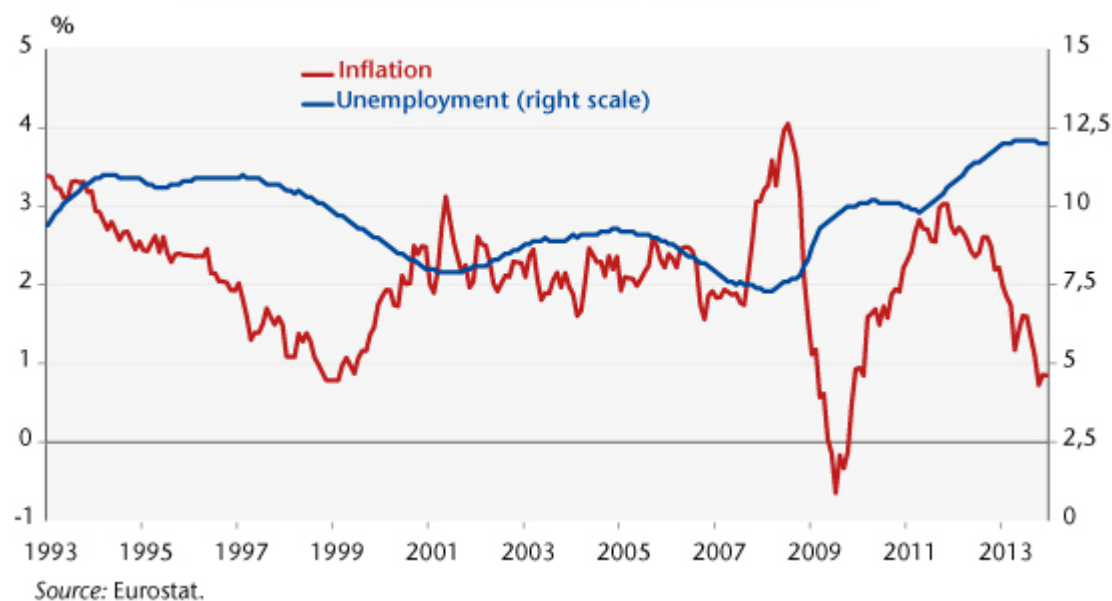
Since the end of 2013, a few signs of economic recovery have appeared in the euro zone. Initial estimates of growth in the fourth quarter of 2013 have confirmed that the recession is ending, with GDP up 0.3%. Nevertheless, the economy is still in poor health. As proof, simply recall that 12% of the labour force is currently unemployed, which is the highest level since 1993 (see chart). Growth is expected to accelerate in 2014 and 2015. According to the ECB forecasts announced in March 2014, growth will hit 1.2% in 2014 and 1.5% in 2015, a pace that is still insufficient to lead to a rapid or significant reduction in the unemployment rate. In addition, since the end of 2013 inflation has dropped below the threshold of 1% and is coming dangerously close to a point where deflation is a risk. Furthermore, still according to the ECB forecasts, inflation should not exceed 1.0% in 2014, before pushing up to 1.3% in 2015 and 1.5% in 2016. It is in any case far from the mid-term target of 2%. The objective of price stability as defined by the ECB will therefore not be met. At his press conference in March, Mario Draghi announced that the maintenance of the ECB key interest rate [\[1\]](#) at 0.25% and the absence of additional (so-called unconventional) measures could stimulate the euro zone. The status quo was justified by the absence of signs of a more rapid fall in inflation. By taking this stand, the ECB President is indicating that he is satisfied with a situation where inflation remains permanently below the 2% level and where the euro zone is marked by persistent mass unemployment. Are we therefore supposed to reinterpret the definition of price stability invoked by the ECB and accept that the term *below* is more important in the eyes of the members of the ECB Governing Council than the term *close to 2%*? The answer to this question is obviously not neutral, since it would reflect a certain asymmetry in the central bank's reaction to inflation, with

the ECB reacting more quickly when inflation exceeds 2% than when it falls below 2%, including over the forecast horizon of its own team. But however its main objective is interpreted, the fact remains that the risk to price stability is not currently a barrier to the implementation of a more expansionary monetary policy. In these conditions, the ECB has all the room it needs to be actively concerned about its other objectives, including first of all growth and unemployment.

So what tools does the ECB have available, knowing that with the benchmark rate at 0.25% it has only very limited manoeuvring room for a downward adjustment? The ECB must therefore use other levers. Communication by the central banks has played an increasing role in the implementation of monetary policy, as this can be used to influence agents' expectations and hence the impact of decisions on inflation and growth. In this respect, the central bank has recently (July 2013) engaged in what is called forward guidance by stating that the key rate will be maintained at a low level for an extended period [2]. The ECB could go further by conditioning a hike in the key interest rate on a target unemployment rate, as both the Bank of England and the Federal Reserve have done; this would give added substance to its objectives on employment and growth. In addition, unconventional measures could be used to strengthen the expansionary character of monetary policy. This mainly means measures that alter the size or composition of the central bank's balance sheet, which would supplement the role of the reduction in short-term rates in influencing financing conditions. A recent report by France's Council of Economic Analysis (see [here](#)) points in this direction, and in particular proposes that the ECB should purchase securitized small and medium enterprises' (SME) loans in order to reduce the cost of business financing. The Outright monetary transactions (OMT) programme [3] could have been activated to support the reduction in long-term sovereign rates. The announcement of this measure did indeed contribute to lowering

long-term sovereign rates in Spain and Italy, in particular because it sent a signal that the risk of collapse of the euro zone was being averted. Up to now, the ECB has not intervened in the markets to buy government securities. Yet given its unlimited capacity for intervention, doing this would help to reduce long-term rates. Note, however, that the OMT programme is currently being challenged by Germany's Constitutional Court in Karlsruhe, which has questioned the programme's constitutionality, with the case being referred to the European Court of Justice. A rejection or restriction of the ECB's actions in this matter would be unfortunate. The ECB's scope for intervention does of course need to be clarified. But it is also essential to retain the objectives of price stability and growth. The judges in Germany and at the European Court of Justice would be well advised to keep this in mind.

Figure. Unemployment rate and inflation rate in the euro zone





# Revisions of the growth potential: the impact on deficits

By Hervé Péléraux

## Public finances – battered by the Great Recession

At the end of the Great Recession of 2008/09, the fiscal problem that governments had to face was seemingly simple, as was the solution put forward. The operation of the automatic stabilizers and the stimulus packages put in place to counter the 2008/09 recession sharply increased the public deficits. This situation, which was dictated by urgency, was acceptable in the short term, but not in the longer term. Logically this would lead to an adjustment in the public accounts to reduce the deficits and halt the growth of the debt. Fiscal discipline at a forced pace under the baton of the European Commission was therefore the economic policy instrument adopted by almost all the euro zone countries.

The appropriateness of this strategy, which was undertaken to solve the initial problem, i.e. the excessive deficits in the euro zone, should nevertheless be discussed. It relied on a macroeconomic diagnosis made at the end of the recession in 2008/09 that conditioned the assessment on the spontaneous capacity for an economic recovery – in effect, the fraction of the public deficit that was likely to be spontaneously absorbed by renewed growth depended on this capacity for recovery.

## Part of the deficits could be absorbed on their own

The public deficit excluding interest expense, i.e. the primary deficit, can be subdivided into two components: a cyclical component and a structural component. The cyclical



component results from cyclical fluctuations in GDP around its potential, that is to say, the level of GDP achievable without inflationary pressures using the available production factors: during a phase when GDP is slowing relative to its growth potential, and thus when the output gap is widening, tax revenues slow, and public spending, in particular on social welfare, picks up. What follows is a spontaneous increase in the deficit. In economic theory this self-corrective mechanism is called the “automatic stabilizers”. The other component of the deficit is deduced from the previous one as a complement to the total deficit: this is the deliberate component, which results from the impact of economic policy. This discretionary component can be eliminated only by implementing a policy that is symmetrical to what gave rise to it, that is to say, by means of an austerity policy. By its nature it has a dampening effect on the recovery, whereas the expansionary policy during the previous phase results in boosting activity. Fiscal policy is thus an instrument for smoothing the economic cycle.

The spontaneous portion of the deficit that appeared after the 2008/09 recession was destined to be automatically reduced once growth returned. Only the elimination of the discretionary component justified a restrictive policy. The extent of the effort needed to achieve this therefore depended on the measurement of the output gap, which conditioned the estimate of the cyclical deficit, and by inference the estimate of the deliberate deficit.

### **The cycle's effect on the evaluation of the potential**

The measurement of the output potential that is used to calculate the output gap is obviously central for calibrating as accurately as possible the budget cuts needed to eliminate the portion of the deficit that cannot be absorbed spontaneously by growth. But policymakers face a major difficulty here, i.e. the unobservable nature of the potential, which consequently must be estimated – and economists are far from unanimous about these estimates.

Moreover, periodic revisions can be significant even within the same institution, which modifies the diagnosis made and – if this institution happens to be responsible for defining the rules constraining fiscal policy, as in the case of the European Commission (EC) – the measures to be taken as well.

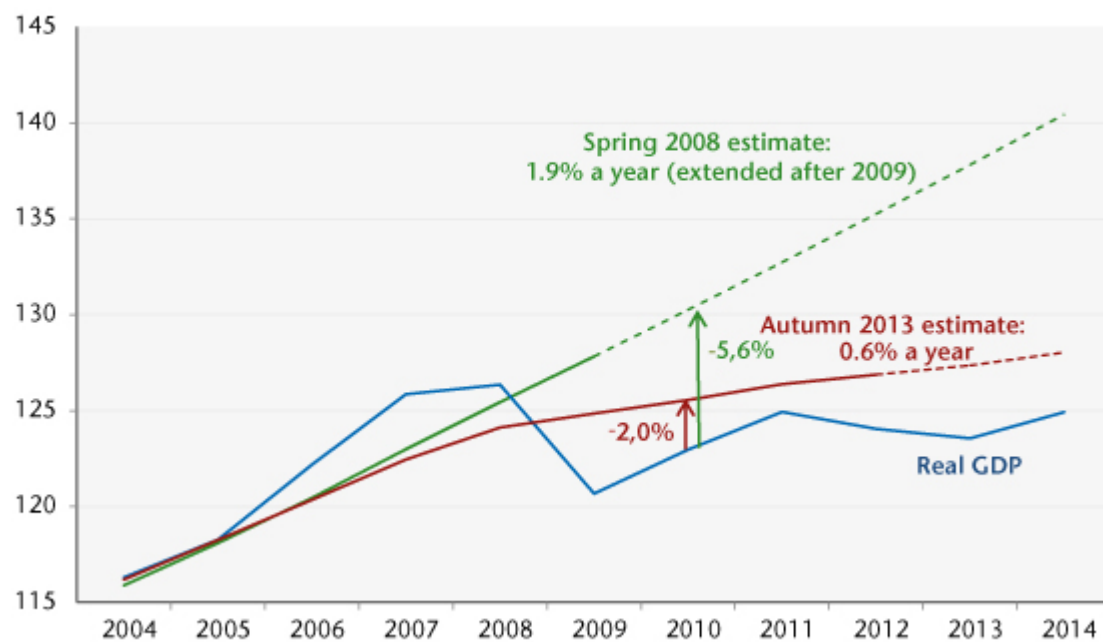
A review of the revisions of the growth potential calculated by the EC shows the uncertainty of this estimate (see last section below). The estimate also appears to depend on current growth, which is somewhat paradoxical for an estimate of a supply function that depends on long-term economic parameters such as increases in the labour force, productivity and the capital stock. It is understandable that the trajectory of these supply parameters is deflected slightly during cyclical hiccups, particularly through investment, which is a vehicle for technical progress and ensures the growth of capital or a loss in human capital due to long-term unemployment. But the fact that the inclusion in the estimates of a cyclical phenomenon, even one as massive as the recession of 2008/09, is leading to revisions of the growth potential on the order of that seen between Spring 2008 and Spring 2009 raises questions. This is particularly so as these revisions have also affected the years prior to the recession, which were not affected by changes in the conditions of accumulation. Thereafter, the resumption of growth in 2010 led to revisions of the growth potential in the other direction, including for the years prior to the recession. Finally, the economic downturn in 2011 led to a further series of revisions, once again downwards.

### **Self-sustained austerity**

The reduction in growth potential led to significant revisions downwards of the estimated output gap (see chart). These are not neutral for calibrating the fiscal consolidation policy. This is because for a given deficit, the estimate of the output gap of -2% for 2010, for example, versus nearly -6% under the assumption of a continuation of the trajectory of

potential GDP estimated before the recession, would increase the part of the perceived structural deficit and thus call for heightened austerity. That's what happened in 2010, when the stimulus packages gave way to plans for drastic budget cuts. Generalized to all member countries, they nipped the nascent recovery in the bud and plunged the euro zone countries into a new recession.

### Revision of the euro zone's growth potential



Sources: European Commission, Eurostat.

The excessive sensitivity of the estimate of potential growth to current growth precipitated the commitment to austerity policies in the euro zone and subsequently pushed towards tightening fiscal restraint further. By depressing economic activity, austerity fuelled factors that undercut supply through the destruction of capital, a slowdown in investment and deskilling the labour supply. The economies' capacity for a spontaneous recovery was thus undermined, which could only lead to an increase in the share of the structural deficit in the total deficit, and ultimately to the need for greater austerity.

The budget purge thus led to a second recession, which

invalidated the deficit reduction targets set at the beginning, as the automatic stabilizers have again increased the cyclical component of the deficit. Rigour, poorly calibrated, was counter-productive and thus could not achieve the initial goal of rapid deficit reduction. The results are far from being commensurate with the sacrifices made by the European economies.

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### **The European Commission's estimate of the euro zone's potential GDP**

The 2008/09 recession led the European Commission to revise its estimate of the growth potential for the member countries rather significantly. For the euro zone as a whole, the revision process began between Spring 2008 and Spring 2009, when the effects of the financial crisis were expressed in real activity: the start of the recession in the euro zone in the fourth quarter of 2008 was associated with sharp downward revisions of the growth potential for 2008 and 2009, by -0.7 and -1.2 points, respectively (Table). There were also relatively substantial revisions to earlier years, from -0.3 to -0.5 points for the years 2004 to 2007. However, no major revision occurs between the estimates of Spring 2009 and Spring 2010, despite the downturn in year-on-year GDP growth, indicating that the modification of the economic landscape had already been included in the estimates.

The growth potential has been revised not only downwards, but also upwards when growth picked up after the recession. Between Spring 2010 and Spring 2011, the revisions were spread from +0.1 to +0.3 points and also affected more distant years. Finally, a new series of downward revisions took place with the second economic downturn in 2011. The years prior to 2008 changed little, but they fall within a broader range for the years 2008 to 2013, from -0.2 to -0.8 points, which for 2012

amounts to dividing the potential growth rate by two and a half.

**Table. Revisions of the euro zone's growth potential**

	Spring 2008	Spring 2009	Spring 2010	Spring 2011	Spring 2012	Spring 2013
2004	1,9	1,6	1,7	1,9	1,9	1,9
2005	1,9	1,5	1,6	1,7	1,8	1,8
2006	2,0	1,5	1,5	1,8	1,8	1,8
2007	2,1	1,6	1,5	1,8	1,8	1,7
2008	2,0	1,3	1,3	1,6	1,4	1,4
2009	1,9	0,7	0,8	0,9	0,7	0,6
2010		0,7	0,8	1,0	0,7	0,6
2011			1,0	1,1	0,8	0,7
2012				1,1	0,6	0,4
2013					0,7	0,4
2014						0,5
GDP growth * (year on year)	1,0	-1,3	-2,1	2,0	0,7	-0,9

\* The year-on-year GDP growth shown here corresponds to the latest national accounts known at the time when the estimate is made, i.e. Q4 for the preceding year for the European Commission's Spring estimate. These figures are calculated with the GDP as is known at the time, i.e. with the version available at the beginning of the month of April for each year.

Sources: European Commission, Eurostat.

The effect of current growth on the estimation of growth potential by the European Commission is thus obvious. This results in a high variability of the growth potential and therefore significant revisions of the output gap, which affects economic policy decisions since the structural balance depends on this evaluation.

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## Manic-depressive austerity: let's talk about it!

By [Christophe Blot](#), [Jérôme Creel](#), and [Xavier Timbeau](#)

*Following discussions with our colleagues from the European Commission [\[1\]](#), we return to the causes of the prolonged*

*period of recession experienced by the euro zone since 2009. We continue to believe that premature fiscal austerity has been a major political error and that an alternative policy would have been possible. The economists of the European Commission for their part continue to argue that there was no alternative to the strategy they advocated. It is worth examining these conflicting opinions.*

In the [iAGS 2014](#) report (as well as in the [iAGS 2013](#) report and in [various OFCE publications](#)), we have developed the analysis that the stiff fiscal austerity measures taken since 2010 have prolonged the recession and contributed to the rise in unemployment in the euro zone countries, and are now exposing us to the risk of deflation and increased poverty.

Fiscal austerity, which started in 2010 (mainly in Spain, Greece, Ireland and Portugal, with a fiscal impulse [\[2\]](#) for the euro zone of -0.3 GDP point that year), and then was intensified and generalized in 2011 (a fiscal stimulus of -1.2 GDP point across the euro zone, see table), and then reinforced in 2012 (-1.8 GDP point) and continued in 2013 (-0.9 GDP point), is likely to persist in 2014 (-0.4 GDP point). At the level of the euro zone, since the start of the global financial crisis of 2008, and while taking into account the economic recovery plans of 2008 and 2009, the cumulative fiscal impulse boils down to a restrictive policy of 2.6 GDP points. Because the fiscal multipliers are high, this policy explains in (large) part the prolonged recession in the euro zone.

The fiscal multipliers summarize the impact of fiscal policy on activity [\[3\]](#). They depend on the nature of fiscal policy (whether it involves tax increases or spending cuts, distinguishing between transfer, operating and investment expenditure), on the accompanying policies (mainly the ability of monetary policy to lower key rates during the austerity treatment), and on the macroeconomic and financial environment (including unemployment, the fiscal policies enacted by

trading partners, changes in exchange rates and the state of the financial system). In times of crisis, the fiscal multipliers are much higher, *i.e.* at least 1.5 for the multiplier of transfer spending, compared with near 0 in the long-term during normal times. The reason is relatively simple: in times of crisis, the paralysis of the banking sector and its inability to provide the credit economic agents need to cope with the decline in their revenues or the deterioration in their balance sheets requires the latter to respect their budget constraints, which are no longer intertemporal but instantaneous. The impossibility of generalizing negative nominal interest rates (the well-known “zero lower bound”) prevents central banks from stimulating the economy by further cuts in interest rates, which increases the multiplier effect during a period of austerity.

**Table. Fiscal impulses in the euro area**

In GDP points

	2010	2011	2012	2013	2014
DEU	1,3	-1,1	-1,2	0,2	0,1
FRA	-0,5	-1,8	-1,2	-1,4	-0,7
ITA	-0,7	-0,4	-3,0	-1,5	-0,6
ESP	-1,4	-1,3	-3,4	-1,6	-1,0
NLD	-1,1	-0,5	-1,4	-1,5	-1,0
BEL	-0,1	0,1	-0,6	-1,0	-0,5
IRL	-4,2	-1,5	-2,0	-1,7	-1,7
PRT	-0,3	-3,7	-3,9	-1,5	-1,5
GRC	-7,6	-5,5	-3,9	-3,3	-1,7
AUT	0,5	-1,4	-0,3	-0,9	-0,4
FIN	1,3	-0,7	-0,3	-1,4	-0,3
EA (11)	-0,3	-1,2	-1,8	-0,9	-0,4

Sources: Eurostat, National accounts.

If the fiscal multipliers are higher in times of crisis, then a rational reduction in the public debt implies the postponement of restrictive fiscal policies. We must first get out of the situation that is causing the increase in the multiplier, and once we are back into a “normal” situation then reduce the public debt through tighter fiscal policy. This is especially important as the reduction in activity induced by tightening fiscal policy may outweigh the fiscal



effort. For a multiplier higher than 2, the budget deficit and public debt, instead of falling, could continue to grow, despite austerity. The case of Greece is instructive in this respect: despite *real* tax hikes and *real* spending cuts, and despite a partial restructuring of its public debt, the Greek government is facing a public debt that is not decreasing at the pace of the budgetary efforts – far from it. The “fault” lies in the steep fall in GDP. The debate on the value of the multiplier is old but took on new life at the beginning of the crisis.[\[4\]](#) It received a lot of publicity at the end of 2012 and in early 2013, when the IMF (through the voice of [O. Blanchard and D. Leigh](#)) challenged the European Commission and demonstrated that these two institutions had, since 2008, systematically underestimated the impact of austerity on the euro zone countries. The European Commission recommended remedies that failed to work and then with each setback called for strengthening them. This is why the fiscal policies pursued in the euro zone reflected a considerable error of judgment and are the main cause of the prolonged recession we are experiencing. The magnitude of this error can be estimated at almost 3 percentage points of GDP for 2013 (or almost 3 points of unemployment): If austerity had been postponed until more favourable times, we would have reached the same ratio of debt-to-GDP by the deadline imposed by treaty (in 2032), but with the benefit of additional economic activity. The cost of austerity since 2011 is thus almost 500 billion euros (the total of what was lost in 2011, 2012 and 2013). The nearly 3 additional points of unemployment in the euro zone are now exposing us to the risk of deflation, which will be very difficult to avoid.

Although the European Commission follows these debates on the value of the multiplier, it (and to some extent the IMF) developed another analysis to justify its choice of economic policy in the euro zone. This analysis holds that the fiscal multipliers are *negative* in times of crisis *for the euro zone*, and for the euro zone alone. Based on this analysis, austerity

should *reduce* unemployment. To arrive at what seems to be a paradox, we must accept a particular counterfactual (what would have happened if we had not implemented austerity policies). For example, in the case of Spain, without an immediate fiscal effort, the financial markets would have threatened to stop lending to finance the Spanish public debt. The rise in interest rates charged by the financial markets to Spain would have pushed its government into brutal fiscal restraint, the banking sector would not have survived the collapse of the value of Spain's sovereign notes, and the increased cost of credit due to the fragmentation of the financial markets in Europe would have led to a crisis that spiralled way beyond what the country actually experienced. In this analytical model, the austerity recommended is not the result of dogmatic blindness but an acknowledgement of a lack of choice. There was no other solution, and in any case, delaying austerity was not a credible option.

Accepting the European Commission's counterfactual amounts to accepting the idea that the fiscal multipliers are negative. It also means accepting the notion that finance dominates the economy, or at least that judgments on the sustainability of the public debt must be entrusted to the financial markets. According to this counterfactual, quick straightforward austerity would regain the confidence of the markets and would therefore avoid a deep depression. Compared to a situation of postponed austerity, the recession induced by the early straightforward budget cuts should lead to less unemployment and more activity. This counterfactual thesis was raised against us in a seminar held to discuss the iAGS 2014 report organized by the European Commission (DGECFIN) on 23 January 2014. Simulations presented on this occasion illustrated these remarks and concluded that the austerity policy pursued had been beneficial for the euro zone, thereby justifying the policy *a posteriori*. The efforts undertaken put an end to the sovereign debt crisis in the euro zone, a prerequisite for hoping one day to

get out of the depression that began in 2008.

In the [iAGS 2014](#) report, publically released in November 2013, we responded (in advance) to this objection based on a very different analysis: massive austerity did not lead to an end to the recession, contrary to what had been anticipated by the European Commission following its various forecasting exercises. The announcement of austerity measures in 2009, their implementation in 2010 and their reinforcement in 2011 never convinced the financial markets and failed to prevent Spain and Italy from having to face higher and higher sovereign rates. Greece, which went through an unprecedented fiscal tightening, plunged its economy into a deeper depression than the Great Depression, without reassuring anyone. Like the rest of the informed observers, the financial market understood clearly that this drastic remedy would wind up killing the patient *before* any cure. The continuation of high government deficits is due largely to a collapse in activity. Faced with debt that was out of control, the financial markets panicked and raised interest charges, further contributing to the collapse.

The solution is not to advocate more austerity, but to break the link between the deterioration in the fiscal situation and the rise in sovereign interest rates. Savers need to be reassured that there will be no default and that the state is credible for the repayment of its debt. If that means deferring repayment of the debt until later, and if it is credible for the State to postpone, then postponement is the best option.

Crucial to ensuring this credibility were the intervention of the European Central Bank during the summer of 2012, the initiation of the project for a banking union, and the announcement of unlimited intervention by the ECB through Outright Monetary Transactions ([Creel and Timbeau \(2012\)](#)), which are conditional upon a programme of fiscal stabilization. These elements convinced the markets almost

immediately, despite some institutional uncertainty (particularly concerning the banking union and the state of Spain's banks, and the judgment of Germany's Constitutional Court on the European arrangements), and even though OMT is an option that has never been implemented (in particular, what is meant by a programme to stabilize the public finances conditioning ECB intervention). Furthermore, in 2013 the European Commission negotiated a postponement of fiscal adjustment with certain Member States ([Cochard and Schweisguth \(2013\)](#)). This first tentative step towards the solutions proposed in the two IAGS reports gained the approval of the financial markets in the form of a relaxation of sovereign spreads in the euro zone.

Contrary to our analysis, the counterfactual envisaged by the European Commission, which denies the possibility of an alternative, assumes an unchanged institutional framework [\[5\]](#). Why pretend that the macroeconomic strategy should be strictly conditioned on institutional constraints? If institutional compromises are needed in order to improve the orientation of economic policies and ultimately to achieve a better result in terms of employment and growth, then this strategy must be followed. Since the Commission does not question the rules of the game in political terms, it can only submit to the imperatives of austerity. This form of apolitical stubbornness was an error, and in the absence of the ECB's "political" step, the Commission was leading us into an impasse. The implicit pooling of the public debt embodied in the ECB's commitment to take all the measures necessary to support the euro (the "Draghi put") changed the relationship between the public debt and sovereign interest rates for every country in the euro zone. It is always possible to say that the ECB would never have made this commitment if the countries had not undertaken their forced march towards consolidation. But such an argument does not preclude discussing the price to be paid in order to achieve the institutional compromise. The fiscal multipliers are clearly (and strongly) positive, and it would

have been good policy to defer austerity. There was an alternative, and the policy pursued was a mistake. It is perhaps the magnitude of this error that makes it difficult to recognize.

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[1] We would like to thank Marco Buti for his invitation to present the iAGS 2014 report and for his suggestions, and also Emmanuelle Maincent, Alessandro Turrini and Jan in't Veld for their comments.

[2] The fiscal impulse measures the restrictive or expansionary orientation of fiscal policy. It is calculated as the change in the primary structural balance.

[3] For example, for a multiplier of 1.5, tightening the budget by 1 billion euros would reduce activity by 1.5 billion euros.

[4] See [Heyer \(2012\)](#) for a recent review of the literature.

[5] The institutional framework is here understood broadly. It refers not only to the institutions in charge of economic policy decisions but also to the rules adopted by these institutions. The OMT is an example of a rule change adopted by an institution. Strengthening the fiscal rules is another element of a changing institutional framework.

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## **The euro zone quartered**

By [Céline Antonin](#), [Christophe Blot](#), Sabine Le Bayon and Danielle Schweisguth

*This text summarizes the [OFCE's 2013-2014 forecast for the euro zone economy](#).*

After six quarters of decline, GDP in the euro zone has started to grow again in the second quarter of 2013. This upturn in activity is a positive signal that is also being corroborated by business surveys. It shows that the euro zone is no longer sinking into the depths of depression. It would nevertheless be premature to conclude that a recovery is underway, as the level of quarterly growth (0.3%) is insufficient to cause any significant reduction in unemployment. In October 2013, the unemployment rate stabilized at 12% of the workforce, a record high. Above all, the crisis is leaving scars and creating new imbalances (unemployment, job insecurity and wage deflation) that will act as obstacles to future growth, especially in certain euro zone countries.

Several factors point towards a pick-up in economic activity that can be expected to continue over the coming quarters. Long-term sovereign interest rates have fallen, particularly in Spain and Italy. This reflects that the threat of a breakup of the euro zone is fading, which is due in part to the conditional support announced by the ECB a little over a year ago (see [Friends of acronyms: here comes the OMT](#)). Above all, there should be an easing of fiscal austerity, given that the European Commission has granted additional time to several countries, including France, Spain and the Netherlands, to deal with their budget deficits (see [here](#) for a summary of the recommendations made by the European Commission). Driven by the same mechanisms that we have already described in our previous forecasts, a little higher growth should follow this easing of austerity (-0.4 GDP point of fiscal effort in 2013, down from -0.9 point in 2013 and -1.8 in 2012). After two years of recession in 2012 and 2013, growth is expected to come to 1.1% in 2014.

Nevertheless, this growth will not be sufficient to erase the

traces left by the widespread austerity measures implemented since 2011, which pushed the euro zone into a new recession. In particular, employment prospects are improving only very slowly because growth is too weak. Since 2008, the euro zone has destroyed 5.5 million jobs, and we do not expect a strong recovery in net job creation. Unemployment could fall in some countries, but this would be due mainly to discouraged jobseekers withdrawing from the workforce. At the same time, less austerity does not mean that there will be no austerity. With the exception of Germany, fiscal consolidation efforts will continue in all the euro zone countries. And whether this is achieved through a reduction in public spending or an increase in the tax burden, households will bear the brunt of the adjustment. At the same time, the persistence of mass unemployment will continue to fuel the deflationary pressures already at work in Spain and Greece. The improved competitiveness that results in these countries will boost exports, but at the expense of increasingly undermining domestic demand. The impoverishment of the countries of southern Europe is going to be aggravated. Growth in these countries in 2014 will again be lower than in Germany, Austria, Finland and France (Table).

As a consequence, the euro zone will be marked by increasing heterogeneity, which could wind up solidifying public opinion in different countries against the European project and making the governance of the monetary union more difficult as national interests diverge.



Table. Growth in the euro zone

In %

	2013				2014				2012	2013	2014
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4			
DEU	0,0	0,7	0,2	0,3	0,3	0,4	0,4	0,4	0,9	0,9	1,5
FRA	-0,2	0,5	0,0	0,2	0,3	0,4	0,4	0,4	0,0	0,1	1,3
ITA	-0,6	-0,3	0,0	0,1	0,1	0,2	0,2	0,2	-2,4	-1,8	0,4
ESP	-0,4	-0,1	0,0	0,0	0,2	0,3	0,3	0,3	-1,6	-1,4	0,7
NLD	-0,4	-0,2	0,3	0,3	0,3	0,3	0,4	0,4	-1,3	-1,1	1,1
BEL	0,0	0,2	0,2	0,4	0,4	0,4	0,6	0,6	0,3	0,1	1,6
IRL	-0,6	0,4	0,2	0,3	0,4	0,4	0,4	0,4	0,1	-0,5	1,4
PRT	-0,4	1,1	0,0	0,2	0,2	0,3	0,3	0,3	-3,2	-1,7	1,0
GRC	1,1	9,6	0,5	-1,1	-3,9	1,2	1,3	1,5	-6,4	-4,1	-0,4
AUT	0,1	0,1	0,3	0,3	0,4	0,4	0,4	0,4	0,6	0,4	1,3
FIN	-0,2	0,2	0,3	0,4	0,4	0,5	0,5	0,5	-0,8	-0,9	1,7
EUZ	-0,2	0,3	0,1	0,2	0,3	0,4	0,4	0,4	-0,6	-0,3	1,1

Sources : Eurostat, OFCE calculations and forecasts, October 2013.

# Is the euro area out of recession?

By [Philippe Weil](#)

At its meeting on October 9<sup>th</sup>, the [Euro Area Business Cycle Dating Committee](#) of the [Centre for Economic Policy Research](#) (CEPR) in London drew on the OFCE for this thorny issue (for the composition of this committee, which I chair, see [here](#)). The Committee's mission is to establish a chronology of recessions and expansions in the euro area, similar to what the National Bureau of Economic Research has done for the United States, [dating back to 1854](#).

This chronology is valuable in two ways.

The first is that it allows economists to examine the characteristics of Europe's economic development. Do

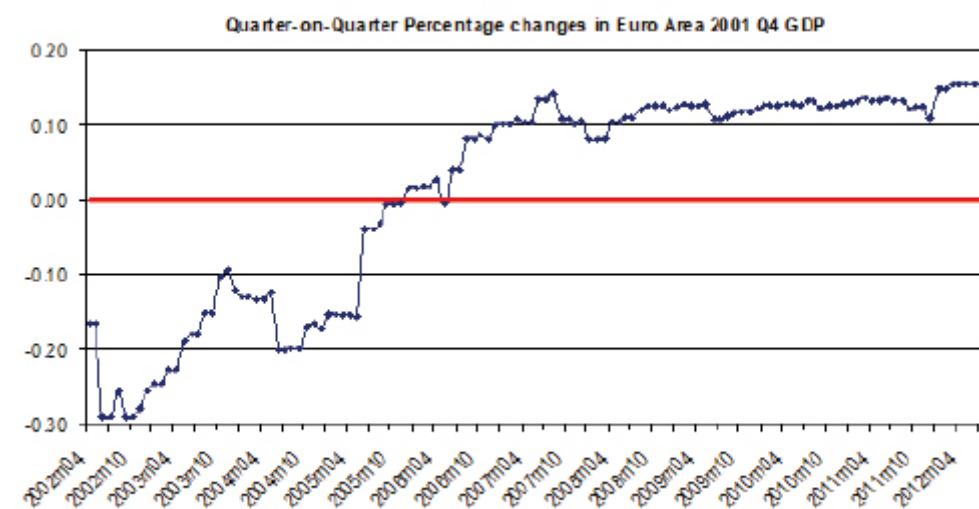
recessions tend to be short or long-lasting? Frequent or rare? Deep or mild? Is the euro area evolving in concert with the US economy? Is the slowdown in economic activity caused by the financial crisis unusual (more persistent than usual, sharper)? Without a clear definition of the timing of the ups and downs in Europe's economic activity and without a sketch of cyclical fluctuations, we cannot provide answers to these relatively basic questions.

The second advantage of this chronology is that establishing it requires an examination of all aspects of economic activity: GDP, of course, but also consumption, investment and especially employment (number of employed persons, number of hours worked). According to the CEPR's dating exercise, an expansion is a period in which every aspect of economic activity is growing significantly. It is not necessarily an episode of at least two consecutive quarters of GDP growth (much less one quarter!). For example, the CEPR Dating Committee has determined that the countries composing the future euro area were in recession during [the period from the 3<sup>rd</sup> quarter of 1980 to the 3<sup>rd</sup> quarter of 1982](#), whereas real GDP had risen for several quarters during this time and it was higher at the end of the recession than at the beginning! The culprits were investment and employment, which fell sharply during this period.

To add to the complexity of the dating effort, the harsh reality of the world of economic statistics should not be forgotten: the statistics reach us late and are subsequently revised, sometimes significantly, over time. Unlike meteorologists who know the temperature at the top of the Eiffel Tower in real time, economists have no idea, for example, of the level of GDP for the current month or quarter. The first estimates are released only several months later (e.g. the first flash estimate of euro area GDP for the third quarter of 2013 will be published by Eurostat only on 14 November 2013), and it might turn out that growth rates that

seem positive based on preliminary estimates wind up after subsequent revisions to be negative – or vice versa. By examining all the determinants of economic activity (including employment), and not just GDP, the Committee is guarding against (so far successfully) the imperfections in this data so as to avoid, for instance, declaring the existence of a recession which turns out to be a statistical mirage that disappears after further review of the data. Thus, the Committee did not report [in September 2003](#) the existence of a recession between 2001 and 2003 even though the data showed a decrease in GDP during that time (but never, it is true, for two consecutive quarters). It concluded that there had been a prolonged pause during a period of expansion. This was a good move, as subsequent revisions of GDP cancelled these quarters of declining economic activity (see Figure 1). Its diagnosis was thus well advised.

**Figure 1. Quarter-on-quarter Percentage Changes In the Euro Area 2001 Q4 GDP (relative to the previous quarter)**

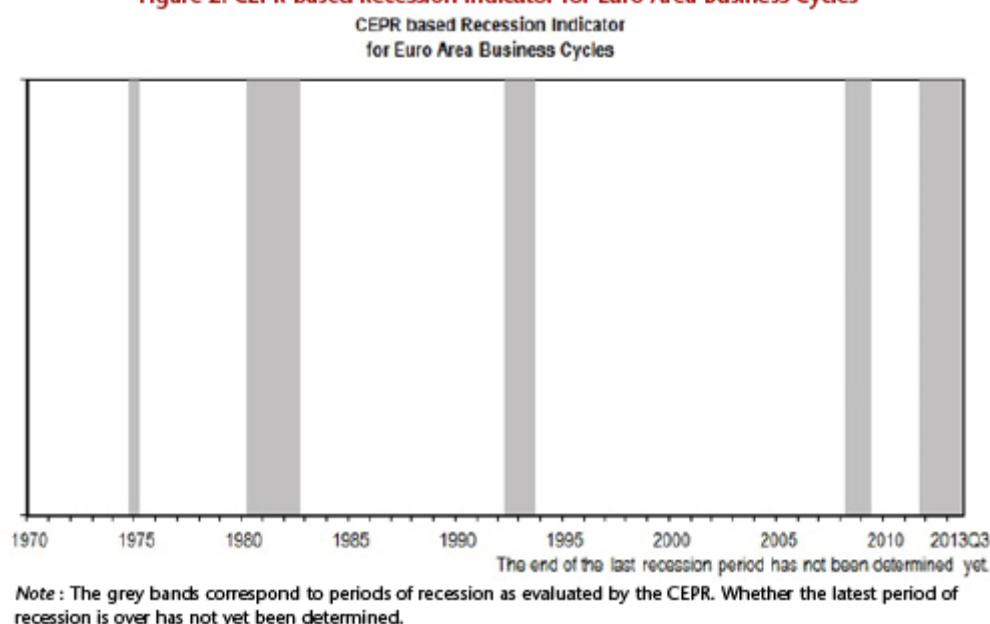


Source : ECB Monthly Bulletin.

So let's get back to the euro area in the state we see it in October 2013. The area hit a [peak in economic activity in the 3<sup>rd</sup> quarter of 2011](#) and, since going into recession at that time, it experienced quarterly growth that was slightly positive in the second quarter of 2013. The first estimate for the third quarter of 2013 will not be known, as mentioned earlier, until 14 November. There are, it is true, several corresponding indexes indicating that the cycle is in an upwards phase and that the macroeconomic outlook for 2014 is more favourable. But [on 9 October](#) the Dating

Committee noted, nevertheless, that it would be premature at that time to conclude that the euro area was out of recession. Indeed, neither the length nor the strength of the putative recovery in economic activity was sufficient to conclude that the recession was already over. This judgment was not based on the absence at that point of two consecutive quarters of GDP growth because this is not the criterion that (mechanically) guides the Committee's thinking. Nor does it reflect any pessimism about the economic outlook for 2014, because the Committee is not in the business of making predictions. The Committee's assessment is based simply on a review of all the data available at the time it meets. The Committee has not excluded that the euro area is simply going through a pause in the recession it entered a year ago.

**Figure 2. CEPR-based Recession Indicator for Euro Area Business Cycles**



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# Shocks, unemployment and adjustment – the limits of the European union

By [Christophe Blot](#)

In an article published in 2013 in *Open Economies Review* [\[1\]](#),

C. A. E. Goodhart and D. J. Lee compare the mechanisms for recovering from the crisis in the United States and Europe. Based on a comparison of the situation of three states (Arizona, Spain and Latvia) faced with a property crash and recession, the authors explore the reasons for the growing divergence observed among the euro zone countries, a divergence that is not found in the United States. Their analysis is based on the criteria for optimum currency areas, which enable the members of a monetary union to adjust to adverse shocks and to avoid a lasting difference in their unemployment rates during an economic slowdown or downturn. While Latvia is not formally part of a monetary union [\[2\]](#), its currency nevertheless has remained firmly anchored to the euro during the crisis. Thus none of the countries studied by Goodhart and Lee resorted to a nominal devaluation to absorb the financial and real shocks that they faced. The authors conclude that while Arizona dealt with the shocks better than Spain, this was due both to the greater fiscal solidarity that exists between the states of the United States and to the greater integration of the US banking system, which helps to absorb shocks specific to each state.

In addition to *de jure* or *de facto* membership in a monetary union, Arizona, Spain and Latvia also all went through a real estate boom in the 2000s, followed by a correction that began in 2006 in Arizona and Latvia, and a year later in Spain (Figure 1). The real estate crisis was accompanied by a recession, with the same time lag persisting between Spain and the other two states. Latvia recorded the sharpest downturn in activity (-21% between 2007 and 2010). However, the downturns experienced by Arizona (-5.5% since 2007) and Spain (5% since 2008) were comparable. While the downward adjustment of the property market stopped in Arizona (recovery is underway in the US state), the recession is continuing in Spain. Overall, this difference in adjustment is reflected in a continuing increase in unemployment in Spain, whereas it has fallen by 2.8 percentage points in Arizona from the peak in the first

quarter of 2010 (Figure 2).

Spain's inability to pull out of the recession along with the increasing divergence of the economies in the euro zone raises the question of the capacity of the euro zone countries to adjust to a negative shock. The theory of optimum currency areas, originally developed by Mundell in 1961 [3], can help to evaluate the conditions in which a country may have an interest in joining a monetary union. The optimality of this choice depends on the country's ability to absorb shocks without resorting to currency devaluation. Different adjustment mechanisms are involved. These consist mainly of the following: [4] the flexibility of prices and in particular of wages; labour mobility; the existence of fiscal transfers between the countries in the monetary union; and financial integration. Price flexibility corresponds to an internal devaluation mechanism. As for depreciation, the point is to become more competitive – by lowering relative labour costs – to stimulate exports and growth during a negative shock. However, this type of adjustment generally takes much longer and is more costly, as is suggested by the recent examples of Iceland and Ireland. [5] Labour mobility makes for an adjustment whenever the recession leads people to migrate from a state with high unemployment to one where it is lower. The implementation of fiscal transfers occurs when various mechanisms in states where growth is slowing make it possible to benefit from stabilizing transfers from other states in the union or from a higher level of government. Finally, Goodhart and Lee also consider the stabilizing role of the local banking system. In this case, in the euro zone, the less the local banking system has been weakened by the real estate crisis or the public debt crisis, the greater is its capacity to absorb the shock.

The authors analyzed the adjustment of the economies in question in the light of these four criteria. They studied in particular the degree of price flexibility and labour mobility

as a function of unemployment in the three states. Then they evaluated the importance of fiscal transfers and the architecture of the banking landscape. Their findings were as follows:

1. Price flexibility has played only a marginal role in adjustment, except in Latvia where rising unemployment has led to a decline in unit labor costs. These costs did not on the other hand react significantly to the rise in unemployment in Spain and Arizona.
2. Though migration is more marked in the United States than in Europe, the differences are still not able to explain the gap in the adjustment of unemployment rates. However, it appears that the role of migration as an adjustment mechanism has strengthened in Europe. Nevertheless, this is still insufficient to ensure the convergence of unemployment rates.
3. In 2009 and 2010, Arizona received substantial transfers from the federal government, whereas at the European level there is no automatic mechanism for transfers between states. Even so, Latvia received assistance from the IMF in 2009, while the euro zone countries came to the aid of Spain's banks. Nevertheless, in the absence of a more substantial EU budget, the European countries can benefit only from emergency assistance, which, while able to meet a specific need for funds, is not sufficient to play the role of an economic stabilizer.
4. Finally, the authors emphasize that the financial amplification of the shocks was on a lesser scale in Arizona in so far as the bulk of the banking business is conducted by national banks that are consequently less sensitive to local macroeconomic and financial conditions. The risk of credit rationing is thus lessened, which helps to better absorb the initial shock. In Spain, with the exception of a few banks with international operations, which enables them to diversify their risks, banking depends on local banks,

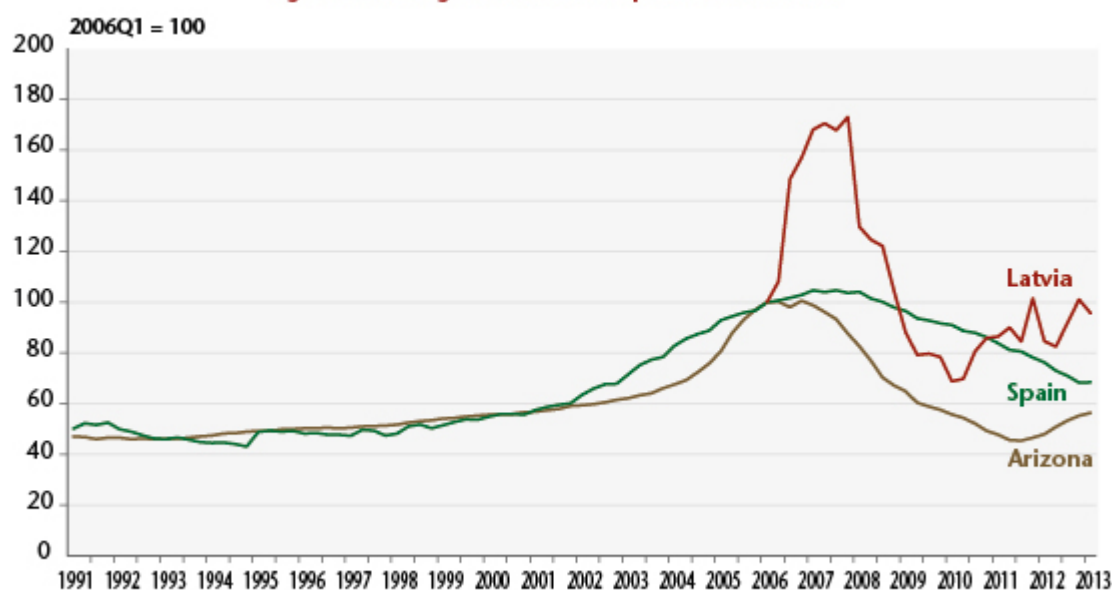


which are therefore more vulnerable. This increased fragility pushes the banks to restrict access to credit, which reinforces the initial shock. Latvia is in an alternative position in that its financial activity is carried out mainly by foreign banks. The nature of risk thus differs, because local financial activity is disconnected from Latvia's macroeconomic situation and depends instead on the situation in the country where these banks conduct their principal activity (*i.e.* Sweden, to a great extent).

The crisis in the euro zone thus has an institutional dimension. From the moment the countries freely consented to surrender their monetary sovereignty, they in effect also abandoned the use of a currency devaluation to cushion recessions. However, it is essential that alternative adjustment mechanisms are operative in order to ensure the "sustainability" of monetary unification. In this respect, the article written by Goodhart and Lee is a reminder that such mechanisms are still lacking in the euro zone. Negotiations over the EU budget have not offered any prospect for the implementation of fiscal transfers to stabilize shocks at the European level. The discussion on Eurobonds has stalled. Although the European Stability Mechanism (ESM) acts as a tool for solidarity between Member States, it meets a different need, because it involves only emergency financial assistance and is not a mechanism for automatic stabilization. Banking integration could also help dampen fluctuations. However, the crisis has led to greater fragmentation of European banking markets. The latest report on financial integration in Europe, published by the ECB, shows a 30% decrease in cross-border bank flows in the recent period. Similarly, despite the common monetary policy, the interest rates charged by European banks have recently diverged [\[6\]](#) (Figure 3). Thus, despite the European banking passport created by the European Directive of 15 December 1989 on the mutual recognition of authorizations of credit institutions, cross-border banking in Europe is

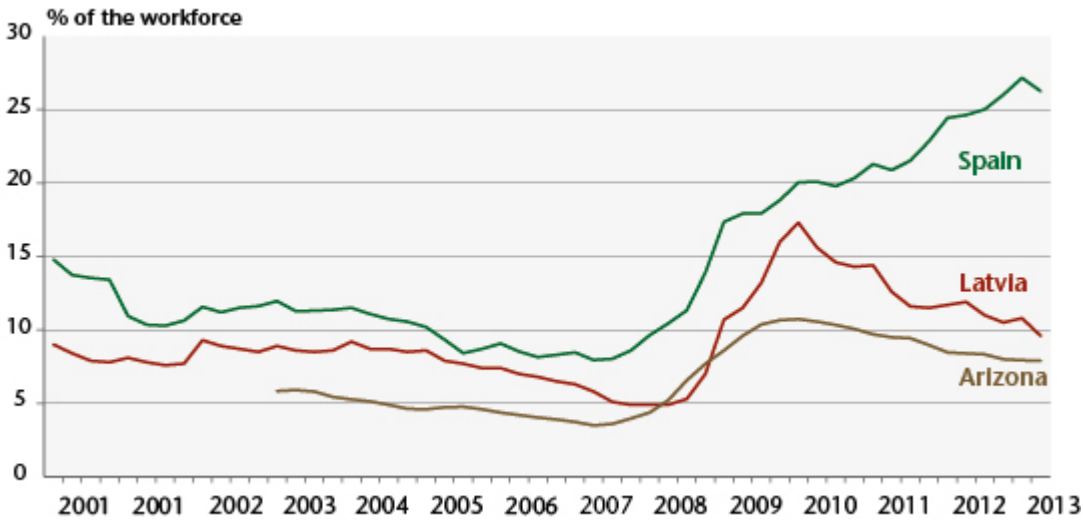
still relatively undeveloped. The retail banking model is based on the existence of long-term relationships between the bank and its clients, which undoubtedly explains why the integration process is taking much longer than for the stocks, bonds and currency markets. It is nevertheless still the case that a banking union could be a further step in this difficult process of integration. This would promote the development of transnational activity, which would also help to de-link the problem of bank solvency and liquidity from the problem of financing the public debt.

**Figure 1 : Changes in real estate prices in real terms**



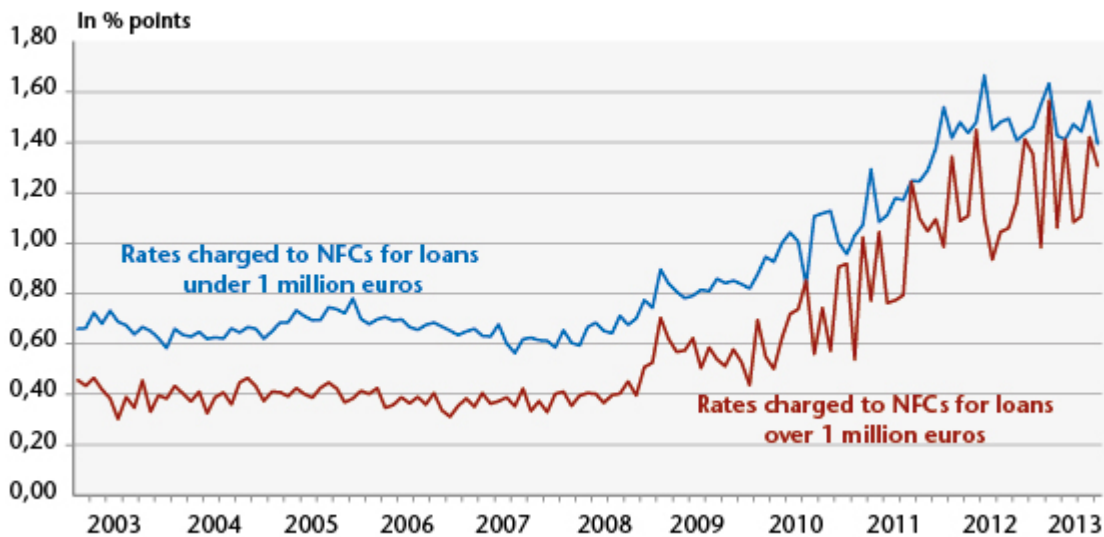
Source : Bank of International Settlements, Federal Housing Finance Agency.

Figure 2 : Unemployment rates



Sources : Bureau of Labor Statistics, Instituto Nacional de Estadísticas, Agence nationale pour l'emploi (Latvia).

Figure 3 : Dispersion of rates charged by banks in the euro zone



Source : European Central Bank. NFC = Non-financial corporation.

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[1] "Adjustment mechanisms in a currency area", *Open Economies Review*, January 2013. A preliminary version of this article can be downloaded at: <http://www.lse.ac.uk/fmg/workingPapers/specialPapers/PDF/SP212.pdf>

[2] Latvia has been part of the European currency mechanism since 2005 and is to adopt the euro on 1 January 2014.

[3] “A theory of optimum currency areas”, *American Economic Review*, vol. 51, 1961.

[4] One could also add the level of an economy’s openness or the degree of diversification of production. Mongelli (2002) offers a detailed review of these various criteria. See: [“New views on the optimum currency area theory: what is EMU telling us?”](#), *ECB Working Paper*, no. 138.

[5] See [Blot and Antonin \(2013\)](#) for a comparative analysis of the cases of Ireland and Iceland.

[6] C. Blot and F. Labondance (2013) offer an analysis of the transmission of currency policy to the rates charged by the banks to non-financial companies ([see here](#)) and to real estate loans ([see here](#)).

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# Does too much finance kill growth?

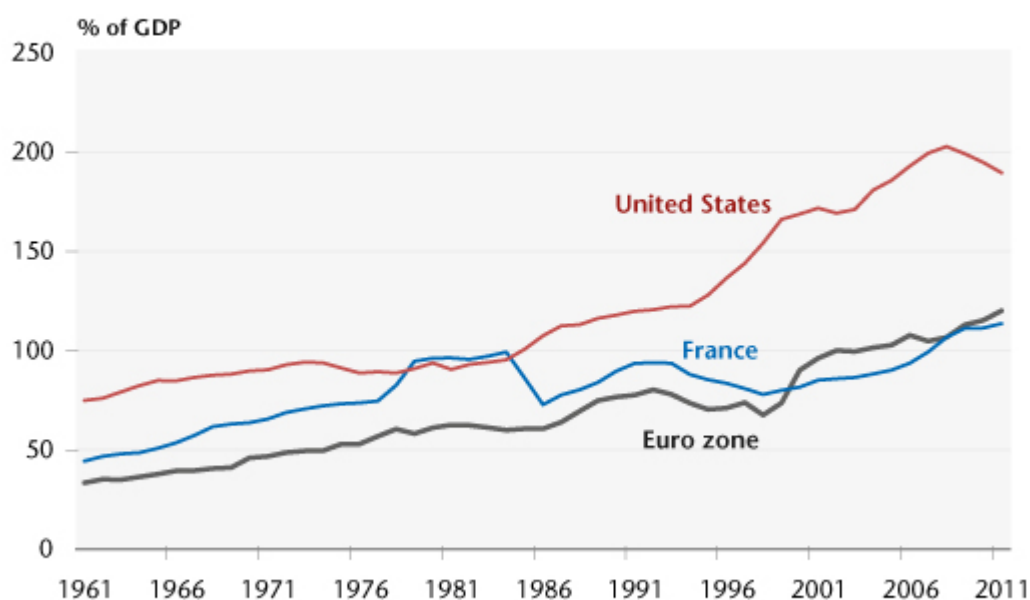
By [Jérôme Creel](#), [Paul Hubert](#) and Fabien Labondance

Is there an optimal level of financialization in an economy? An [IMF](#) working paper written by Arcand, Berkes and Panizza (2012) focuses on this issue and attempts to assess this level empirically. The paper highlights the negative effects caused by excessive financialization.

Financialization refers to the role played by financial services in an economy, and therefore the level of indebtedness of economic agents. The indicator of the level of financialization is conventionally measured by calculating the ratio of private sector credit to GDP. Until the early 2000s,

this indicator took into account only the loans granted by deposit banks, but the development of shadow banking ([Bakk-Simon et al., 2012](#)) has been based on the credit granted by all financial institutions. This indicator helps us to understand financial intermediation ([Beck et al., 1999](#)) [1]. The graph below shows how financialization has evolved in the euro zone, France and the United States since the 1960s. The level has more than doubled in these three economies. Before the outbreak of the subprime crisis in the summer of 2007, loans to the private sector exceeded 100% of GDP in the euro zone and 200% in the United States.

**Figure. Credit granted to the private sector by banks and other financial institutions**



Source : World Bank.

Arcand, Berkes and Panizza (2012) examined the extent to which the increasingly predominant role played by finance has an impact on economic growth. To understand the importance of this paper, it is useful to recall the existing differences in the findings of the empirical literature. On the one hand, until recently the most prolific literature highlighted a positive causal relationship between financial development and economic growth ([Rajan and Zingales, 1998](#), and [Levine, 2005](#)): the financial sector acts as a lubricant for the economy, ensuring a smoother allocation of resources and the emergence

of innovative firms. These lessons were derived from models of growth (especially endogenous) and have been confirmed by international comparisons, in particular with regard to developing countries with small financial sectors.

Some more skeptical authors believe that the link between finance and economic growth is exaggerated ([Rodrik and Subramanian, 2009](#)). [De Gregorio and Guidotti \(1995\)](#) argue that the link is tenuous or even non-existent in the developed countries and suggest that once a certain level of economic wealth has been reached, the financial sector makes only a marginal contribution to the efficiency of investment. It abandons its role as a facilitator of economic growth in order to focus on its own growth ([Beck, 2012](#)). This generates major banking and financial groups that are “too big to fail”, enabling these entities to take excessive risks since they know they are covered by the public authorities. Their fragility is then rapidly transmitted to other corporations and to the economy as a whole. The subprime crisis clearly showed the power and magnitude of the effects of correlation and contagion.

In an attempt to reconcile these two schools of thought, a nonlinear relationship between financialization and economic growth has been posited by a number of studies, including in particular the Arcand, Berkes and Panizza (2012) study. Using a dynamic panel methodology, they explain per capita GDP growth by means of the usual variables of endogenous growth theory (*i.e.* the initial GDP per capita, the accumulation of human capital over the average years of education, government spending, trade openness and inflation) and then add to their model credit to the private sector and the square of this same variable in order to take account of potential non-linearity. They are thus able to show that:

1. The relationship between economic growth and private sector credit is positive;
2. The relationship between economic growth and the square

of private sector credit (that is to say, the effect of credit to the private sector when it is at a high level) is negative;

3. Taken together, these two factors indicate a concave relationship – a bell curve – between economic growth and credit to the private sector.

The relationship between finance and growth is thus positive up to a certain level of financialization, and beyond this threshold the effects of financialization gradually start to become negative. According to the different specifications estimated by Arcand, Berkes and Panizza (2012), this threshold (as a percentage of GDP) lies between 80% and 100% of the level of loans to the private sector. [2]

While the level of financialization in the developed economies is above these thresholds, these conclusions point to the marginal gain in efficiency that financialization can have on an economy and the need to control its development. Furthermore, the argument of various banking lobbies, *i.e.* that regulating the size and growth of the financial sector would negatively impact the growth of the economies in question, is not supported by the data in the case of the developed countries.

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[1] While this indicator may seem succinct as it does not take account of disintermediation, its use is justified by its availability at international level, which allows comparisons. Furthermore, more extensive lessons could be drawn with a protean indicator of financialization.

[2] [Cecchetti and Kharroubi \(2012\)](#) clarify that these thresholds should not be viewed as targets, but more like “extrema” that should be reached only in times of crisis. In “normal” times, it would be better that debt levels are lower

so as to give the economies some maneuvering room in times of crisis.

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## Competitiveness: danger zone!

By [Céline Antonin](#), [Christophe Blot](#), Sabine Le Bayon and [Catherine Mathieu](#)

The crisis affecting the euro zone is the result of macroeconomic and financial imbalances that developed during the 2000s. The European economies that have provoked doubt about the sustainability of their public finances (Spain, Portugal, Greece and Italy [\[1\]](#)) are those that ran up the highest current account deficits before the crisis and that saw sharp deteriorations in competitiveness between 2000 and 2007. Over that same period Germany gained competitiveness and built up growing surpluses, to such an extent that it has become a model to be emulated across the euro zone, and especially in the countries of southern Europe. Unit labor costs actually fell in Germany starting in 2003, at a time when moderate wage agreements were being agreed between trade unions and employers and the coalition government led by Gerhard Schröder was implementing a comprehensive programme of structural reform. This programme was designed to make the labour market [\[2\]](#) more flexible and reform the financing of social protection but also to restore competitiveness. The concept of competitiveness is nevertheless complex and reflects a number of factors (integration into the international division of production processes, development of a manufacturing network that boosts network effects and innovation, etc.), which also play an important role.

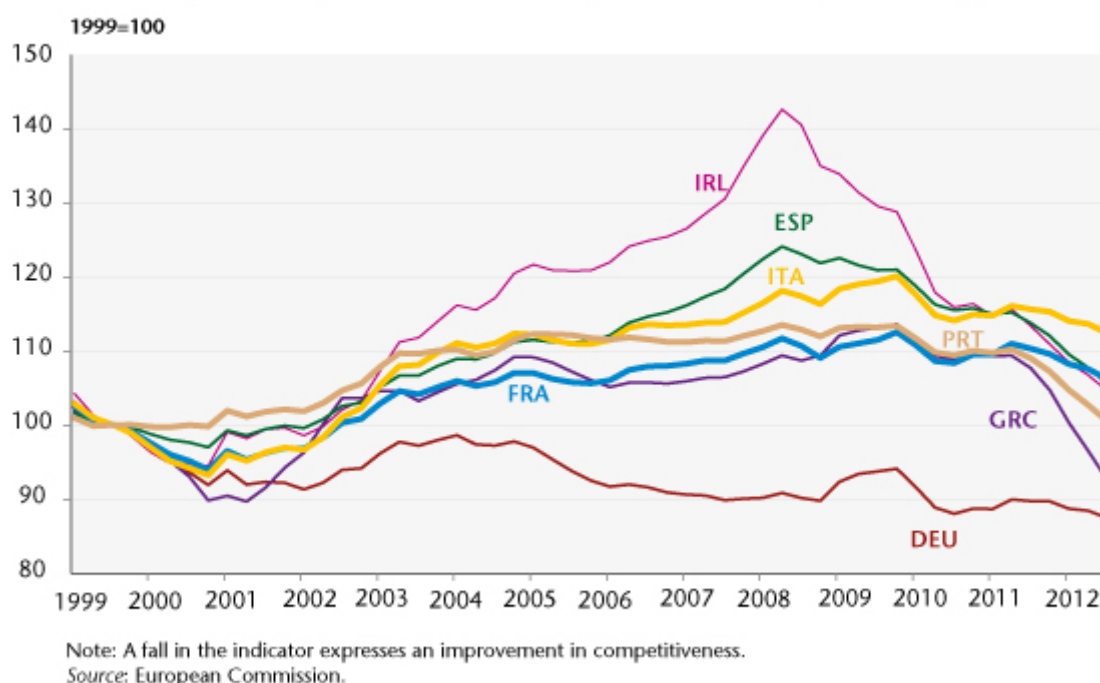


In addition, as is highlighted in a [recent analysis by Eric Heyer](#), Germany's structural reforms were accompanied by a broadly expansionary fiscal policy. Today, the incentive to improve competitiveness, strengthened by the implementation of improved monitoring of macroeconomic imbalances (see [here](#)), is part of a context marked by continued fiscal adjustment and high levels of unemployment. In these conditions, the implementation of structural reforms coupled with a hunt for gains in competitiveness could plunge the entire euro zone into a deflationary situation. In fact, Spain and Greece have already been experiencing deflation, and it is threatening other southern Europe countries, as we show in [our latest forecast](#). This is mainly the result of the deep recession hitting these countries. But the process is also being directly fueled by reductions in public sector wages, as well as in the minimum wage (in the case of Greece). Moreover, some countries have cut unemployment benefits (Greece, Spain, Portugal) and simplified redundancy procedures (Italy, Greece, Portugal). Reducing job protection and simplifying dismissal procedures increases the likelihood of being unemployed. In a context of under-employment and sluggish demand, the result is further downward pressure on wages, thereby increasing the deflationary risks. Furthermore, there has also been an emphasis on decentralizing the wage bargaining process so that they are more in tune with business realities. This is leading to a loss of bargaining power on the part of trade unions and employees, which in turn is likely to strengthen downward pressure on real wages.

The euro zone countries are pursuing a non-cooperative strategy that is generating gains in market share mainly at the expense of other European trading partners. Thus since 2008 or 2009 Greece, Spain, Portugal and Ireland have improved their competitiveness relative to the other industrialized countries (see graph). The continuation of this strategy of reducing labor costs could plunge the euro zone into a deflationary spiral, as the countries losing market share seek

in turn to regain competitiveness by reducing their own labour costs. Indeed, this non-cooperative strategy, initiated by Germany in the 2000s, has already contributed to the crisis in the euro zone (see the box on p.52 of the [ILO report](#) published in 2012). It is of course futile to hope that the continuation of this strategy will provide a solution to the current crisis. On the contrary, new problems will arise, since deflation [\[3\]](#) will make the process of reducing both public and private debt more expensive, since debt expressed in real terms will rise as prices fall: this will keep the euro zone in a state of recession.

Figure 1. Competitiveness measured by unit labour costs (total economy)



[\[1\]](#) The Irish case is somewhat distinct, as the current account deficit seen in 2007 was due not to trade, but a shortfall in income.

[\[2\]](#) These reforms are examined in detail in a report by the Conseil d'analyse économique (no. 102). They are summarized in a special study [La quête de la compétitivité ouvre la voie de la déflation](#) ("The quest for competitiveness opens the door to deflation").

[3] For a more comprehensive view of the dynamics of debt-driven deflation, see [here](#).

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# Monetary policy and property booms: dealing with the heterogeneity of the euro zone

By [Christophe Blot](#) and Fabien Labondance

The transmission of monetary policy to economic activity and inflation takes place through various channels whose role and importance depend largely on the structural characteristics of an economy. The dynamics of credit and property prices are at the heart of this process. There are multiple sources of heterogeneity between the countries of the euro zone, which raises questions about the effectiveness of monetary policy but also about the means to be used to reduce this heterogeneity.

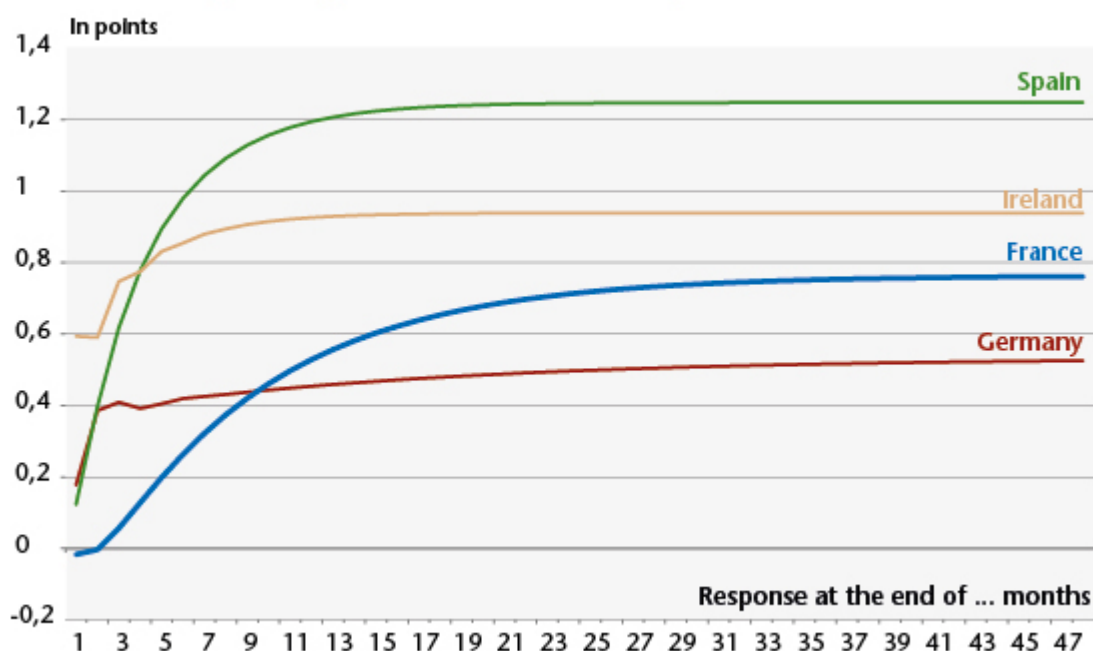
The possible sources of heterogeneity between countries include the degree of concentration of the banking systems (*i.e.* more or fewer banks, and therefore more or less competition), the financing arrangements (*i.e.* fixed or variable rates), the maturity of household loans, their levels of debt, the proportion of households renting, and the costs of transactions on the housing market. The share of floating

rate loans perfectly reflects these heterogeneities, as it is 91% in Spain, 67% in Ireland and 15% in Germany. In these conditions, the common monetary policy of the European Central Bank (ECB) has asymmetric effects on the euro zone countries, as is evidenced by the divergences in property prices in these countries. These asymmetries will then affect GDP growth, a phenomenon that has been observed both “before” and “after” the crisis. These issues are the subject of an article that we published in the OFCE’s [Ville et Logement](#) (Housing and the City) issue. We evaluated heterogeneity in the transmission of monetary policy to property prices in the euro zone by explicitly distinguishing two steps in the transmission channel, with each step potentially reflecting different sources of heterogeneity. The first describes the impact of the interest rates controlled by the ECB on the rates charged for property loans by the banks in each euro zone country. The second step involves the differentiated impact of these bank rates on property prices.

Our results confirm the existence of divergences in the transmission of monetary policy in the euro zone. Thus, for a constant interest rate set by the ECB at 2%, as was the case between 2003 and 2005, the estimates made during the period preceding the crisis suggest that the long-term equilibrium rate applied respectively by Spanish banks and Irish banks would be 3.2% and 3.3%. In comparison, the equivalent rate in Germany would be 4.3%. Moreover, the higher rates in Spain and Ireland amplify this gap in nominal rates. We then show that the impact on bank rates of changes in the ECB’s key rate is, before the crisis, stronger in Spain and Ireland than it is in Germany (figure), which is related to differences in the share of loans made at floating rates in these countries. It should be noted that the transmission of monetary policy was severely disrupted during the crisis. The banks did not necessarily adjust supply and demand for credit by changing rates, but by tightening the conditions for granting loans. [1] Furthermore, estimates of the relationship between the rates charged by

banks and property prices suggest a high degree of heterogeneity within the euro zone. These various findings thus help to explain, at least partially, the divergences seen in property prices within the euro zone. The period during which the rate set by the ECB was low helped fuel the housing boom in Spain and Ireland. The tightening of monetary policy that took place after 2005 would also explain the more rapid adjustment in property prices observed in these two countries. Our estimates also suggest that property prices in these two countries are very sensitive to changes in economic and population growth. Property cycles cannot therefore be reduced to the effect of monetary policy.

**Figure. Impact on bank rates of a 1 point hike in ECB rates**



Source : Authors' calculations.

To the extent that the recent crisis has its roots in the macroeconomic imbalances that developed in the euro zone, it is essential for the proper functioning of the European Union to reduce the sources of heterogeneity between the Member states. However, this is not necessarily the responsibility of monetary policy. First, it is not certain that the instrument of monetary policy, short-term interest rates, is the right tool to curb the development of financial bubbles. And second, the ECB conducts monetary policy for the euro zone as a whole

by setting a single interest rate, which does not permit it to take into account the heterogeneities that characterize the Union. What is needed is to encourage the convergence of the banking and financial systems. In this respect, although the proposed banking union still raises many problems (see [Maylis Avaro and Henri Sterdyniak](#)), it may reduce heterogeneity. Another effective way to reduce asymmetry in the transmission of monetary policy is through the implementation of a centralized supervisory policy that the ECB could oversee. This would make it possible to strengthen the resilience of the financial system by adopting a means of regulating banking credit that could take into account the situation in each country in order to avoid the development of the bubbles that pose a threat to the countries and the stability of the monetary union (see [CAE report no. 96](#) for more details).

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[1] [Kremp and Sevestre \(2012\)](#) emphasize that the reduction in borrowing volumes is not due simply to the rationing of the supply of credit but that the recessionary context has also led to a reduction in demand.