Leave the euro?

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Evaluating the impact of France leaving the euro zone ("Frexit") is tricky, as many channels for doing this exist and the effects are uncertain. However, given that this proposal is being advanced in the more general debate over the costs and benefits of membership in the European Union and the euro, it is useful to discuss and estimate what is involved.

There is little consensus about the many points involved in an analysis of the issue of membership in the euro. On the one hand, the benefits linked to the single currency 18 years after its creation are not viewed as completely obvious; on the other, it is not evident that the monetary zone has become less heterogeneous, and, possibly linked to that, the current account imbalances built up in the first decade of the euro zone's existence, which have grown since then due to the consequences of the 2008 global financial crisis, are putting constraints on economic policy.

The dissolution of Europe's monetary union would be an unprecedented event, not only for the member states but also from the point of view of the history of monetary unions. Not that there have been no experiences of dissolution – Rose (2007) counted 69 cases of withdrawal from a monetary union since the end of the Second World War – but in many respects these experiences offer little if any basis for comparison (Blot & Saraceno, 2014). Nor do they reveal any empirical patterns that could inform us about the possible misfortunes or chances of success that a break-up of the euro zone might have.

However, the reference to past episodes is not the only tool

with which the economist can carry out an analysis of a break-up of the euro zone. It is indeed possible to highlight the mechanisms that would be at work if the monetary union project in Europe were to be wound up. There are numerous possible pathways to a break-up of the euro zone, and any analysis of the costs and benefits must be interpreted with the utmost caution, since in addition to uncertainty about any quantitative assessment of what is involved, there is also the issue of what scenario an exit would create. In these circumstances, a departure from the euro zone cannot necessarily be understood solely from the point of view of its impact on exchange rates or its financial effects. It is very likely that an exit would be accompanied by the implementation of alternative economic policies. The analysis carried out here does not enter this territory, but merely explains the macroeconomic mechanisms at work in the event of a break-up of the euro zone, without detailing the reaction of economic policy or second-round effects.

The central hypothesis adopted here is that involving a complete break-up of the monetary union, and not the simple departure of France alone. Indeed, if France, the second-largest euro zone economy, were to exit, the very existence of the monetary zone would be called into question. The devaluation of the French franc against the southern Europe countries remaining in the euro zone would destabilize their economies and push them out of the scaled-down euro zone. We do not deal here with all the technical elements related to how a break-up would be organized [1] – launching the circulation of new currencies, liquidation of the ECB and termination of the TARGET system, etc. – but rather on an analysis of the macroeconomic effects [2]. Two types of effects would then be at work. First, the dissolution of the European monetary union would de facto lead to a return to national currencies, and therefore to a devaluation or revaluation of the currencies of the euro zone countries vis-à-vis not only their euro zone partners but also non-euro zone

countries. Second, the redenomination of assets and liabilities now denominated in euros and the prospect of exchange movements would have financial effects that we analyze in the light of past financial crises. Our scenario is therefore for a contained crisis.

A unilateral exit from the euro zone by France and the ensuing break-up of the euro zone exclude a scenario for a common currency where strong cooperation between the old member states would help to maintain a high level of exchange stability and effectively continue the economic status quo. There is little likelihood of a scenario like this, since it would lead to not using the margins of maneuver opened up by the exit and to maintaining the much-denounced and presumed straitjacket. The crisis would be contained in that the most violent effects would be reduced by coordinated policies. This would mean exchange movements that are rapid and substantial, but which stabilize over a time horizon of a few quarters [3]. We assume, furthermore, that each country pursues its own interest without special co-operation.

I – A summary of the economic mechanisms at work

The gains expected from leaving the euro zone

In the first place, leaving the euro zone would mean that the exchange rates between the currencies of the countries that compose it could once again vary against each other. Given this, the question arises of the value at which the exchange rates of these currencies will tend to converge. The expected gains would be, on the one hand, an improvement in competitiveness due to the devaluation of the franc. A devaluation would lead to imported inflation in the short term, before increasing purchasing power and spurring growth. The second gain involves the possibility of defining a monetary and fiscal policy that is differentiated by country, and therefore more appropriate to France’s situation.

An exit from the euro zone would also make it possible to set tariffs less favorable to imports from other countries, and thus more favorable to producers on the national territory, but which would also affect consumer prices and thus consumer purchasing power[4].

The costs of leaving the euro zone

France's exit from the euro zone would lead to the departure of other countries, which would see their currencies depreciate against the franc, especially the southern European countries. The net effect on competitiveness may prove ambiguous.

A Frexit would lead to currency movements, which would translate into a return of transaction costs on currency exchanges between euro zone countries. Moreover, the break-up of the euro zone would also lead to a redenomination of assets and debts in the national currency. Beyond the legal aspects, these balance sheet effects would impoverish agents who hold assets denominated in a depreciating currency or debts re-denominated in an appreciating currency (and enrich those in the reverse situation). Uncertainties about balance sheet effects, particularly for financial intermediaries and banks, could be expected to lead to a period experiencing a sharp downturn in lending.

How much additional autonomy would be acquired for monetary policy is uncertain at present. Indeed, it is difficult to conceive of a monetary policy that is much more expansionary than the ECB's policy of negative rates and security redemptions [5]. The Banque de France could, of course, buy back the national public debt by creating money, but, in light of the low current interest rates on French sovereign debt, it is not clear that this would lead to significant gains [6]. It should be noted that a persistent current account deficit would need to be financed by external savings and that this external constraint could affect monetary policy, for example

by requiring an increase in short-term and long-term interest rates that could impose capital controls by the government.

Finally, the introduction of trade protectionism would obviously lead to retaliation by the aggrieved partners, which would hurt French exports. The overall net effect on world trade would be negative, with no gain at the national level.

II – The impact on exchange rates and competitiveness

A Frexit would not lead to strong gains in competitiveness. We simulated the effect of a Frexit in the following way:

1. We assume that a Frexit would lead to a rapid disintegration of the euro zone;

1. We then use our estimates of long-run equilibrium exchange rates presented in Chapter 4 of the *2017 iAGS Report*. It appears that the equilibrium parity for the new franc would correspond to an actual effective devaluation of 3.6% compared to the current level of the euro. This is a real change, once it has been corrected for the effects of inflation and is effective, that is, taking into account exchange rate fluctuations in relation to different trading partners, possibly in the opposite direction. The new franc would be devalued relative to the German currency, but would appreciate relative to the Spanish currency;
2. Using the empirical estimates of exchange rate adjustments (Cavallo et al., 2005), we determine a short-term exchange rate trajectory. Our estimate is for a 13.7% depreciation of France’s effective exchange rate with respect to the other euro zone countries, and an appreciation of 8.6% with respect to the countries that do not belong to the euro zone.

Using simulations with the emod.fr model, we estimate a modest increase in competitiveness. The effect on GDP would be close to 0 in the first year and 0.4% after three years. These

figures are low and refer to a scenario without any readjustment within the euro zone. If we consider the possibility of a gradual adjustment within the euro zone (based on the mechanisms, for example, referred to in *iAGS 2016*), the potential gain would be even lower. Once again it is possible to envisage that the monetary policy conducted by the Banque de France would seek to devalue the French currency more strongly than that of its competitors. But in such a scheme, it is very likely that the latter will in turn wish to preserve their competitiveness and engage in a policy of competitive devaluations.

III – The financial impact: The effects of the banking crises

The dissolution of the euro zone and the return to national currencies would have significant repercussions for the national banking and financial systems through their international business, and it would bring about a return of exchange rate risk within the euro zone. We first assess the risks that the collapse of the euro zone would have for the banking system. The mechanisms at work are likely to provoke a banking crisis, which could have a high cost for economic activity.

The return to national currencies in a financially integrated space would necessarily entail a major upheaval for the financial system. These effects would not be comparable to those observed at the time the euro was adopted. Indeed, as Villemot et Durand (2017) have shown, potentially the balance sheet effects would be significant for a low coordination scenario.

The balance sheet effects could be reduced if there were international coordination when leaving the euro. Such co-ordination would make it possible to distribute the ECB‘s assets and liabilities in a coherent way, notably within the framework of TARGET 2. However, it’s difficult to assume a significant level of coordination when leaving the eurozone,

and it is illusory to believe that the difficulties in achieving coordination will lessen. On the contrary, they are likely to increase in a climate of instability instead of one with a shared destiny. As a result, the scenario we use for leaving the euro zone excludes the establishment of a new financial or monetary architecture.

The risk of a banking or financial crisis is central to understanding the impact of the break-up of the euro zone. The impacts would pass through three main channels. The first involves a flight of deposits and savings and the distress liquidation of financial assets. The second is related to the effects of currency misalignments on banks' balance sheets and insurers. The third concerns the sovereign risk that would affect either the public debt and its financing, or if this debt were subject to uncontrolled monetization, the return of intense external pressure. The economic literature includes recent efforts (notably Rogoff and Reinhart, Borio, Schularik, the IMF) to try to evaluate banking or financial crises. It should be clarified at the outset that this literature does not deal with the dissolutions of monetary unions. In the various banking crises recorded since the 1970s by Laeven and Valencia (2010 and 2012), there is no mention of a crisis linked to the dissolution of a monetary union. Nevertheless, the financial dynamics in play in the event of the break-up of the euro zone would be, as mentioned above, risk factors for a banking or financial crisis.

Moreover, the economic literature on currency crises has pointed to the link with banking crises (Kaminsky and Reinhart, 1999). The collapse of a monetary union in reality reflects a crisis situation for the exchange rate system, which leads to revaluations and devaluations with the over-adjustment of exchange rates, as highlighted in the previous section. The reference to the cost of banking crises thus illustrates the potentially negative effects of exiting the euro zone. However, it should be remembered that these costs

correspond to an overall assessment of banking crises that does not make it possible to identify precisely the mechanisms through which the financial shock is propagated into the real economy – an assessment that would involve identifying the impact of rising risk premiums and the effect of credit rationing, where it is much more difficult to determine the uncertainty. An analysis by Bricongne et al. (2010) of the various channels through which the 2007-2008 financial crisis was transmitted suggests that a significant amount remains unexplained. Also, in the absence of a more detailed analysis, we make the assumption that the historical experiences of banking crisis are the main quantitative element that can be used to get close to the eventual negative impact – via the financial effects – of a break-up of the euro zone.

Laeven and Valencia (2012) analysed 147 banking crises in developed and emerging countries over the last few decades (1970-2011). They calculated the losses in production as the three-year cumulative loss of actual GDP relative to trend GDP [7]. For the developed countries, the cumulative loss of growth was on average 33 GDP points. During these three crisis years, the public debt increased on average by 21 GDP points (partly due to bank recapitalizations), the central bank's balance sheet increased by 8 GDP points, and the level of non-performing loans increased by 4 percentage points. It should be noted that there was a high degree of heterogeneity in the cost of the crises, depending on the crisis and country in question. For example, the authors' assessment of the cost of the 2008 banking crisis in terms of growth following the bankruptcy of Lehman Brothers was 31 GDP points for the United States and 23 GDP points for the euro zone as a whole. Hoggarth, Reis and Saporta (2002) conducted a similar study and sought to provide robust assessments of trend GDP. They noted cumulative production losses during crisis periods ranging from 13 to 20 GDP points, depending on the indicator chosen. However, these estimates of the cost of banking crises are to be taken with caution, since they are based on numerous

assumptions, in particular on the trajectories that countries would have followed in the absence of a crisis.

IV – The gains from monetary autonomy

The gains from an alternative monetary policy would depend on the new direction taken by a monetary policy that remains to be defined and that will determine the conditions for financing the economy. Such a policy would probably be ultra-accommodative due to the financial and banking instability generated by the balance sheet effects.

Evaluations of the contribution of financial conditions in France from 2014 to 2018, however, suggest that these are not the most important factor explaining the sluggishness of economic activity. Over this period, the contribution of financial and monetary conditions to GDP growth is between -0.1 and 0.2 points [8]. There is thus little gain to be expected from a new ultra-accommodative monetary policy (independently of the effects on exchange rates discussed in the first section or the impact of external pressure).

Conclusion

This text has attempted to outline the possible consequences of a Frexit, without going into too detailed and therefore perilous quantification.

1. Contrary to what is sometimes advanced, there is little to be expected in terms of competitiveness or manoeuvring room for short-term monetary policy;
2. The main cost would come from the banking or financial crisis arising from balance sheet effects, particularly given the context of a disorderly exit.

At this stage of the analysis, it is difficult to identify the potential positive economic effects of a Frexit, while the risks of a negative impact due to financial effects seem to be very significant.

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[1] These points are to a large extent discussed in *Capital Economics* (2012).

[2] It is difficult to develop a long-term counterfactual scenario in the case of exiting the euro. We therefore focus on the short- and medium-term effects of possible transitions.

[3] We implicitly eliminate the scenario of a currency war where each country would try to gain competitiveness by devaluations that would permanently lead us away from convergence towards a real equilibrium exchange rate.

[4] The introduction of tariffs like this calls for leaving the European Union. Without developing this analysis here, it is very likely that leaving the euro zone would lead to leaving the European Union. There have been assessments of the EU's contribution to intra-European trade and growth that we are not using here in our short-term approach.

[5] Through its quantitative easing program, the ECB essentially purchases sovereign debt bonds, including French debt securities. In February 2017, the outstanding securities held by the ECB under this programme (PSPP) amounted to € 1,457.6 billion. Breaking down the purchases based on the share of the ECB's capital subscribed by the central banks of the member states, the fraction of French debt securities exceeds 200 billion euros.

[6] Getting free from the constraints of the Stability and Growth Pact could be a gain in itself. This assumes that the constraints of the SGP go beyond simply the sustainability of the public debt demand.

[7] These evaluations show, however, that there is a high degree of heterogeneity in the assessed costs depending on the country in question.

[8] https://www.ofce.sciences-po.fr/pdf/documents/prev/prev1016/france.pdf

Austerity in Europe: a change of course?

By Marion Cochard and Danielle Schweisguth

On 29 May, the European Commission sent the members of the European Union its new economic policy recommendations. In these recommendations, the Commission calls for postponing the date for achieving the public deficit goals of four euro zone countries (Spain, France, Netherlands and Portugal), leaving them more time to hit the 3% target. Italy is no longer in the excessive deficit procedure. Only Belgium is called on to intensify its efforts. Should this new roadmap be interpreted as a shift towards an easing of austerity policy in Europe? Can we expect a return to growth in the Old Continent?

These are not trivial matters. An OFCE Note (no. 29, 18 July 2013) attempts to answer this by simulating three scenarios for fiscal policy using the iAGS model. It appears from this study that postponing the public deficit targets in the four euro zone countries does not reflect a real change of course for Europe's fiscal policy. The worst-case scenario, in which Spain and Portugal would have been subject to the same recipes as Greece, was, it is true, avoided. The Commission is implicitly agreeing to allow the automatic stabilizers to work when conditions deteriorate. However, for many countries, the recommendations with respect to budgetary efforts still go beyond what is required by the Treaties (an annual reduction in the structural deficit of 0.5 percent of GDP), with as a consequence an increase of 0.3 point in the unemployment rate in the euro zone between 2012 and 2017.

We believe, however, that a third way is possible. This would involve adopting a "fiscally serious" position in 2014 that does not call into question the sustainability of the public debt. The strategy would be to maintain a constant tax burden

and to allow public spending to keep pace with potential growth. This amounts to maintaining a neutral fiscal stimulus between 2014 and 2017. In this scenario, the public deficit of the euro zone would improve by 2.4 GDP points between 2012 and 2017 and the trajectory in the public debt would be reversed starting in 2014. By 2030, the public deficit would be in surplus (0.7%) and debt would be close to 60% of GDP. Above all, this scenario would lower the unemployment rate significantly by 2017. The European countries could perhaps learn from the wisdom of Jean de La Fontaine's fable of the tortoise and the hare: "*Rien ne sert de courir, il faut partir à point*", *i.e.* Slow and steady wins the race.

France: why such zeal?

By Marion Cochard and Danielle Schweisguth

On 29 May, the European Commission sent the members of the European Union its new economic policy recommendations. As part of this, the Commission granted France an additional two years to reach the deficit reduction target of 3%. This target is now set for 2015, and to achieve this the European Commission is calling for fiscal impulses of -1.3 GDP points in 2013 and -0.8 point in 2014 (see "Austerity in Europe: a change of course?"). This would ease the structural effort needed, since the implementation of the previous commitments would have required impulses of -2.1 and -1.3 GDP points for 2013 and 2014, respectively.

Despite this, the French government has chosen not to relax its austerity policy and is keeping in place all the measures announced in the draft Finance Act (PLF) of autumn 2012. The continuing austerity measures go well beyond the Commission's

recommendations: a negative fiscal impulse of -1.8 GDP point, including a 1.4 percentage point increase in the tax burden for the year 2013 alone. Worse, the broad guidelines for the 2014 budget presented by the government to Parliament on 2 July 2013 point to a structural effort of 20 billion euros for 2014, *i.e.* one percentage point of GDP, whereas the Commission required only 0.8 point. The government is thus demanding an additional 0.6 GDP point fiscal cut, which it had already set out in the multi-year spending program in the 2013 Finance Act.

The table below helps to provide an overview of the effort and of its impact on the French economy. It shows the trends in growth, in unemployment and in the government deficit in 2013 and 2014, according to three budget strategies:

1. One using the relaxation recommended by the Commission in May 2013;
2. One based on the budget approved by the government for 2013 and, *a priori*, for 2014;
3. One based on an alternative scenario that takes into account the negative 1.8 GDP point fiscal impulse for 2013 and calculates a fiscal impulse for 2014 that would be sufficient to meet the European Commission's public deficit target of -3.6%.

The different scenarios for deficit reduction in France

In %

	Relaxation (1)		Approved budget (2)		Alternative scenario (3)	
	2013	2014	2013	2014	2013	2014
Fiscal impulse	-1.3	-0.8	-1.8	-1.0	-1.8	-0.2
Unemployment rate	10.5	10.6	10.7	11.1	10.7	10.5
Growth	0.2	1.3	-0.2	1.0	-0.2	1.7
Public deficit	-4.3	-3.6	-3.9	-3.1	-3.9	-3.6

Source : Authors' calculations based on the iAGS model.

According to our estimates using the iAGS model [1], the public deficit would be cut to 3.1% of GDP in 2014 in scenario (2), whereas the Commission requires only 3.6%. As a

consequence of this excess of zeal, the cumulative growth for 2013 and 2014 if the approved budget is applied would be 0.7 percentage point lower than growth in the other two scenarios (0.8 point against 1.5 points). The corollary is an increase in unemployment in 2013 and 2014: the unemployment rate, around 9.9% in 2012, would thus rise to 11.1% in 2014, an increase of more than 350,000 unemployed for the period. In contrast, the more relaxed scenario from the European Commission would see a quasi-stabilization of unemployment in 2013, while the alternative scenario would make it possible to reverse the trend in unemployment in 2014.

While the failure of austerity policy in recent years seems to be gradually impinging on the position of the European Commission, the French government is persisting along its same old path. In the face of the social emergency that the country is facing and the paradigm shift that seems to be taking hold in most international institutions, the French government is choosing to stick to its 3% fetish.

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[1] iAGS stands for the Independent Annual Growth Survey. This is a simplified model of the eleven main economies in the euro zone (Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Netherlands, Portugal and Spain). For more detail, see the working document Model for euro area medium term projections.

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iAGS, independent Annual

Growth Survey 2013

by OFCE (Paris), ECLM (Copenhagen) and IMK (Düsseldorf)

The independent Annual Growth Survey (iAGS) brings together a group of internationally competitive economists from three European economic institutes to provide an independent alternative to the Annual Growth Survey (AGS) published by the European Commission. iAGS 2013 focuses on the Eurozone economic outlook and on the sustainability of public finances until 2032. This first report advocates delaying and spreading fiscal consolidation in due respect of current EU fiscal rules.

Four years after the start of the Great Recession, the euro area remains in crisis. GDP and GDP per head are below their pre-crisis level. The unemployment rate has reached a historical record level of 11.6 % of the labour force in September 2012, the most dramatic reflection of the long lasting social despair that the Great Recession produced. The sustainability of public debt is a major concern for national governments, the European Commission and financial markets, but successive and large consolidation programmes have proven unsuccessful in tackling this issue. Up to now, asserting that austerity was the only possible strategy to get out of this dead end has been the cornerstone of policymakers' message to European citizens. But this assertion is based on a fallacious diagnosis according to which the crisis stems from the fiscal profligacy of members states. For the Euro area as a whole, fiscal policy is not the origin of the problem. Higher deficits and debts were a necessary reaction by governments facing the worst recession since WWII. The fiscal response was successful in two respects: it stopped the recession process and dampened the financial crisis. As a consequence, it led to a sharp rise in the public debt of all Euro area countries.

During normal times, sustainability of public debt is a long-

term issue whereas unemployment and growth are short-term ones. Yet, fearing an alleged imminent surge in interest rates and constrained by the Stability and Growth Pact, though transition towards more normal times had not been completed, member states and the European Commission reversed priorities. This choice partly reflects well-known pitfalls in the institutional framework of EMU. But it is equally reflecting a dogmatic view in which fiscal policy is incapable of demand management and the scope of public administrations has to be fettered and limited. This ideology has led member states to implement massive fiscal austerity during bad times.

As it is clear now, this strategy is deeply flawed. Eurozone countries and especially Southern European countries have undertaken ill-designed and precipitous consolidation. The austerity measures have reached a dimension that was never observed in the history of fiscal policy. The cumulative change in the fiscal stance for Greece from 2010 to 2012 amounts to 18 points of GDP. For Portugal, Spain and Italy, it has reached respectively 7.5, 6.5 and 4.8 points of GDP. The consolidation has rapidly become synchronized leading to negative spillovers over the whole euro area, amplifying its first-round effects. The reduction in economic growth in turn makes sustainability of public debt ever less likely. Thus austerity has been clearly self-defeating as the path of reduction of public deficits has been by far disappointing regarding the initial targets defined by member states and the Commission.

Since spring 2011 unemployment within the EU-27 and the Euro zone has begun to increase rapidly and in the past year alone unemployment has increased by 2 million people. Youth unemployment has also increased dramatically during the crisis. In the second quarter of 2012 9.2 million young people in the age of 15-29 years were unemployed, which corresponds to 17.7 percent of the 15-29 years old in the workforce and accounts for 36.7 percent of all unemployed in the EU-27.

Youth unemployment has increased more dramatically than the overall unemployment rate within the EU. The same tendencies are seen for the low skilled workers. From past experience it is well known that once unemployment has risen to a high level it has a tendency to remain high the years after. This is known as persistence. Along with the rise in unemployment the first symptoms that unemployment will remain high in the coming years are already visible. In the second quarter of 2012 almost 11 million people in EU had been unemployed for a year or longer. Within the last year long term unemployment has increased with 1.4 million people in the EU-27 and with 1.2 million people within the Euro area.

As a result of long term unemployment the effective size of the workforce is diminished which in the end can lead to a higher structural level in unemployment. This will make more difficult to generate growth and healthy public finances within the EU in the medium term. Besides the effect of long term unemployment on potential growth and public finances one should also add that long term unemployment may cause increased poverty because sooner than expected unemployment benefits will stop. Thus long term unemployment may also become a deep social issue for the European society. Given our forecast for unemployment in EU and the Euro area, we estimate that long term unemployment can reach 12 million in EU and 9 million in the Euro area at the end of 2013.

What is striking is that consequences of ill-designed consolidation could and should have been expected. Instead, they have been largely underestimated. Growing theoretical and empirical evidence according to which the size of multipliers is magnified in a fragile situation has been overlooked. Concretely, whereas in normal times, that is when the output gap is close to zero, a reduction of one point of GDP of the structural deficit reduces activity by a range of 0.5 to 1% (this is the fiscal multiplier), this effect exceeds 1.5% in bad times and may even reach 2% when the economic climate is

strongly deteriorated. All the features (recession, monetary policy at the zero bound, no offsetting devaluation, austerity amongst key trading partners) known to generate higher-than-normal multipliers were in place in the euro area.

The recovery that had been observed from the end of 2009 was brought to a halt. The Euro area entered a new recession in the third quarter of 2011 and the situation is not expected to improve: GDP is forecast to decrease by 0.4 % in 2012 and again by 0.3 % in 2013. Italy, Spain, Portugal and Greece seem to sink in an endless depression. The unemployment soared to a record level in the Eurozone and especially in Spain, Greece, Portugal and Ireland. Confidence of households, non financial companies and financial markets has collapsed again. Interest rates have not receded and governments of Southern countries still face unsustainable risk premium on their interest rate, despite some policy initiatives, while Germany, Austria or France benefit from historically low interest rates.

Rather than focus on public deficits the underlying cause of the crisis needs to be addressed. The euro area suffered primarily from a balance of payments crisis due to the build-up of current account imbalances between its members. When the financial flows needed to finance these imbalances dried up the crisis took hold in the form of a liquidity crisis. Attempts should have been made to adjust nominal wages and prices in a balanced way, with minimal harm to demand, output and employment. Instead salvation was sought in across-the-board austerity, forcing down demand, wages and prices by driving up unemployment.

Even if some fiscal consolidation was almost certainly a necessary part of a rebalancing strategy to curb past excesses in some countries, it was vital that those countries with large surpluses, especially Germany, took symmetrical action to stimulate demand and ensure faster growth of nominal wages and prices. Instead the adjustment burden was thrust on the deficit countries. Some progress has been made in addressing

competitive imbalances, but the cost has been huge. Failure to ensure a balanced response from surplus countries is also increasing the overall trade surplus of the euro area. This is unlikely to be a sustainable solution as it shifts the adjustment on to non-euro countries and will provoke counteractions.

There is a pressing need for a public debate on such vital issues. Policymakers have largely ignored dissenting voices, even as they have grown louder. The decisions on the present macroeconomic strategy for the Euro area should not be seized exclusively by the European Commission at this very moment, for the new EU fiscal framework leaves Euro area countries some leeway. Firstly, countries may invoke exceptional circumstances as they face "*an unusual event outside the control of the (MS) which has a major impact on the financial position of the general government or periods of severe economic downturn as set out in the revised SGP (…)".* Secondly, the path of consolidation may be eased for countries with excessive deficits, since it is stated that "*in its recommendation, the Council shall request that the MS achieves annual budgetary targets which, on the basis of the forecast underpinning the recommendation, are consistent with a minimum annual improvement of at least 0.5 % of GDP as a benchmark, in its cyclically adjusted balance net of one-off and temporary measures, in order to ensure the correction of the excessive deficit within the deadline set in the recommendation*". This is of course a minimum, but it would also be seen as a sufficient condition to bring back the deficit to Gdp ratio towards 3 % and the debt ratio towards 60 %.

A four-fold alternative strategy is thus necessary:

First, delaying and spreading the fiscal consolidation in due respect of current EU fiscal rules. Instead of austerity measures of nearly 100 billion euros for the whole euro area, a more balanced fiscal consolidation of 0.5 point of GDP, in accordance with treaties and fiscal compact, would give for

the sole 2013 year a concrete margin for manoeuvre of more than 60 billion euros. This amount would substantially contrast with the vows of the June and October 2012 European Councils to devote (still unbudgeted) 120 billion euros until 2020 within the Employment and Growth Pact. By delaying and capping the path of consolidation, the average growth for the Eurozone between 2013 and 2017 may be improved by 0.7 point per year.

Second, it involves that the ECB fully acts as a lender of last resort for the Euro area countries in order to relieve MS from the panic pressure stemming from financial markets. For panic to cease, EU must have a credible plan made clear to its creditors.

Third, significantly increasing lending by the European Investment Bank as well as other measures (notably the use of structural funds and project bonds), so as to meaningfully advance the European Union growth agenda. Vows reported above have to be transformed into concrete investments.

Fourth, a close coordination of economic policies should aim at reducing current accounts imbalances. The adjustment should not only rely on deficit countries. Germany and the Netherlands should also take measures to reduce their surpluses.