

# Is Greece in the process of divorce?

By [Jérôme Creel](#)

The ongoing Greek saga is looking more and more like an old American TV series. JR Ewing returns to the family table feeling upset with Sue Ellen for her failure to keep her promise to stop drinking. Given the way things are going, a divorce seems inevitable, especially if Bobby sides with his brother and refuses to help his sister-in-law any longer.

Just like in Dallas, addiction to a potentially toxic substance, public debt, is plaguing Europe's states and institutions. Analyses on Greece focus mainly on debt-to-GDP ratios. On these terms, Greece's public debt-to-GDP ratio rose from 2011 to 2014: European public opinion can therefore legitimately question the ability of the Greek people (really the Greek state) to curb spending and raise taxes. A divorce is inevitable. But if we look at the amounts involved, the situation seems somewhat different.

Between 2011 and 2014, Greece's public debt decreased by 39 billion euros according to Eurostat. Seen in this light, the Greek state is making a real effort. But this obscures the aid of the creditors. The Greek state has in fact benefited from the restructuring of its debt, including a partial but important default on its public debt to its private creditors. According to [Jeromin Zettelmeyer, Christoph Trebesch and Mitu Gulati](#), the amount of debt for which the Greek state was forgiven was on the order of 100 billion euros. Without this aid, the amount of Greece's debt would have increased between 2011 and 2014 by 61 billion euros (100 billion minus the aforementioned 39 billion). This is not nothing for a country like Greece. However, note that Greek debt accounts for only 3.5% of the euro zone's total public debt.

Furthermore, how were the other EU countries faring at the same time? No better! The addiction to public debt, if we can indeed speak of addiction, is general. The public debt of the EU and the euro zone rose by 6 GDP points, or by 1400 billion and 800 billion respectively. By comparison, the increase in the Greek debt is a drop in the ocean. Germany's public debt rose by 68 billion euros, Italy's by 227 billion, Spain's and France's by 285 billion respectively, and the United Kingdom's by 277 billion pounds, or 470 billion euros, again according to Eurostat. Relative to their respective GDPs, Spain's debt increased by almost 30 points, Italy's by more than 15 points, France's by 10 points, and the UK's by nearly 8 points. Only Germany has seen its debt ratio go down, thanks to stronger economic growth.

[Paul de Grauwe](#) recently insisted on the fact that Greece's debt is sustainable: given the various debt restructurings already undertaken, the public debt-to-GDP ratio of 180% would be roughly 90% in present value, i.e. after having accounted for future interest payments and scheduled repayments, some of which are in a very distant future<sup>[1]</sup>.

Economists, including in this case Paul de Grauwe, use the state's intertemporal budget constraint to understand the sustainability of public debt. Rather than using a retrospective approach, the public debt can be analysed from a prospective approach. If the following year's debt depends on the present debt, then by symmetry, the present debt depends on the following year's debt. But next year's debt will depend on the following year's debt, by iteration. Ultimately, the present debt depends on the debt of the following year and on and on until the end of time: it depends on future debts. But these future debts also depend on future public deficits. The intertemporal budget constraint thus expresses the fact that today's public debt is equal to the sequence of future public deficits and to the final debt (that at the end of time), all expressed in present values.

In contrast to businesses and households, the state is supposed to have an infinite time horizon, which makes it possible to reset the present value of the debt at the “end of time” to zero. We can then say that the public debt is sustainable if future governments provide adequate public surpluses to pay off that debt. This is possible after periods of high public deficits, provided that these periods are followed by others during which governments accumulate budget surpluses. Given the extension of the maturity of Greek debt and the low level of future interest payments, the budget surplus required to repay the current debt is low. Paul de Grauwe concludes that Greece is subject to a liquidity crisis rather than a sovereign default crisis. So, again according to Paul de Grauwe, what is needed is to adjust the fiscal austerity plans and forthcoming reforms to the actual level of the public debt, which is substantially lower than the level being used as the basis for negotiations between the Greek state and the “institutions” (ECB, Commission, IMF). In other words, the “institutions” can loosen their grip.

The “Greek case” can thus be relativized and the divorce put off. Sue Ellen’s addiction is less exceptional than it seems at first glance.

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[\[1\]](#) After 2015 and 2019, which will involve substantial repayments from the Greek state, the “difficult” years will then be situated beyond 2035 (see the amortization profile of Greece’s debt in [Antonin et al., 2015](#)).

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# The ECB's quantitative easing exercise: you're never too young to start

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

The ECB decision to launch a quantitative easing (QE) programme was widely anticipated. Indeed, on several occasions in the second half of 2014 Mario Draghi had reiterated that the Governing Council was unanimous in its commitment to take the steps needed, in accordance with its mandate, to fight against the risk of a prolonged slowdown in inflation. Both the scale and the characteristics of the ECB plan announced on 22 January 2014 sent a strong, though perhaps belated signal of the Bank's commitment to fight the risk of deflation, which has been spreading in the euro zone, as can be seen in particular in inflation expectations over a two-year horizon (Figure 1). In a [special study entitled, "Que peut-on attendre du l'assouplissement quantitatif de la BCE?"](#) ["What can we expect from the ECB's quantitative easing?"], we clarify the implications of this new strategy by explaining the mechanisms for the transmission of quantitative easing, drawing on the numerous empirical studies on previous such programmes in the US, the UK and Japan.

Figure. Inflation expectations in the euro



Source : ECB (Survey of Professional Forecasters).

The terms of the quantitative easing decided by the ECB are indeed similar to those adopted by other central banks, especially by the US Federal Reserve and the Bank of England, which make comparisons legitimate. It appears from the American, British and Japanese experience that the measures implemented have led to a decline in sovereign interest rates and more generally to an improvement in the financial conditions of the overall economy[1]. This has been the result of sending a signal about the present and future stance of monetary policy and a reallocation of investors' portfolios. Some studies [2] also show that the US QE caused a depreciation of the dollar. The transmission of QE from the ECB to this variable could be critical in the case of the euro zone. An analysis using VAR models shows that the monetary policy measures taken by the ECB will have a significant impact on the euro but also on inflation and inflationary expectations. It is likely that the effects of the depreciation of the euro on European economic activity will be positive (cf. [Bruno Ducoudré and Eric Heyer](#)), which would make it easier for Mario Draghi to bring inflation back on target. The measure would therefore have the positive effects

expected; however, it might be regrettable that it was not implemented earlier, when the euro zone was mired in recession. Inflation in the euro zone has fallen constantly since late 2011, reflecting a gathering deflationary risk month after month. In fact, the implementation of QE from March 2015 will consolidate and strengthen a recovery that would undoubtedly have occurred anyway. Better late than never!

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[1] The final impact on the real economy is, however, less certain, in particular because the demand for credit has remained stagnant.

[2] Gagnon, J., Raskin, M., Remache, J. and Sack, B. (2011). "The financial market effects of the Federal Reserve's large-scale asset purchases," *International Journal of Central Banking*, vol. 7(10), pp. 3-43.

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## **Is the ECB impotent?**

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

In June 2014, the ECB announced a set of new measures (a detailed description of which is provided in a special study entitled, "[How can the fragmentation of the euro zone banking system be fought?](#)", *Revue de l'OFCE*, No. 136, in French) in

order to halt the lowering of inflation and sustain growth. Mario Draghi then clarified the objectives of the ECB's monetary policy by indicating that the Bank wanted to expand its balance sheet by a trillion euros to return to a level close to that seen in the summer of 2012. Among the measures taken, much was expected from the new targeted long-term refinancing operation (TLTRO), which gives banks in the euro zone access to ECB refinancing with a maturity of 4 years in return for providing credit to the private sector (excluding mortgages). However, after the first two allocations (24 September 2014 and 11 December 2014), the picture has become rather complicated, with the amounts allocated well below expectations. This reflects the difficulty the ECB is having in fighting effectively against the risk of deflation.

Indeed, having allotted 82.6 billion euros in September (versus anticipations of between 130 and 150 billion), the ECB granted "only" 130 billion on December 11, *i.e.* once again a lower amount than had been anticipated. So we are a long way from the maximum amount of 400 billion euros that had been evoked by Mario Draghi in June 2014 for these two operations. Moreover, these first two allotments were clearly insufficient to boost the ECB's balance sheet significantly (Figure 1), and all the more so as banks are continuing to reimburse the three-year loans that they received in late 2011 and early 2012 in the very long-term refinancing operation (VLTRO) [\[1\]](#). What explains the banks' reluctance to make use of this operation, even though it allows them to refinance the loans granted at a very low rate for a 4 year term?

The first is that the banks already have very broad and very advantageous access to ECB liquidity through the monetary policy operations already implemented by the ECB [\[2\]](#). These operations actually offer a lower interest rate than does the TLTRO (0.05% against 0.15%). Similarly, a TLTRO is not more attractive than some long-term market financing, especially since many banks do not have financing constraints. TLTRO is

thus of marginal interest, due to the maturity of the operation, and more restrictive because it is conditioned on the distribution of credit. For the first two operations conducted in September and December 2014, the allotment could not exceed 7% of outstanding loans to the non-financial private sector in the euro zone, excluding loans for housing, as of 30 April 2014. A new series of TLTRO will be conducted between March 2015 and June 2016, on a quarterly basis. This time the maximum amount that can be allocated to the banks will depend on the growth in outstanding loans to the non-financial private sector in the euro zone, excluding loans for housing, between 30 April 2014 and the date of the operation in question.

The second explanation is that the weakness of credit in the euro zone is not simply the result of supply factors but also demand factors. Sluggish activity and private agents' efforts to shed debt are holding back lending.

Third, beyond banks' ability to find refinancing, it is also possible that they are trying to reduce their exposure to risk. The problem is thus related to their assets. However, non-performing loans are still at a very high level, especially in Spain and Italy (Figure 2). In addition, although the Asset Quality Review (AQR) conducted by the ECB has revealed that insolvency risks are limited in the euro zone, the report also points out that some banks are highly leveraged and that they have mainly used the available liquidity to buy government bonds in order to meet their capital requirements. They are then reducing their balance sheet risk by limiting loans to the private sector.

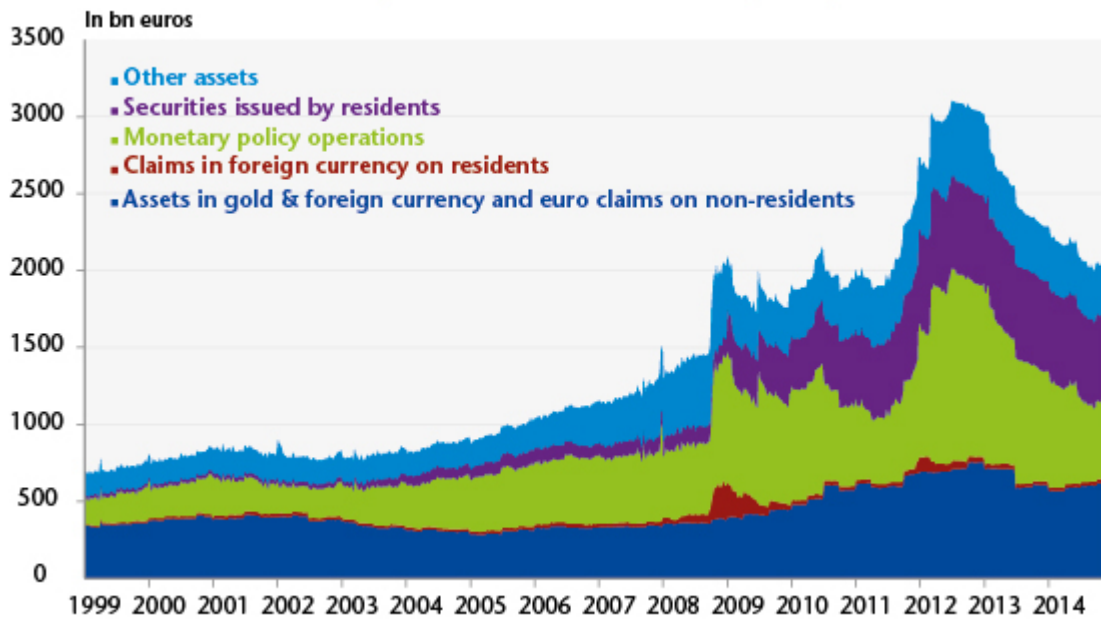
Finally, two uncertainties are also reducing the banks' participation in the TLTRO. The first concerns the stigma attached to the conditionality of the TLTRO and to the fact that banks that do not meet their commitments on the distribution of credit will be required to repay the financing obtained from the ECB after two years. So banks facing



uncertainty about their ability to increase their lending may very well wish to avoid the prospect of having to repay the funds sooner. The second factor concerns uncertainties about the programs for purchasing ABS and covered bonds[3]. The banks could also turn to these programs to get cash in exchange for the sale of assets that they would like to get rid of.

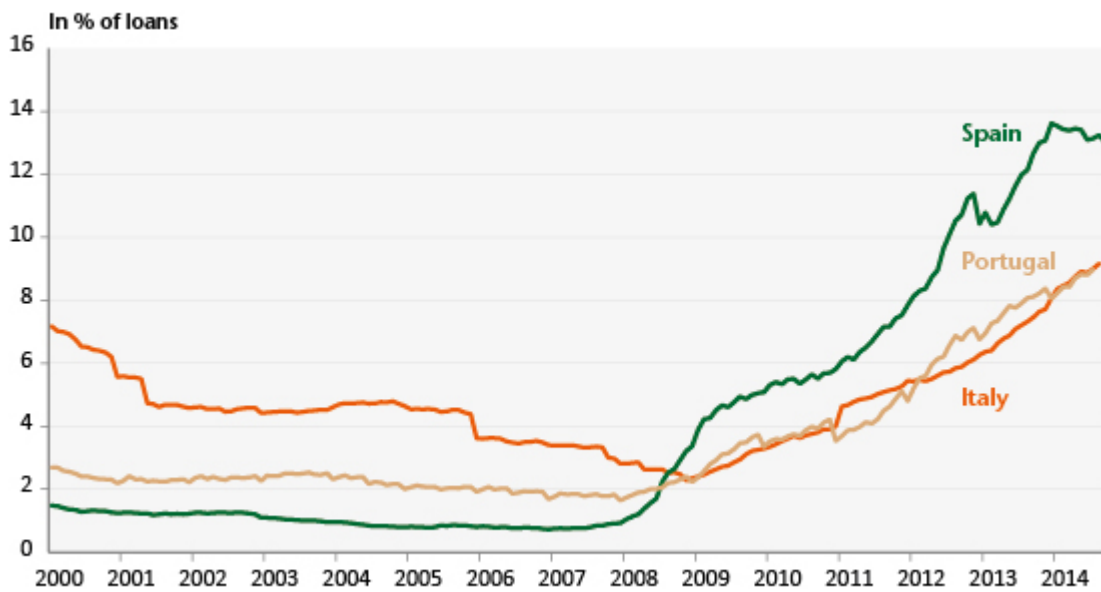
Has monetary policy become totally ineffective? The answer is certainly no, since by giving banks a guarantee that they can refinance their activity through various programs (TLTRO, ABS, covered bonds, etc.), the ECB is reducing the risk that credit will be rationed due to the deteriorated state of some banks' liabilities. Monetary policy is thus helping to free up the credit channel. But its effects are nevertheless limited, as is suggested by [Bech, Gambacorta and Kharroubi \(2012\)](#) , who show that monetary policy is less effective in periods of recovery following a financial crisis. Can we get out of this impasse? This observation on the effectiveness of monetary policy shows that the ECB should not be viewed as the be-all and end-all. It is still essential to complement its support for activity through an expansionary fiscal policy across the euro zone. This point was also reiterated by the President of the ECB during this summer's [conference at Jackson Hole](#): "Demand side policies are not only justified by the significant cyclical component in unemployment. They are also relevant because, given prevailing uncertainty, they help insure against the risk that a weak economy is contributing to hysteresis effects."

Figure 1. ECB balance sheet (assets)



Source: ECB.

Figure 2. Bad debt



Source: National central banks.

[1] See the special study in the *Revue de l'OFCE* no. 136, "[Comment lutter contre la fragmentation du système bancaire de](#)

[la zone euro?"](#) for an examination of the various monetary policy measures taken by the ECB since the onset of the financial crisis and an estimate of their impact on the real economy.

[2] This includes standard monetary policy operations as well as the VLTR0 operation through which the ECB provided liquidity for an exceptional term of 3 years in December 2011 and February 2012.

[3] This involves programs for the purchase of securities in the market and not cash distributed directly to the banks. The covered bonds and ABS are securities pledged on assets whose remuneration depends on that of the underlying asset, which is by necessity a mortgage in the case of covered bonds and which in the case of ABS may include other types of loans (credit cards, cash loans to businesses, etc.).

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## **Does growth in the euro zone really depend on a hypothetical German fiscal stimulus?**

By [Christophe Blot](#) and [Jérôme Creel](#)

The debate on economic policy in Europe was re-ignited this summer by [Mario Draghi](#) during the now traditional symposium at Jackson Hole, which brings together the world's main central bankers. Despite this, it seems that both the one side

([Wolfgang Schäuble](#), Germany's finance minister) and the other ([Christine Lagarde](#), head of the IMF) are holding to their positions: fiscal discipline plus structural reforms, or demand stimulus plus structural reforms. Although the difference can seem tenuous, the way is now open for what Ms. Lagarde called "fiscal manoeuvring room to support a European recovery". She is targeting Germany in particular, but is she really right?

In an [interview](#) with the newspaper *Les Echos*, Christine Lagarde said that Germany "very likely has the fiscal manoeuvring room necessary to support a recovery in Europe". It is clear that the euro zone continues to need growth (in second quarter 2014, GDP was still 2.4% below its pre-crisis level in first quarter 2008). Despite the interest rate cuts decided by the ECB and its ongoing programme of exceptional measures, a lack of short-term demand is still holding back the engine of European growth, mainly due to the generally tight fiscal policy being pursued across the euro zone. In today's context, support for growth through more expansionary fiscal policy is being constrained by tight budgets and by a political determination to continue to cut deficits. Fiscal constraints may be real for countries that are heavily in debt and have lost market access, such as Greece, but they are more of an institutional nature for countries able to issue government debt at historically very low levels, such as France. For Ms. Lagarde, Germany has the manoeuvring room that makes it the only potential economic engine for powering a European recovery. A more detailed analysis of the effects of its fiscal policy – both internally and spillovers to European partners – nevertheless calls for tempering this optimism.

The mechanisms that underlie the hypothesis of Germany driving growth are fairly simple. An expansionary fiscal policy in Germany would boost the country's domestic demand, which would increase imports and create additional opportunities for companies in other countries in the euro zone. In return,

however, the impact could be tempered by a slightly less expansionary monetary policy: as [Martin Wolf](#) argues, didn't Mario Draghi ensure that the ECB would do everything in its power to ensure price stability over the medium term?

In a [recent OFCE working document](#), we have tried to capture these various commercial and monetary policy effects in a dynamic model of the euro zone. The result is that a positive fiscal impulse of 1 GDP point in Germany for three consecutive years (a plan involving 27.5 billion euros per year [\[1\]](#)) would boost growth in the euro zone by 0.2 point in the first year. This impact is certainly not negligible. However, this is due solely to the stimulation that would benefit German growth and not to spillovers to Germany's European partners. Indeed, and as an example, the increase in Spain's growth would be insignificant (0.03 point of growth in the first year). The weakness of the spillover effects can be explained simply by the moderate value of Germany's fiscal multiplier [\[2\]](#). Indeed, the recent literature on multipliers suggests that they rise as the economy goes deeper into a slump. But based on the estimates of the output gap retained in our model, Germany is not in this situation, and indeed the multiplier has dropped to 0.5 according to the calibration of the multiplier effects selected for our simulations. For an increase in German growth of 0.5 percentage points, the effect of the stimulation on the rest of the euro zone is therefore low, and depends on Germany's share of exports to Spain and the weight of Spanish exports in Spanish GDP. Ultimately, a German recovery would undoubtedly be good news for Germany, but the other euro zone countries may be disappointed, just as they undoubtedly will be from the implementation of the minimum wage, at least in the short term, as is suggested by [Odile Chagny and Sabine Le Bayon](#) in a recent post. We can also assume that in the longer term the German recovery would help to raise prices in Germany, thereby degrading competitiveness and providing an additional channel through which other countries in the euro zone could benefit from stronger growth.

And what would happen if the same level of fiscal stimulus were applied not in Germany, but rather in Spain, where the output gap is more substantial? In fact, the simulation of an equivalent fiscal shock (27.5 billion euros a year for three years, or 2.6 points of Spanish GDP) in Spain would be much more beneficial for Spain but also for the euro zone. While in the case of a German stimulus, growth in the euro zone would increase by 0.2 percentage points over the first three years, it would increase by an average of 0.5 points per year for three years in the event of a stimulus implemented in Spain. These simulations suggest that if we are to boost growth in the euro zone, it would be best to do this in the countries with the largest output gap. It is more effective to spend public funds in Spain than in Germany.

In the absence of any relaxation of the fiscal constraints on Spain, a stimulus plan funded by a European loan, whose main beneficiaries would be the countries most heavily affected by the crisis, would undoubtedly be the best solution for finally putting the euro zone on a path towards a dynamic and sustainable recovery. The French and German discussions of an investment initiative are therefore welcome. Hopefully, they will lead to the adoption of an ambitious plan to boost growth in Europe.

**Table. Impact of a fiscal expansion in Germany and in Spain**

In percentage points

	Fiscal expansion in Germany			Fiscal expansion in Spain		
	German growth	Spanish growth	Euro zone growth	German growth	Spanish growth	Euro zone growth
2013	0,5	0,0	0,2	0,0	4,9	0,5
2014	0,6	0,0	0,2	0,0	5,8	0,7
2015	0,5	0,0	0,2	0,0	2,8	0,4
2016	0,0	0,0	0,0	0,0	-0,7	-0,1
2017	-0,6	0,0	-0,2	0,0	-2,6	-0,3
2018	-0,8	0,0	-0,2	0,0	-3,0	-0,3
2019	-0,7	0,0	-0,2	0,0	-2,9	-0,3

Source: IAGS model.

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[1] The measure is then compensated in a strictly equivalent way so that the shock amounts to a transient fiscal shock.

[2] Recall that the fiscal multiplier reflects the impact of fiscal policy on economic activity. Thus, for one GDP point of fiscal stimulus (or respectively, tightening), the level of activity increases (respectively, decreases) by  $k$  points.

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## Dealing with the ECB's triple mandate

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

The financial crisis has sparked debate about the role of the central banks and monetary policy before, during and after the economic crisis. The prevailing consensus on the role of the central banks is eroding. Having price stability as the sole objective is giving way to the conception of a triple mandate that includes inflation, growth and financial stability. This is *de facto* the orientation that is being set for the ECB. We delve into this situation in one of the [articles](#) of the OFCE issue entitled *Reforming Europe* [1], in which we discuss the implementation of these three objectives.

The exclusive pursuit of the goal of price stability is now insufficient to ensure macroeconomic and financial stability. [2] A new paradigm is emerging in which the central banks need to simultaneously ensure price stability, growth and financial

stability. This has been the orientation of recent institutional changes in the ECB, including its new responsibility for micro-prudential supervision. [\[3\]](#) Furthermore, the conduct of the euro zone's monetary policy shows that the ECB has also remained attentive to trends in growth [\[4\]](#). But if the ECB is indeed pursuing a triple mandate, what then is the proper relationship between these missions?

The crucial need for coordination between the different actors in charge of monetary policy, financial regulation and fiscal policy is lacking in the current architecture. Furthermore, certain practices need to be clarified. The ECB has played the role of lender of last resort (with banks and to a lesser extent States) even though it has not specifically been assigned this role. Finally, in a new framework in which the ECB plays a greater role in determining the euro zone's macroeconomic and financial balance, we believe it is necessary to strengthen the democratic accountability of the Bank. The definition of its objectives in the Maastricht Treaty in fact gives it strong autonomy in interpretation (see in particular the discussion by Christophe Blot, [here](#)). Moreover, while the ECB regularly reports on its work to the European Parliament, the latter does not have any way to direct this [\[5\]](#).

Based on these observations, we discuss several proposals for coordinating the ECB's three objectives more effectively henceforth:

1 – Even without modifying the treaties in force, it is important that the heads of the ECB be more explicit about the different objectives being pursued [\[6\]](#). The declared priority of price stability no longer corresponds to the practice of monetary policy: growth seems to be an essential objective, as is financial stability. More transparency would make monetary policy more credible and certainly more effective in preventing another financial and banking crisis in particular. The use of exchange rate policy [\[7\]](#) should not be overlooked,



as it can play a role in reducing macroeconomic imbalances within the euro zone.

2 – In the absence of such clarification, the ECB's extensive independence needs to be challenged so that it comes up to international standards in this area. Central banks rarely have independence in deciding their objectives: for example, the US Federal Reserve pursues an explicit dual mandate, while the Bank of England's actions target institutionalized inflation. An explicit triple mandate could be imposed on the ECB by the governments, with the heads of the ECB then needing to make effective tradeoffs between these objectives.

3 – The increase in the number of objectives pursued has made it more difficult to deal with tradeoffs between them. This is particularly so given that the ECB has *de facto* embarked on a policy of managing the public debt, which now exposes it to the problem of the sustainability of Europe's public finances. The ECB's mandate should therefore explicitly spell out its role as lender of last resort, a normal task of central banks, which would clarify the need for closer coordination between governments and the ECB.

4 – Rather than calling the ECB's independence completely into question, which would never win unanimity among the Member States, we call for the creation *ex nihilo* of a body to supervise the ECB. This could emanate from the European Parliament, which is responsible for discussing and analyzing the relevance of the monetary policy established with respect to the ECB's expanded objectives: price stability, growth, financial stability and the sustainability of the public finances. The ECB would then not only be invited to report on its policy – as it is already doing to Parliament and through public debate – but it could also see its objectives occasionally redefined. This “supervisory body” could for example propose quantified inflation targets or unemployment targets.

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[1] *Reforming Europe*, edited by Christophe Blot, Olivier Rozenberg, Francesco Saraceno and Imola Strehö, *Revue de l'OFCE*, no. 134, May 2014. This issue is available in [French](#) and [English](#) and has been the subject of a post on the OFCE [blog](#).

[2] This link is examined in "[Assessing the Link between Price and Financial Stability](#)" (2014), Christophe Blot, Jérôme Creel, Paul Hubert, Fabien Labondance and Francesco Saraceno, *Document de travail de l'OFCE*, 2014-2.

[3] The implementation of the banking union gives the ECB a role in financial regulation (Decision of the Council of the European Union of 15 October 2013). It is henceforth in charge of banking supervision (particularly credit institutions considered "significant") in the Single supervisory mechanism (SSM). As of autumn 2014, the ECB will be responsible for micro-prudential policy, in close cooperation with national organizations and institutions. See the article by Jean-Paul Pollin, "Beyond the banking union", in *Revue de l'OFCE*, [Reforming Europe](#).

[4] Castro (2011), "[Can central banks' monetary policy be described by a linear \(augmented\) Taylor rule or by a nonlinear rule?](#)", *Journal of Financial Stability* vol.7(4), p. 228-246. This paper uses an estimation of Taylor rules between 1991:1 and 2007:12 to show that the ECB reacted significantly to inflation and to the output gap.

[5] In the United States, the mandate of the Federal Reserve is set by Congress, which then has a right of supervision and can therefore amend the Fed's articles and mandate.

[6] Beyond clarifying objectives in terms of inflation and growth, the central bank's fundamental objective is to ensure confidence in the currency.

[7] This issue is considered in part in a recent OFCE [post](#).

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# The ECB – or how to become less conventional

By [Jérôme Creel](#) and [Paul Hubert](#)

The gloomy economic situation in the euro zone and the deflationary risks it is facing are leading the members of the European Central Bank (ECB) to consider a new round of quantitative easing, as can be seen in [recent statements by German, Slovakian and European central bankers](#). What might this involve, and could these measures be effective in boosting the euro zone economy?

Quantitative easing (QE) includes several different types of unconventional monetary policy. To define them, it is necessary to start by characterizing conventional monetary policy.

*Conventional* monetary policy involves changing the key interest rate (the rate for so-called medium-term refinancing operations) by what are called open market operations so as to influence financing conditions. These operations can change the size of the central bank's balance sheet, including by means of money creation. So there is a stumbling block in distinguishing between conventional and unconventional policy: increasing the size of the central bank's balance sheet is not sufficient in itself to characterize an unconventional policy.

In contrast, strictly speaking an unconventional quantitative

easing policy gives rise to an increase in the size of the central bank's balance sheet but without any immediate additional money creation: the extra liquidity provided by the central bank to the commercial banks serves to increase their reserves with the central bank, so long as these reserves are ultimately used for the subsequent acquisition of securities or to grant loans. These reserves, which are the commercial banks' safe assets, help to consolidate their balance sheets: risky assets decrease in proportion, while safe assets increase.

Another type of unconventional monetary policy, qualitative easing, consists of modifying the structure of the central bank's balance sheet, usually on the assets side, but without changing the size of the balance sheet. This may mean that the central bank purchases riskier securities (not AAA rated) to the detriment of safer securities (AAA). In doing this, the central bank reduces the amount of risk on the balance sheets of the banks from which it has acquired these higher-risk securities.

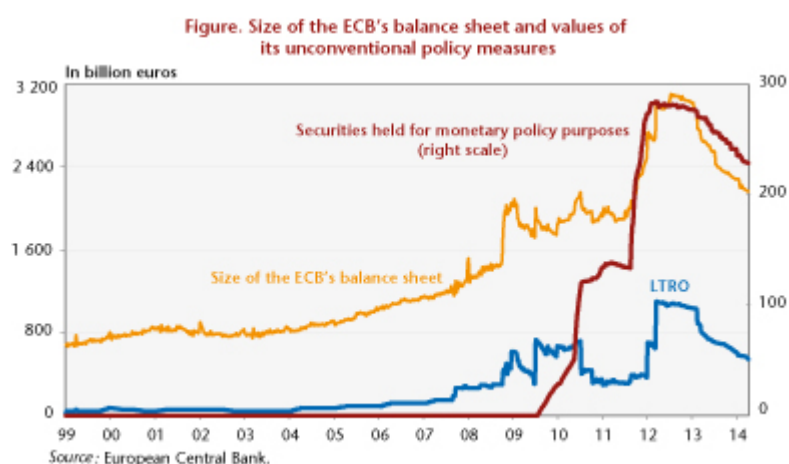
A final type of unconventional monetary policy involves conducting an easing policy that is both qualitative and quantitative: credit easing, *i.e.*, the size of the balance sheet of the central bank and the resulting risk increase in concert.

Unconventional monetary policies that are often attributed to the ECB include operations to provide long-term liquidity (3 years) at low interest rates, as was done in November 2011 and February 2012, and which were described as very long-term refinancing operations (VLTRO). But were these really unconventional large-scale operations? On the one hand, these operations involved not trillions of euros but an amount closer to 500 billion, which is not negligible after correcting for bank repayments to the ECB. On the other, the LTRO operations are part of the ECB's conventional policy arsenal. Finally, these operations were partially sterilized:

the loans granted by the ECB to the commercial banks were offset by sales of securities by the ECB, thereby altering the structure of its assets. So we can conclude that the VLTRO operations were in part “conventional” and in part “unconventional”.

The situation is different for the Securities Market Programme mechanism, which consisted, on the part of the ECB, of purchasing government debt on the secondary markets during the sovereign debt crisis. This mechanism led to increasing the size of the ECB’s balance sheet, but also the risk involved: the policy of credit easing has indeed been an unconventional policy.

Given the different definitions of unconventional policy in current use, it is helpful to recall that the ECB explicitly indicates the amounts it has agreed within the framework that it sets for its unconventional policies, which are called Securities held for monetary policy purposes. These amounts are graphed in the figure below. They show the frequency and magnitude of the monetary activities that the ECB itself defines as unconventional.



The three different measures shown in the figure (size of the ECB’s balance sheet, LTRO amounts, and amounts of Securities held for monetary policy purposes) are expressed in billions of euros. The first two went up in the fourth quarter of 2008 after the bankruptcy of Lehman Brothers, whereas the third

measure of unconventional policy started only in June 2009. We then see a new joint deepening of these measures at end 2011. Following this episode, the amount of LTRO operations came to 1090 billion euros, which represented about 50% of euro zone GDP (2,300 billion euros), i.e., about one-third of the ECB's balance sheet, while the amount of Securities held for monetary policy purposes was only 280 billion euros, or 13% of euro zone GDP, about a quarter of the LTRO operations. It is interesting to note that the ECB's monetary policy, which depends on the banks' demand for liquidity, changed in 2013. One can interpret the reduction in the balance sheet size as a sign of a less expansionary policy or as a reduction in the demand for liquidity from the banks. In the first case, this would indicate that the strategy for ending the monetary easing policy probably came too early in terms of the European economy – hence the recently evoked recourse to new unconventional measures.

Until then, these measures had been formally introduced to restore the channels for transmitting the ECB's monetary policy to the real economy, channels that in some euro zone countries have been scrambled by the financial crisis and the euro zone crisis. The way to restore these channels was to inject liquidity into the economy and to increase the reserves of the banking sector in order to encourage banks to start lending again. Another objective of these policies was to send a signal to investors about the central bank's ability to ensure the stability and sustainability of the euro zone, as reflected in Mario Draghi's famous "whatever it takes" [\[1\]](#) statement on 26 July 2012.

In a recent working paper with Mathilde Viennot, we consider the effectiveness of conventional and unconventional policies during the financial crisis. We estimate how much the conventional instrument and the purchases of securities held for monetary policy purposes under the ECB's unconventional policies have affected interest rates and the volumes of new

loans granted in various markets: loans to non-financial corporations, to households and on the sovereign debt market, the money market and the deposit market.

We show that unconventional policies have helped to reduce interest rates on the money market, on the government securities market and on loans to non-financial companies. These policies have not, however, affected the volume of loans granted. At the same time, it turns out that the conventional instrument, whose lack of effectiveness was one of the justifications for implementing unconventional measures, had the expected impact on almost all the markets surveyed, and more so in the southern euro zone countries than in the northern ones on the market for 6-month sovereign debt and for real estate loans to consumers.

So it seems that unconventional policies have had a direct impact on the sovereign debt market as well as indirect effects, helping to restore the effectiveness of the conventional instrument on other markets. One of the reasons that helps to explain the weak impact of both instruments on the volumes of loans granted is the need facing the commercial banks [2] to shed debt and reduce the size of their balance sheets by adjusting their portfolio of risk-weighted assets, which has pushed them to increase their reserves rather than to play their intermediation role and to demand relatively higher compensation for each exposure taken.

Though legitimate, this behaviour is affecting the transmission of monetary policy: interest rates fall but lending doesn't restart. It thus seems important that monetary policy is not based exclusively on the banking sector. If there is a new round of unconventional operations, it should be focused directly on the acquisition of sovereign or corporate debt in order to bypass the banking sector. This workaround would undoubtedly lead to amplifying the transmission of monetary policy to the real economy. And it would be welcomed for helping to avoid the risk of deflation

in the euro zone.[\[3\]](#)

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[\[1\]](#) “The ECB is ready to do whatever it takes to preserve the euro. And believe me, it will be enough.”

[\[2\]](#) The reasoning behind unloading debt also applies to their customers: the non-financial agents.

[\[3\]](#) See the [post](#) by Christophe Blot on this subject as well as the recent [Council of Economic Analysis \(CAE\) report](#) by Agnès Bénassy-Quéré, Pierre-Olivier Gourinchas, Philippe Martin and Guillaume Plantin.

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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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## **Does financial instability really undermine economic performance?**

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

What relationship can be established between the degree to



which an economy is financialized (understood as the ratio of credit to the private sector over GDP), financial instability and economic performance (usually GDP per capita) in the European Union (EU)? [A recent working paper \[1\]](#) attempts to provide a few answers to this question.

Two major competing approaches can be found in the economic literature. On the one hand, an approach inherited from Schumpeter emphasizes the need for entrepreneurs to access sources of credit to finance their innovations. The financial sector is thus seen as a prerequisite to innovative activity and a facilitator of economic performance. On the other hand, financial development can be viewed instead as the result or consequence of economic development. Development implies increased demand for financial services on the part of households and businesses. There is therefore a source of endogeneity in the relationship between financial development and economic growth, as one is likely to lead to the other, and vice versa.

Until recently, analytical studies that attempted to disentangle and quantify these causalities showed a positive significant link between an economy's financial depth and its economic performance ([Ang, 2008](#)). However, the onset of the international financial crisis led to nuancing these conclusions. In particular, [Arcand et al. \(2012\)](#) showed that beyond a certain level the impact of increased financialization becomes negative [\[2\]](#). The relationship between financialization and economic performance can be represented by a bell curve: positive at the beginning and then, from a level of 80%-100% for the private credit to GDP ratio, fading to zero or turning negative.

Unlike other works that include both developed and emerging or developing countries, our study focuses on the EU Member States from 1998 to 2011. The advantage of this sample is that we include only economies whose financial systems are developed or at least in advanced stages of development [\[3\]](#).



Moreover, it is a relatively homogeneous political space that permits the establishment of common financial regulations. We adopt the methodology of [Beck & Levine \(2004\)](#) who, using a panel and instrumental variables, are able to resolve the endogeneity issues discussed above. Economic performance is explained by the usual variables in endogenous growth theory, namely initial GDP per capita, the accumulation of human capital over the average years of education, government expenditure, trade openness and inflation. In addition, we include the aforementioned financialization variables. We show that, contrary to the usual results in the literature, an economy's financial depth does not have a positive impact on economic performance as measured by GDP per capita, household consumption, business investment or disposable income. In most cases, the effect of financialization is not different from zero, and when it is, the coefficient is negative. It is therefore difficult to argue that financial and economic development go hand in hand in these economies!

In addition, we included in these estimates different variables quantifying financial instability so as to check whether the results set out above might be due simply to the effects of the crisis. These financial instability variables (Z-score [\[4\]](#), [CISS\[5\]](#), bad debt rate, the volatility of stock market indices and an index reflecting the microeconomic characteristics of Europe's banks) usually seem to have a significant *negative* impact on economic performance. At the same time, the variables measuring the *degree* of an economy's financialization show no obvious effects on performance.

These various findings suggest that it is certainly unrealistic to expect a positive impact of any further increase in the degree of financialization of Europe's economies. It is likely that the European banking and financial systems have reached a critical size beyond which no improvement in economic performance can be expected. Instead, there are likely to be negative effects due to the financial

instability arising out of a financial sector that has grown overly large and whose innovations are insufficiently or poorly regulated.

The findings of this study suggest several policy recommendations. The argument of the banking lobbies that regulating bank size would have a negative impact on growth finds absolutely no support in our results—quite the contrary. Furthermore, we show that financial instability is costly. It is important to prevent it. This undoubtedly requires developing a better definition of micro- and macro-prudential standards, together with effective supervision of Europe's banks. Will the forthcoming banking union help in this regard? There are many sceptics, including the economists of [Bruegel](#), the [Financial Times](#) and the [OFCE](#).

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[\[1\]](#) Creel, Jérôme, Paul Hubert and Fabien Labondance, "Financial stability and economic performance", *Document de travail de l'OFCE*, 2013-24. This study was supported by funding from the European Union Seventh Framework Program (FP7/2007-2013) under grant agreement no. 266800 (FESSUD).

[\[2\]](#) We consider this work in an earlier [post](#).

[\[3\]](#) In addition to the ratio of private sector credit to GDP, the depth of financialization is also indicated by the turnover ratio, which measures the degree of liquidity of financial markets, measured as the ratio of the total value of shares traded to total capitalization.

[\[4\]](#) Index measuring the stability of banks based on their profitability, their capital ratio and the volatility of their net income.

[5] Index of systemic risk calculated by the ECB and including five components of the financial system: the banking sector, non-bank financial institutions, money markets, securities markets (stocks and bonds) and foreign exchange markets.

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# Does too much finance kill growth?

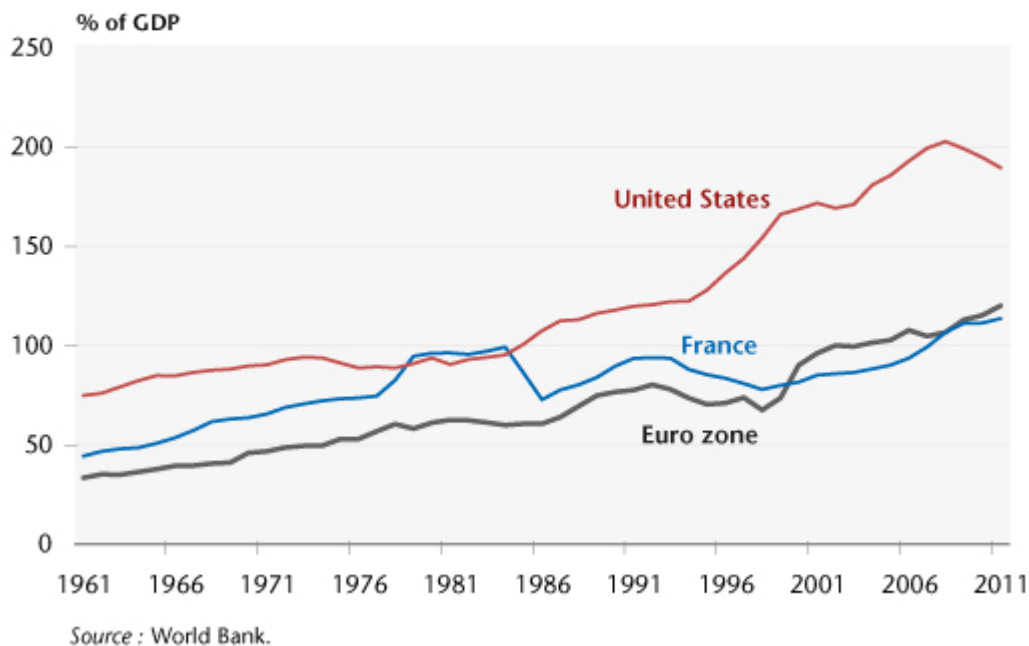
By [Jérôme Creel](#), [Paul Hubert](#) and Fabien Labondance

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**



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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# The Cypri-hot case!

By [Jérôme Creel](#)

In advance of a more in-depth study of the crisis in Cyprus and its impact on the euro zone, here are a few thoughts on the draft agreement reached last Monday morning, 25 March, between the Cypriot Presidency and some of the donors.

This [proposal](#) provides for the winding up of a private bank, Laiki, and shifting of its insured deposits (under 100,000 euros) to another private bank, the Bank of Cyprus, as part of its recapitalization. Deposits in the Bank of Cyprus in excess of 100,000 euros will be frozen and converted into shares. Ultimately, the Bank of Cyprus should be able to achieve a capital ratio of 9%, complying with applicable EU banking legislation. In exchange for these provisions and for an increase in taxes on capital gains and corporate profits, the European institutions will contribute 10 billion euros to Cyprus. Bank deposits guaranteed under the rules in force in the EU will still be insured, while the increase in capital gains taxes will reduce the remuneration of deposits in Cyprus, which have been above the European average.

In one week, the negotiations between the Cypriot authorities, the IMF and Europe's institutions have led to radically different results. For the part of the rescue plan needed for the viability of the banking system, the Cypriot President was apparently faced with a choice between a levy on all depositors, including "small savers", and a bank failure that would entail financial losses only for shareholders, bondholders and "big savers" (those with deposits of over 100,000 euros). It thus took a week for the democratically elected representative of a Member State of the European Union to give in and uphold the interests of the many (the general interest?) over the interests of the few, a handful of bankers.

The March 25<sup>th</sup> draft agreement also included a very interesting reference to the issue of money laundering. Cypriot banks will undergo audits to better understand the origin of the funds they collect. This time it did not take a week, but rather years for members of the Eurogroup to deal formally with a basic question about the operation of the Cypriot economy. Beyond Cyprus itself, there is reason to wonder whether there isn't funny money in the EU too.

One final thought about the International Monetary Fund, the donor partner that together with the European Central Bank and the European Commission makes up the Troika. It seems that it set many of the requirements: should we conclude that the IMF has much more bargaining power than the ECB and the European Commission, that it is the leader of this Troika? If this is so, it would raise some problems: first, the ECB and the Commission are supposed to defend the interests of Europe, which would not be the case if these two institutions were under the thumb of the IMF. Second, we should not forget that during the recapitalization of April 2009, the IMF received additional funds from the EU countries, which was a wise decision on their part if their representatives anticipated that soon they would need recourse to bailout funds, with the funds allocated to the IMF returning back to the EU in the form of loans. That said, having the IMF dictate drastic conditions for qualifying for bailout funds that have largely been contributed by from the EU itself is questionable, and would undermine the process of European integration.