

An ever so fragile recovery

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This text summarizes the OFCE's [economic forecast for 2015-2017](#) for the euro zone and the rest of the world.

The figures for euro zone growth in the first half of 2015 have confirmed the upswing glimpsed at the end of 2014. While the zone's return to growth might once have been taken to indicate the end of the global economic and financial crisis that struck in 2008, the turbulence hitting the emerging countries, particularly over the summer in China, is a reminder that the crisis ultimately seems to be continuing. China's economic weight and its role in world trade are now so substantial that, even in the case of a soft landing, the impact on growth in the developed countries would be significant. We nevertheless anticipate that the scenario for a recovery need not be called into question, and that euro zone growth will be broadly supported by favourable factors (lower oil prices and ECB monetary support) and by some weakening of unfavourable factors (easing of fiscal policies). But the fact remains that the situation in the developing world will add new uncertainty to an already fragile recovery.

Between 2012 and 2014, the euro zone economies stagnated at the very time that the United States turned in average GDP growth of 2%. The recovery that got underway after the sharp contraction in 2008-2009 was quickly cut short in the euro zone by the sovereign debt crisis, which led almost immediately to the uncontrolled tightening of financial conditions and the reinforcement of the fiscal consolidation being implemented in the Member States, as they searched for market credibility.

The euro zone then plunged into a new recession. In 2015,

these economic policy shocks are no longer weighing on demand. The ECB helped to reduce sovereign debt risk premiums by announcing the Outright Monetary Transaction programme (OMT) in September 2012 and then by implementing quantitative easing so as to improve financial conditions and promote a fall in the euro. In terms of fiscal policy, while in some countries the consolidation phase is far from over, the measures being taken are smaller in scale and frequency. Furthermore, growth will also be helped by the fall in oil prices, which should last, and the resulting gains in household purchasing power should in turn fuel private consumption. These factors thus reflect an environment that is much more favourable and propitious for growth.

However, it is clear that this scenario depends on some volatile elements, such as the fall in oil prices and the weaker euro. The Chinese slowdown adds another element of risk to the scenario, which is based on the assumption that China will make a smooth transition from an export-oriented growth model to one driven by domestic demand. We expect the euro zone to grow at a rate of 1.5% in 2015 and 1.8% in 2016 and 2017. The main short-term risks to this scenario are negative. If oil prices go up and the euro doesn't stay down, and if the slowdown in the emerging countries turns into an economic and financial crisis, then growth worldwide and in the euro zone will be significantly lower. This risk is particularly critical given the very high level of unemployment still plaguing the zone (11% in August 2015). Nevertheless, given the pace of anticipated growth, we expect the unemployment rate to fall in 2016-2017 by around 0.6 percentage point per year. At this pace, it will take almost seven years to bring the rate back to its pre-crisis level. So while the prospects for recovery from the 2008 crisis are uncertain, the social crisis undoubtedly has a long time to run.

The redistributive effects of the ECB's QE programme

By Christophe Blot, Jérôme Creel, Paul Hubert, Fabien Labondance and Xavier Ragot

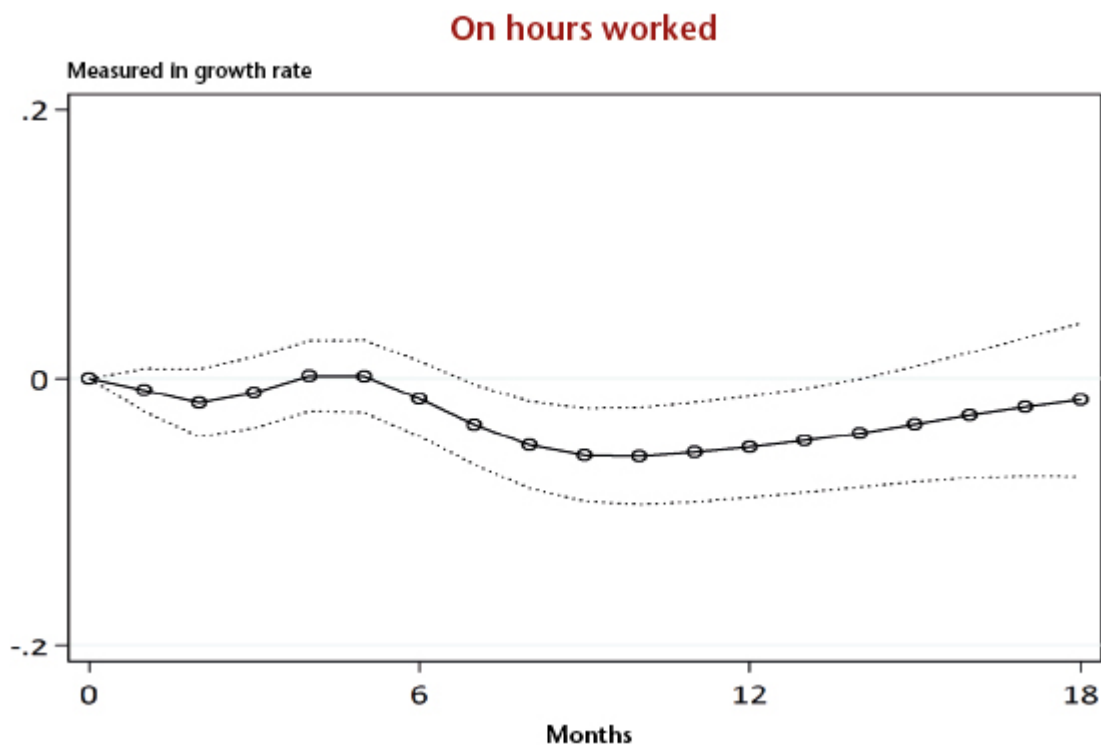
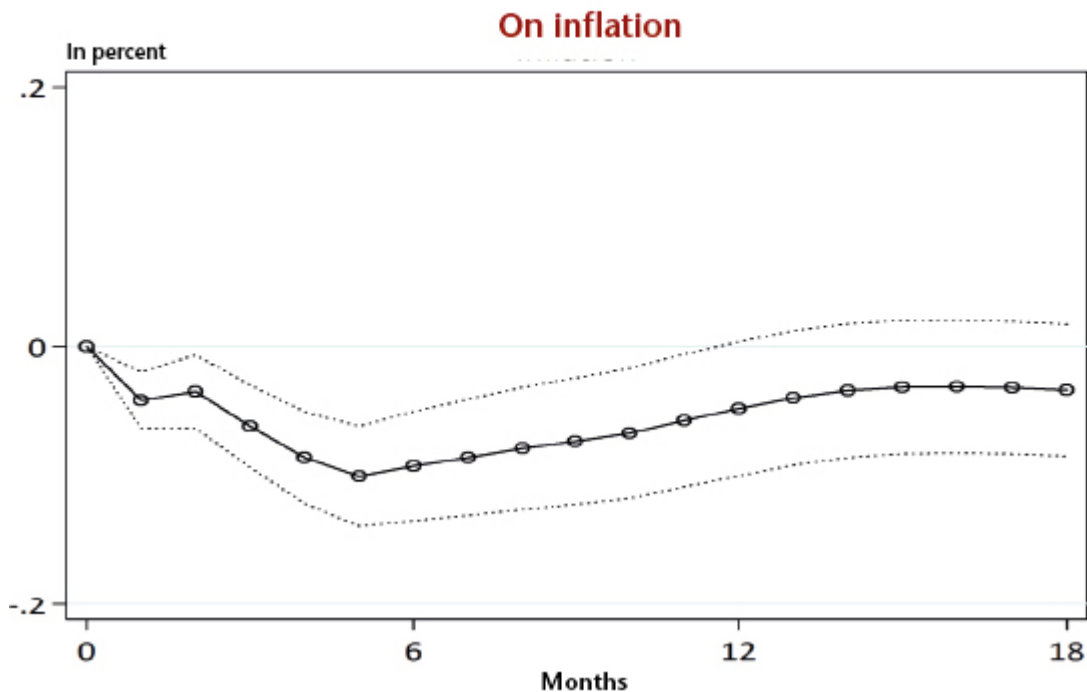
Rising inequality in income and wealth has become a key issue in discussions of economic policy, and the topic has inserted itself into evaluations of the impact of monetary policy in the US and Japan, the precursors of today's massive quantitative easing programmes (QE). The question is thus posed as to whether the ECB's QE policy has had or will have redistributive effects.

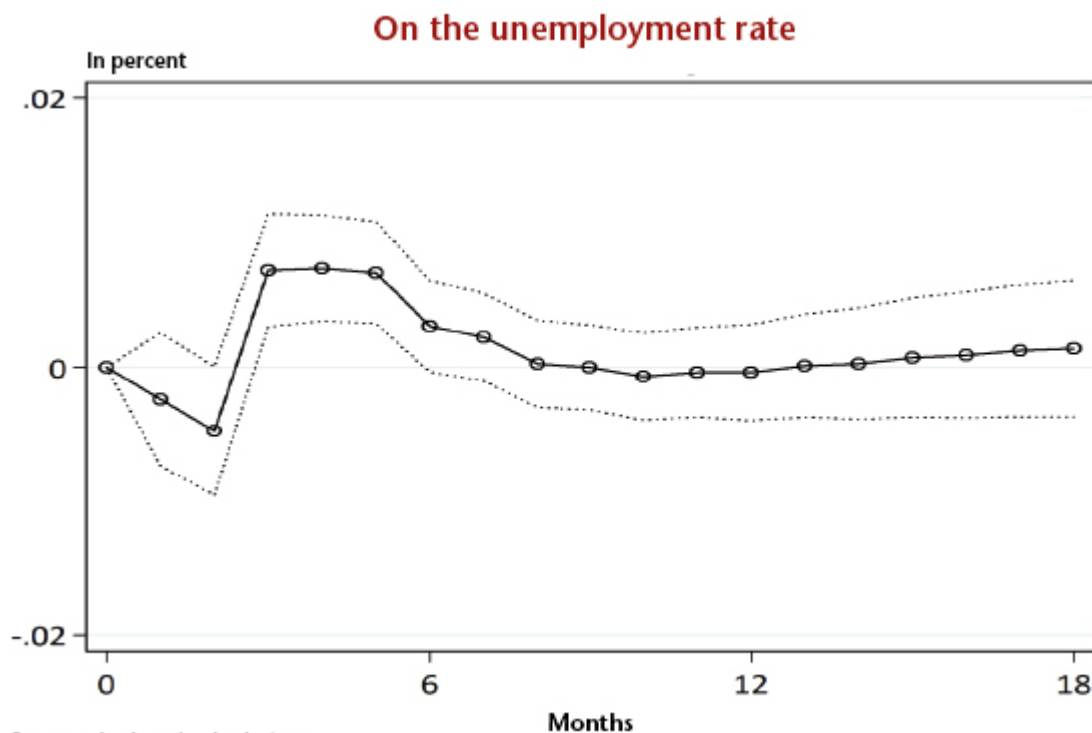
In a paper prepared for the European Parliament, [Blot et al. \(2015\)](#) point out that the empirical literature gives rise to two contradictory conclusions. In the US, the Fed's base rate cuts tend to reduce inequality. Conversely, in Japan an expansionary QE type policy tends to increase inequality. So what's the situation in Europe?

Based on macroeconomic data aggregated for the euro zone as a whole, Blot et al. (2015) show that while European monetary policy, conventional and unconventional, have indeed had an impact on the unemployment rate, the number of hours worked and the rate of inflation (see graphs), this was limited. This result suggests that the ECB's expansionary monetary policy has tended to reduce inequality, but not by much. So when the ECB finally decides to wind up its expansionary policy, we can expect a slight increase in inequalities to follow. Because of this effect, though small, Blot et al. (2015) suggest that the ECB should be held accountable not just for price stability or economic growth, but also for the impact of its policies in

terms of inequality and the mechanisms needed to take this into account.

Figures. The impact of a restrictive monetary policy shock (0.2 percentage point hike in the implicit interest rate) in the euro zone...





Does Price Stability entail Financial Stability?

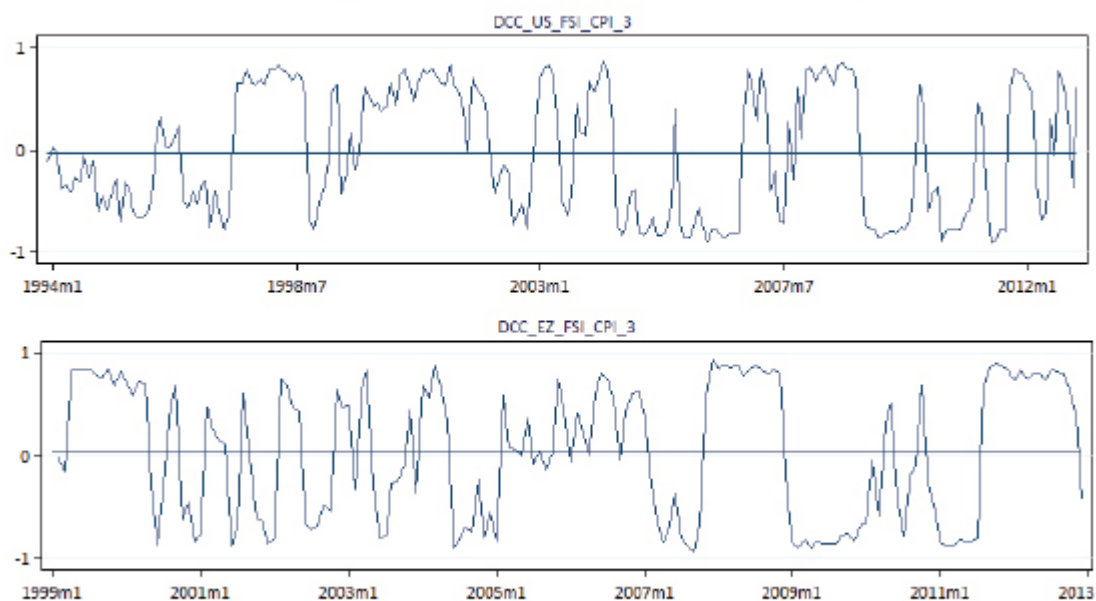
by [Paul Hubert](#) and [Francesco Saraceno \(@fsaraceno\)](#)

[Paul Krugman](#) raises the very important issue of the impact of monetary policy on financial stability. He starts with the well-known observation that, contrary to the predictions of some, expansionary monetary policy did not lead to inflation during the current crisis. He then continues arguing that tighter monetary policy would not necessarily guarantee financial stability either. If the Fed were to revert to a more standard Taylor rule, financial stability would not follow. As Krugman aptly argues, *“That rule was devised to produce stable inflation; it would be a miracle, a benefaction from the gods, if that rule just happened to also be exactly what we need to avoid bubbles.”*

Krugman in fact takes position against the “conventional wisdom”, which has been widespread in academic and policy circles alike, that a link exists between financial and price stability; therefore the central bank can always keep in check financial instability by setting an appropriate inflation target.

The global financial crisis is a clear example of the fallacy of this conventional wisdom, as financial instability built up in a period of great moderation. A [recent analysis](#) by Christophe Blot, Jérôme Creel, Paul Hubert, Fabien Labondance and Francesco Saraceno shows that the crisis is no exception, as over the past few decades, in the US and the Eurozone, the link between price and financial stability has been unclear and moreover unstable over time, as shown on the following figure.

Figure. Coefficient of correlation between consumer price index and financial stability index for the US (top) and the Euro area (bottom)



Source: Authors' computations. For more details on data and methodology, please refer to: <https://ideas.repec.org/a/eee/finsta/v16y2015icp71-88.html>

We therefore subscribe to Krugman's view that financial stability should be targeted by combining macro- and micro-prudential policies, and that inflation targeting is largely insufficient. In another [work](#), Christophe Blot, Jérôme Creel, Paul Hubert and Fabien Labondance argue that the ECB should be

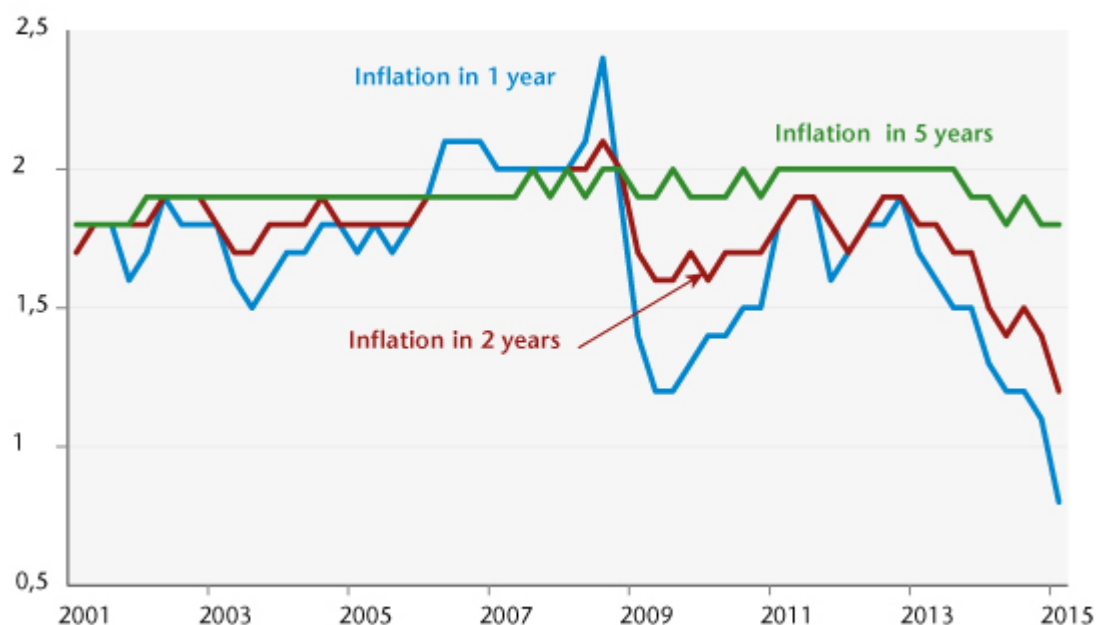
endowed with a triple mandate for financial and macroeconomic stability, along with price stability. They further argue that the ECB should be given the instruments to effectively pursue these three, sometimes conflicting objectives.

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!

[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.

Rotation of voting on the ECB Governing Council: more than symbolic?

By [Sandrine Levasseur](#)

[Lithuania's adoption of the euro](#) on 1 January brought the

number of euro zone members to nineteen, the threshold at which the voting system in the European Central Bank (ECB) Governing Council has to be changed. While this change took place almost unnoticed in France, things were different in Germany and Ireland, where the introduction of the system of rotation in the voting that decides the euro zone's monetary policy has raised concern and even opposition. Is this reaction justified? Here we propose some food for thought and reflection.

1) How will the system of rotation function?

Until now, at the monthly meetings of the ECB Governing Council that decides monetary policy (policy rates, unconventional policies) in the euro zone, the principle "one country, one vote" applied. In other words, each country had, through the Governor of its central bank, a systematic right to vote. To the votes of the 18 Governors were added the votes of the six members of the ECB Executive Board, for a total of 24 votes.

From now on, with the entry of a 19th member into the euro zone, the countries are classified into two groups, in accordance with the Treaty^[1]. The first group consists of the 5 "largest" countries, as defined by the size of GDP and the financial sector, with respective weights in the criterion of 5/6 and 1/6. The second group consists of the other countries, currently numbering 14 ^[2]. Each month the group of five "big" countries has 4 votes and the Group of 14 "small" countries 11 votes (Table 1). The voting within the two groups is organized according to a principle of rotation defined by a [precise schedule](#): the Governor of each "big" country will not vote one time out of every five, while the Governor of each "small" country will not vote 3 times out of 14. However, the 6 members of the ECB Executive Board will continue to benefit from a systematic monthly right to vote. So every month, the conduct of the euro zone's monetary policy will be decided by 21 votes, while under the old principle, that of "one country,

one vote”, 25 votes were cast.

All the Governors will continue to take part in the Council’s two monthly meetings, whether or not they take part in the voting.

Table 1. Rotation group and participation in the ECB’s capital

	GPD* (bn euros)	Bank assets (BA)	Criteria for membership in a vote rotation group (GDP 5/6; AB 1/6)	Rotation group	ECB capital****	
					Share in %	Million euros
Euro zone (19 countries)						
Germany	2 718	7 682	3 545	Group 1 (5 countries/4 votes) The governor of each country votes 80% of the time	18.0	1 948.2
France	2 044	8 229	3 074		14.2	1 534.9
Italy	1 560	4 127	1 988		12.3	1 332.6
Spain	1 023	3 287	1 400		8.8	957.0
Netherlands	602	2 339	892		4.0	433.4
Belgium	380	1 071	496	Group 2 (14 countries/11 votes) The governor of each country votes 78.6% of the time	2.1	228.2
Austria	311	922	413		2.0	212.5
Ireland	164	1 049	312		1.2	125.6
Finland	193	523	248		1.3	136.0
Portugal	164	517	223		1.7	188.7
Greece	182	421	221		2.0	220.1
Luxembourg	45	944	195		0.2	21.9
Slovakia	72	60	70		0.8	83.6
Slovenia	35	49	38		0.3	37.4
Lithuania	34	25	33		0.4	44.7
Cyprus	17	91	29		0.2	16.4
Latvia	23	28	24		0.3	30.5
Estonia	18	19	18		0.2	20.9
Malta	7	55	15		0.1	7.0
	GPD* (bn euros)	Bank assets (BA)	Criteria for membership in a vote rotation group (GDP 5/6; AB 1/6)	Rotation group	ECB capital****	
					Share in %	Million euros
Other EU members						
Potential members of the euro zone:						
Poland	388	361	384	Timetable abandoned	5.1	20.8
Republic Czech	150	192	157	Timetable abandoned	1.6	6.5
Romania	139	89	131	2019	2.6	10.6
Hungary	99	116	102	Timetable abandoned	1.4	5.6
Croatia	43	59	46	Timetable abandoned	0.6	2.5
Bulgaria	40	49	41	Timetable abandoned	0.9	3.5
Countries with opt-out clause:**					0.0	
United Kingdom	1 916	9 146	3 121	Never	13.7	55.5
Sweden	420	1 238	556	Never	2.3	9.2
Danmark	248	1 065	384	Never	1.5	6.0
European Union (28 countries)	13 036	43 753			100	10 825.0

* At end September 2013.

** Explicit (United Kingdom and Denmark) or implicit (Sweden).

*** As announced by the national authorities.

**** The contribution to ECB capital is based on the country’s GDP and population (1/2; 1/2). The key can be different from the amount actually paid into the ECB capital. The net profits and losses of the ECB are not allocated to countries that are not members of the euro zone.

Source: Eurostat and ECB; author’s calculations.

Why change the system of voting rights? The objective is clear

and justified: it is to [maintain the decision-making capacity of the Governing Council](#) as the number of countries joining the euro zone increases.

The new system of voting rights [clearly benefits the members of the ECB Executive Board](#), which now have 28.6% of the voting rights (6/21), while the old system would have given them “only” 24% (6/25). The group of “big” countries has 19% (against 20% in the old system). The group of “small” countries gets 52% (11/21) of the voting rights, whereas it would have had 56% (14/25) if the old voting system had been maintained. The group of “small” countries loses relatively more voting rights than the group of “large” countries, to the advantage of the ECB Executive Board.

2) The arguments of German and Irish opponents of the system of rotation

[The arguments of German opponents of the new system](#), beyond just a loss of prestige, are that the largest economy in the euro zone and also the largest contributor to the ECB’s capital (Table 1) must necessarily take part in the votes deciding the zone’s monetary policy. To ensure that Germany’s interests are not neglected, when Germany doesn’t vote its Governor should have a veto. This veto would also be justified by the principle that you should be responsible only for your own decisions.

In Ireland, [according to the opponents of the new system](#), the myth of equality between the countries of the euro zone is finished: the introduction of a rotation system that favours the big countries is formalizing the lack of equality between the zone’s countries. Ireland has thus been explicitly relegated to being a second tier country. Furthermore, Ireland’s influence in the decision-making process will be reduced even further as the euro zone continues to expand.

The introduction of the rotation system doesn’t seem to have

aroused as much resentment from politicians or civil society in other countries in the euro zone.

3) Do the German and Irish arguments make sense?

As is well known, Germany has a culture of stability all its own, in particular due to its history a strong aversion to inflation. In contrast, the countries of southern European are reputed to have a much less marked aversion to the “inflation tax”. It is this difference in the degree of “acceptable” inflation that has led to modelling the statutes of the ECB more or less on those of the Bundesbank, which was considered the only way of securing Germany’s participation in the euro zone. Today, however, the issue of inflation is no longer posed since the euro zone is entering into deflation, a situation that some think could last for years[\[3\]](#).

Today, it is much more the *methods* the ECB is using to conduct monetary policy that are being questioned in Germany by some of the country’s politicians, economists and citizens. The arguments being made by opponents of the rotation system, based on contributions to the ECB’s capital and more generally being Europe’s leading economic power, echo the policies that have been pursued in recent years by the ECB (e.g. easing eligibility criteria for securities deposited as collateral at the ECB, purchase of securitized assets) but also the future policy of purchasing sovereign bonds. These policies have raised fears in Germany that the ECB balance sheet will contain too much “toxic” debt that sooner or later could be dropped, with the cost of this being borne by the Bank’s principal funder.

Is it really believable that Germany’s interests wouldn’t be taken into account?

There are three arguments for answering “no”. First, even when the German Governor doesn’t vote, Germany will still have a “representative” on the Executive Board (currently Sabine

Lautenschläger)[4]. In theory, of course, the members must consider the interests of the euro zone when they vote and not just the interests of their own country, but the reality is more complex[5]. Furthermore, the Governors, even when they do not vote, still have a [right to speak](#), and therefore some power of persuasion. Finally, more generally, the [desire for a consensus](#) will make it necessary to take into consideration the opinion of the Governors who are not voting.

How justifiable are the arguments of the Irish opponents of the rotation system? It is clear that the counter-arguments developed above (concerning the right to speak and the need for a consensus) that apply to the Germans also apply to the Irish.

However, it is true that Ireland, like all the countries in Group 2, will see its voting rights [further diluted as the euro zone expands](#). When the euro zone is comprised of 20 members, the 15 Group 2 countries will have to share 11 votes (Table 2, [source: p. 91](#)). When the euro zone expands again to 21 members, 16 Group 2 countries will still have to share 11 votes ... At 22 members, the creation of a [third group](#) will result in further dilution of the voting rights of groups 2 and 3, but not of group 1, the group of “large” countries, which will still continue to vote 80% of the time.

The question that is posed for Ireland but also for all the countries currently in Group 2 concerns the future expansion of the euro zone. To date, all the countries of Central and Eastern Europe (CEE) that have not yet adopted the euro have abandoned a timetable for joining the euro zone (Table 1). The only exception is Romania, which has proposed 2019 for joining[6]. Though the prospects of the other countries have not been abandoned, they nevertheless appear very distant[7]. The likelihood that the euro zone will soon include 21 members is rather low, and the probability of exceeding 22 members even lower. Anyway, whatever the configuration, Ireland will never be part of group 3. It is thus the countries that are

lagging in today's group 2 (Malta, Estonia, Latvia, etc.) that have the most to lose in terms of the frequency of voting.

Table 2. Rotation system (first and second steps)

Total no. of governors	Group 1			Group 2			Group 3		
	Governors	Votes	Frequency of vote	Governors	Votes	Frequency of vote	Governors	Votes	Frequency of vote
First step: euro zone from 19 to 21 countries									
19	5	4	80%	14	11	79%			
20	5	4	80%	15	11	73%			
21	5	4	80%	16	11	69%			
Second step: euro zone from 22 to 27 countries									
22	5	4	80%	11	8	73%	6	3	50%
23	5	4	80%	12	8	67%	6	3	50%
24	5	4	80%	12	8	67%	7	3	43%
25	5	4	80%	13	8	62%	7	3	43%
26	5	4	80%	13	8	62%	8	3	38%
27	5	4	80%	14	8	57%	8	3	38%

Source: ECB (2009).

Conclusion

There can be no talk of a unified Europe while explaining that there are several categories of countries. How can there be congratulations for the euro zone gaining new members while at the same time explaining that only certain members can or should participate in its decision-making. In a unified Europe it is not acceptable for there to be a vote in the Council that is systematic only for certain Governors (but not all) or a right of veto that only a few Governors can exercise. Each country loses its monetary sovereignty by joining the euro zone: why should some countries lose more than others? But is it really desirable to go back to the old system of "one country, one vote"? No. The new voting system in the Governing Council is a good compromise between the need to maintain the Council's decision-making capacity (and therefore have a reduced number of voters) and the need to allow each Governor to vote on a regular basis. From this point of view, the rotation system used in the euro zone is more balanced than that used in the United States, where some members may not vote for one, two or even three years [8]. In the euro zone, the length of time that a Governor does not vote on monetary policy will not exceed one month for Group 1 countries, and

for countries currently in Group 2, it shall not exceed three months (so long as the euro zone consists of just 19 countries).

At least in theory. Because, in practice, while the Governing Council will continue to meet twice a month, the vote on the conduct of monetary policy will now take place only every six weeks ... (previously every four). The voting abstention time will thus be (slightly) longer than what is stated in the official documents of the ECB and the euro zone's national central banks...

[1] More specifically, on 21 March 2003 the European Council amended Article 10.2 of the statutes of the Eurosystem in order to allow the establishment of a system of rotation in the ECB Governing Council. The amended article provided that the rotation system could be introduced from the entry of the 16th member into the euro zone and at the latest upon the entry of the 19th member.

[2] The Treaty provides for the creation of a third group upon the entry of a 22nd country.

[3] For the first time since 2009, consumer prices fell, with prices falling -0.2% year on year.

[4] The other members of the Governing Council are from Italy (Mario Draghi, President of the ECB). Portugal (Vítor Constâncio, Vice-President of the ECB), France (Benoît Cœuré), Luxembourg (Yves Mersch) and Belgium (Peter Praet).

[5] The experience of the US Federal Open Market Committee shows that there is a regional bias in the way the Governors

vote (Meade and Sheets, 2005: “Regional Influences on FOMC Voting Patterns”, *Journal of Money Credit and Banking*, 33, pp. 661-678).

[6] It will in any case have to respect the Maastricht criteria (criteria on the public deficit, interest rates, inflation, etc.).

[7] This shift is due in part to the fact that many of the Central and East European countries have benefited from the depreciation of their currencies against the euro. They have thus understood that joining the euro zone would not just bring them benefits. In addition, it is assumed here that the United Kingdom, Denmark and Sweden will never join the euro zone because of their opt-out clause.

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

[Sandrine Levasseur](#)

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

The use of the euro alongside Lithuania's national currency, as a currency for loans, a means of savings and for invoicing,

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

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

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

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

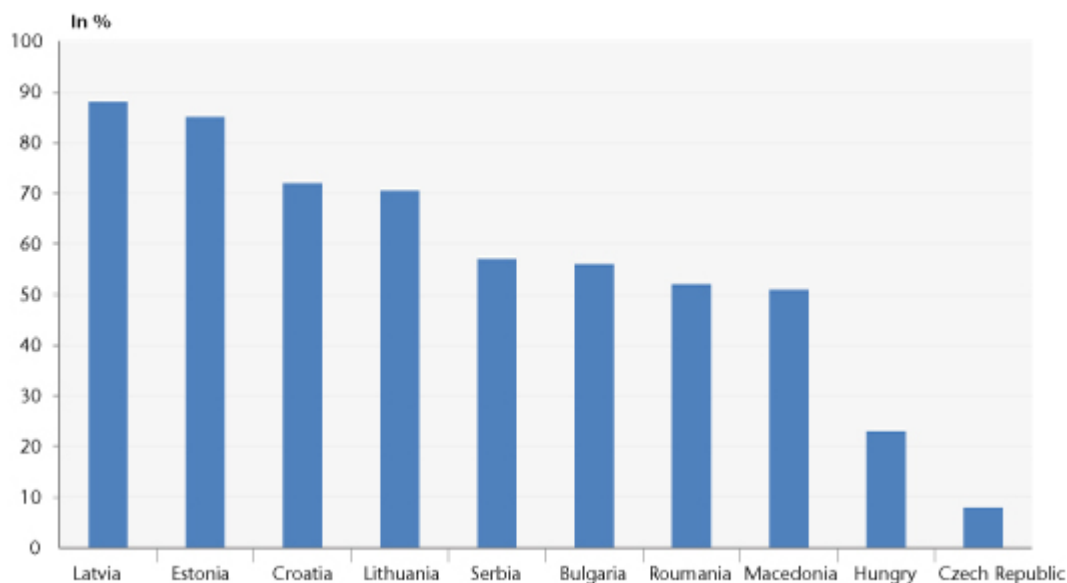
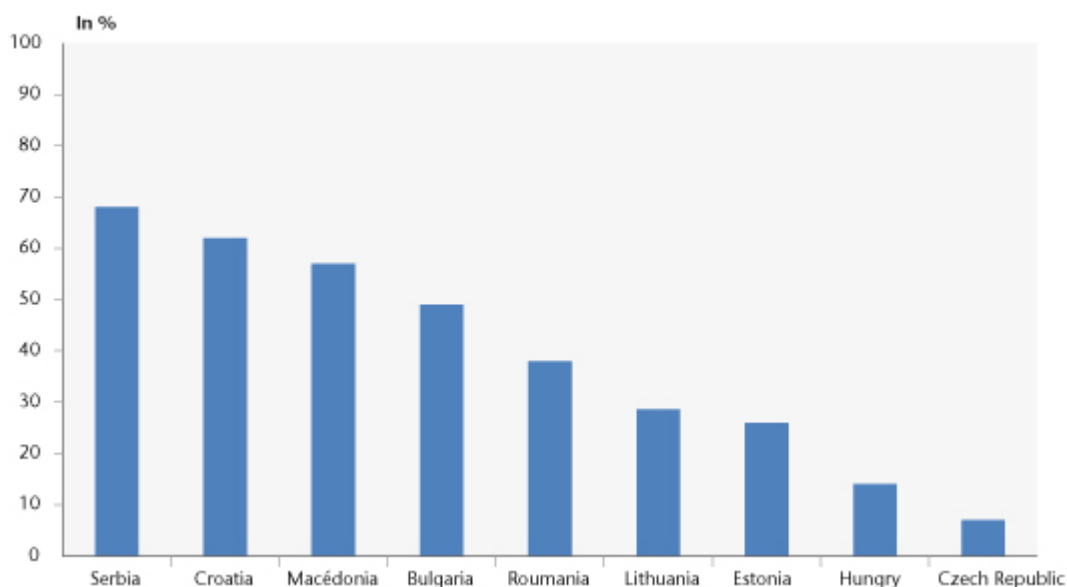


Figure 2. Share of private sector deposits in euros (emerging Europe, 2009)



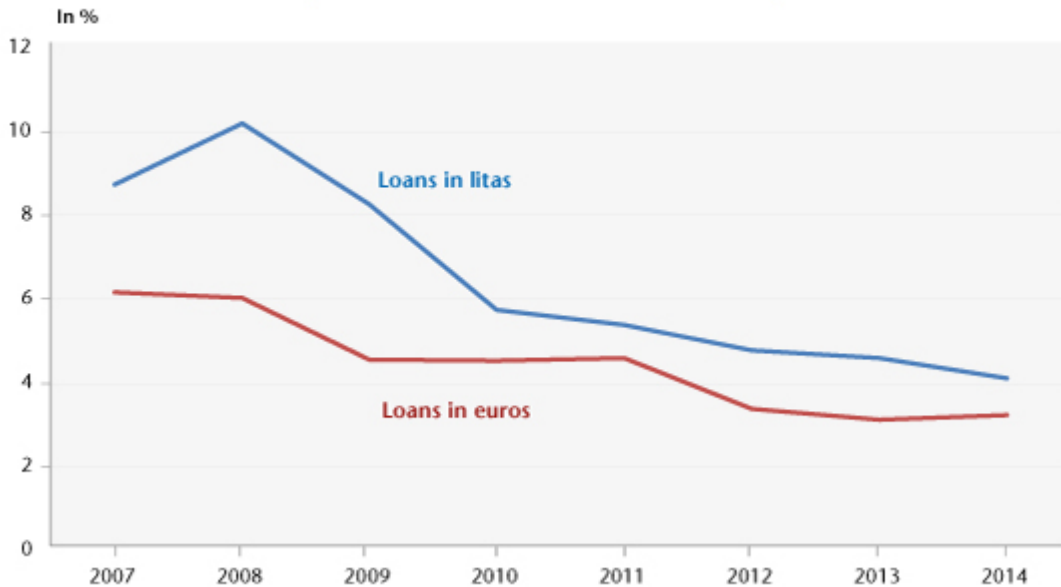
There are a number of reasons why these countries have used the euro in addition to their own currency:

- **The existence of fixed** (or relatively fixed) **exchange rates** against the euro, which protects borrowers against the risk that their euro-denominated debt will grow heavier (since the likelihood of a devaluation / depreciation of the national currency is considered to be low);
- **A lower interest rate on loans denominated in euros** than when the loans are denominated in the national currency;

- **A strong presence of multinational companies (particularly in the banking sector)** that have not only funds in euros but also the “technology” to lend / borrow in euros;
- For loans in euros, **the ex ante existence of bank deposits in euros**, which is itself linked to [multiple factors](#) (e.g. the credibility of the monetary authorities, a strong presence of multinationals, revenue from migration coming from countries in the euro zone) .

These factors have been present to a greater or lesser extent in the different countries. In Lithuania, the existence of a [Currency Board \[2\]](#) vis-à-vis the euro since 2002 has generally contributed to the economy’s “euroization”. This system of fixed exchange rates has enjoyed great credibility, prompting the country’s businesses and consumers to borrow in euros, particularly since these benefited from very low interest rates (Figure 3). The presence of multinational companies in a number of sectors strengthened the use of the euro as a benchmark currency for different functions (billing, deposits and savings). The importance to Lithuania of banks from the euro zone should nevertheless not be overestimated: [the three largest banks operating in Lithuania are from Sweden and Norway](#). The risk of loans in euros thus involves, beyond the risk associated with the value of the Lithuanian lita, a risk associated with the value of a third currency. ... This risk will obviously not disappear with Lithuania’s formal adoption of the euro.

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



What changed on 1 January 2015?

Four changes can be highlighted:

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

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

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

(4) The Governor of Lithuania's Central Bank is now a member of the ECB Governing Council and therefore participates in decision-making on euro zone monetary policy, whereas previously, under its Currency Board system^[3], Lithuania's Central Bank had no choice but to "follow" the decisions taken by the ECB in order to maintain parity with the euro. It could be argued that in any case Lithuania will not carry much weight in the ECB's choice of monetary policy due to the size of its economy. Note, however, that Lithuania's entry into the euro zone is bringing changes to the way decisions are made by the ECB Governing Council. The principle of "one country, one vote" that prevailed until now is being abandoned in accordance with the Treaties, due to the entry of a 19th member into the euro zone. Henceforth, the five "major" countries in the euro zone (defined by the weight of their GDP and their financial system) have now four voting rights, while the other fourteen countries have eleven votes. The vote in each group is established according to a rotation principle, which displeases the Germans, but not just them. In practice, however, it is not certain that this change in the voting system will affect many decisions. For example, while the governor of Germany's central bank now has only 80% of its voting right, it still has 100% of its right to speak... Will not voting one month out of five really mean that it loses its power of persuasion?

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

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

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

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

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

[1] Strictly speaking, euroization refers to the adoption of the euro as legal tender by a country without its being given permission by the issuing institution (i.e. the European Central Bank) or the decision-making authorities (i.e. the heads of State of the European Union member countries). Euroization is then said to be [unilateral](#). It differs from the phenomenon discussed here, where the euro is used in conjunction with the national currency, but only the national currency constitutes [legal tender](#).

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

[3] See footnote 2.

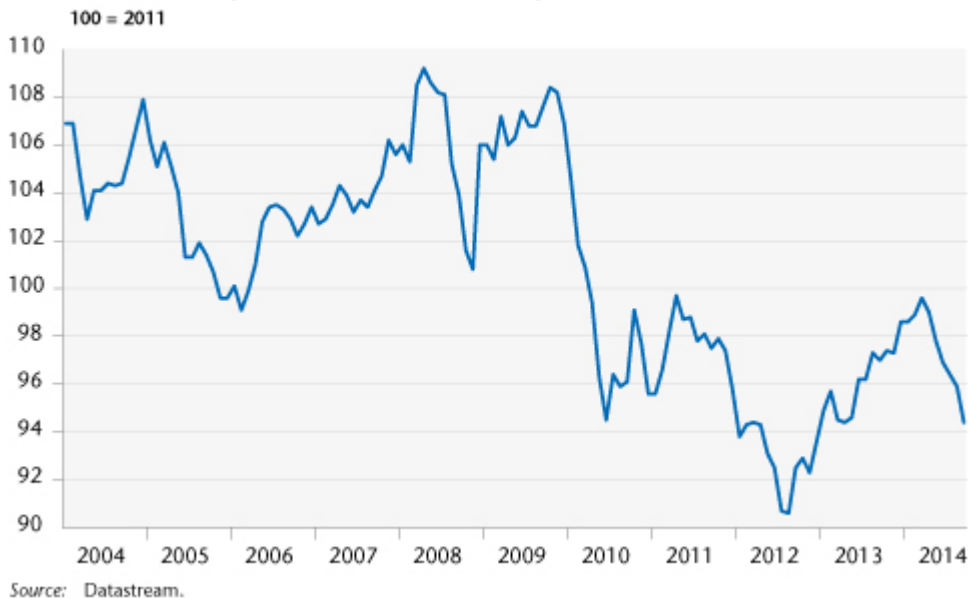
Decline of the euro and competitive disinflation: who's going to gain the most?

By [Bruno Ducoudré](#) and [Eric Heyer](#)

For nearly two years, between mid-2012 and mid-2014, the euro appreciated against the world's major currencies. Having reached a level of USD 1.39 in May 2014, the euro had increased in value since July 2012 by more than 12% against the dollar. During the same period, the euro appreciated by 44% against the yen and more than 3% against the pound sterling.

Since May 2014, this trend has reversed: after rising by nearly 10% between mid-2012 and mid-2014, the real effective exchange rate for the euro, which weights the different exchange rates based on the structure of euro zone trade, has depreciated by 5.2% over the last six months (Figure 1). In fact, within a few months, the euro has lost nearly 10% against the dollar, more than 3% against the yen and 4% against the British pound. The weakening against the pound sterling actually began in August 2013, and has reached over 9% today. We expect the euro to continue to depreciate up to the beginning of 2015, with the single currency's exchange rate falling to 1.20 dollars in the second quarter of 2015.

Figure 1. Effective exchange rate of the euro



For many business people and economics experts, this decline in the euro represents an opportunity to escape the deflation trap currently threatening the euro zone. Faced with sluggish growth in the zone and an inflation rate that is falling dangerously low, the announcement by the European Central Bank of a quantitative easing programme indicates its willingness to devalue the euro against other currencies in order to support Europe's growth and meet its inflation target.^[1] The French government also expects a great deal from the euro's depreciation.^[2] The Treasury Department believes^[3] that a 10% decrease in the effective exchange rate of the euro (against all currencies) would increase our GDP in the first year by 0.6 percentage point, creating 30,000 jobs, reducing the public deficit by 0.2 GDP point and pushing up consumer prices by 0.5%.

The revival of short-term growth in the euro zone through a depreciation of the euro's effective exchange rate would also limit the non-cooperative policy of competitive disinflation being implemented in southern Europe (Greece, Spain, Portugal). While European countries trade mostly with each other and compete sharply for export markets, the effort to improve competitiveness through a disinflation policy is bound

to fail in the euro zone if all the members adopt the same strategy. This is, however, the strategy chosen by the European Commission, *i.e.* by pushing the countries in crisis to reform their labour markets and cut labour costs. In this light, the depreciation of the euro is needed to support structural reform in Europe and support demand [\[4\]](#) even as fiscal austerity policies are further undermining it.

[In a recent study](#), we attempted to assess the effects expected from the depreciation of the euro. We are interested not in the reasons for the variations in the euro (differential performance, behaviour of central banks) but in its macroeconomic implications (in particular its impact on GDP, prices and employment). To assess the sensitivity of exports to price competitiveness for six major OECD countries (France, Germany, Italy, Spain, United States, United Kingdom), we made estimates using new foreign trade equations that distinguish, within the euro zone, intra-zone trade and extra-zone trade. The elasticities obtained are consistent with the existing literature on this subject. It is necessary to make a joint estimation of the equations for export volumes and import prices: this provides a feedback loop in partial equilibrium for a change in the effective exchange rate on import volumes and export volumes. Taking into account the marginal behaviour of importers and exporters tends to limit the effect of a change in the effective exchange rate on the volumes of imports and exports when these have little market power. Simulations show that, in the euro zone, Spain would have the most to gain from a depreciation in the euro's exchange rate against other currencies, but also from a policy of competitive disinflation (case where Spain's export prices grow more slowly than the export prices of its euro zone rivals) (Table 1).

Table 1. Breakdown for the euro zone of a 10% depreciation of the nominal effective exchange rate

Long-term Impact ...				
... of a 10% depreciation of the euro against other currencies (ln %)				
	DEU	FRA	ITA	ESP
Exports	1.3	1.1	1.1	1.7
Imports	-3.2	-2.1	-1.1	-2.3
Export prices	1.4	2.1	1.5	2.0
Import prices	4.3	2.9	2.0	2.9
... of a 10% rise in the prices of competitors in the euro zone (%)				
	DEU	FRA	ITA	ESP
Exports	1.6	1.6	2.1	2.8
Imports	-2.8	-3.3	-1.3	-4.0
Export prices	1.7	3.1	2.9	3.4
Import prices	3.4	4.3	2.3	4.7

Source : OFCE.

For the French economy, we also carried out a more detailed analysis using the OFCE's macroeconomic model *emod.fr*, with the goal of comparing our results with those obtained by the French DG Treasury with the *Mésange* model.

Our results show that a 10% depreciation of the euro against all currencies leads to a gain in price competitiveness for export to France vis-à-vis the rest of the world. The other euro zone countries experience the same gain in competitiveness across all export markets. In this case, the effect on activity would be +0.2% the first year, and +0.5% after three years. Excluding the effect due to the change in price competitiveness, the increased demand resulting from the pick-up in activity among our European partners would be broadly offset by lower demand addressed to France from the rest of the world. On the labour market, the depreciation would create 20,000 jobs in the first year, and 77,000 jobs after three years. The public deficit would improve by 0.3 GDP point in three years (Table 2).

Table 2. Impact on the French economy of a 10% depreciation in the exchange rate of the euro against all currencies

(% difference from level in reference scenario)	n	n+1	n+2	n+7
GDP	0.2	0.5	0.5	0.1
Total salaried employment (in 1000s)	20	53	77	43
Household consumption prices	0.9	1.4	1.8	3.6
Public financing capacity (in % of GDP)	0.0	0.2	0.3	0.2

Note: A depreciation of the euro would be favourable to short-term activity via an improvement in France's price-competitiveness vis-à-vis non euro zone countries. The positive effect of the euro's depreciation on the activity of our euro zone partners and the negative effect on our non euro zone partners is taken into account.

Source : emod.fr.

Finally, we simulated the effect of a 10% increase in the prices of our competitors in the euro zone on the whole of France's export markets. This 10% improvement in price competitiveness vis-à-vis the other euro zone countries would have a positive effect on activity via an increase in exports, investment and employment (Table 3). The impact on activity would be +0.4% in the first year and +0.9% after three years. It would be zero after 10 years. Nearly 130,000 jobs would be created in a period of 3 years and the government deficit would improve by 0.5 GDP point over this period.

Table 3. Impact on the French economy of a 10% improvement in France's price competitiveness relative to the euro zone countries

(% difference from level in reference scenario)	n	n+1	n+2	n+7
GDP	0.4	0.8	0.9	0.2
Total salaried employment (in 1000s)	33	90	129	82
Household consumption prices	1.0	1.7	2.3	5.2
Public financing capacity (in % of GDP)	0.0	0.3	0.5	0.5

Note: A 10% deterioration in France's price competitiveness relative to the rest of the world is understood to mean a 10% decline in the prices of all France's rivals on its export markets.

Source : emod.fr

[1] See C. Blot and F. Labondance, "[Why a negative interest rate?](#)", *Blog de l'OFCE*, 23 June 2014.

[2] See the [speech by Prime Minister F. Hollande on 5 February 2013 to the European Parliament](#).

[3] Economic and Social Report of France's 2014 draft budget bill.

[4] See the [speech by M. Draghi "Unemployment in the euro area"](#), Jackson Hole, 22 August 2014.

Are the macroeconomic forecasts of the central banks better than those of private agents?

By [Paul Hubert](#)

Private expectations – about inflation, growth and interest rates – are a critical component of most modern macroeconomic models, as they determine the current and future realizations of these very variables. Monetary policy has been shaped more and more by the incorporation of these expectations in central bankers' calculations and the influence they have on private expectations through interest rate decisions and the way these are communicated. The establishment by the central banks of a forward-looking policy orientation, called "forward guidance", has further reinforced the importance of central bank macroeconomic forecasts as a tool of monetary policy for influencing private expectations.

A recent article in the [Revue de l'OFCE \(no. 137 – 2014\)](#) evaluates the forecasting performance of the US Federal Reserve relative to that of private agents. This empirical review of the existing literature confirms that the Fed performs better than private agents in forecasting inflation,

but not on GDP growth. Furthermore, the Fed does even better over longer forecast horizons. Despite this, its superiority seems to have been declining in recent times, though it's still significant. This article highlights the potential reasons for the Fed's superior performance, and suggests that this could stem from better information about the shocks hitting the economy rather than from a better model of the economy. The publication of these macroeconomic forecasts therefore helps to disseminate information among economic agents and boosts the effectiveness of monetary policy by allowing private agents to better foresee trends and possible developments.

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.

[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](#).

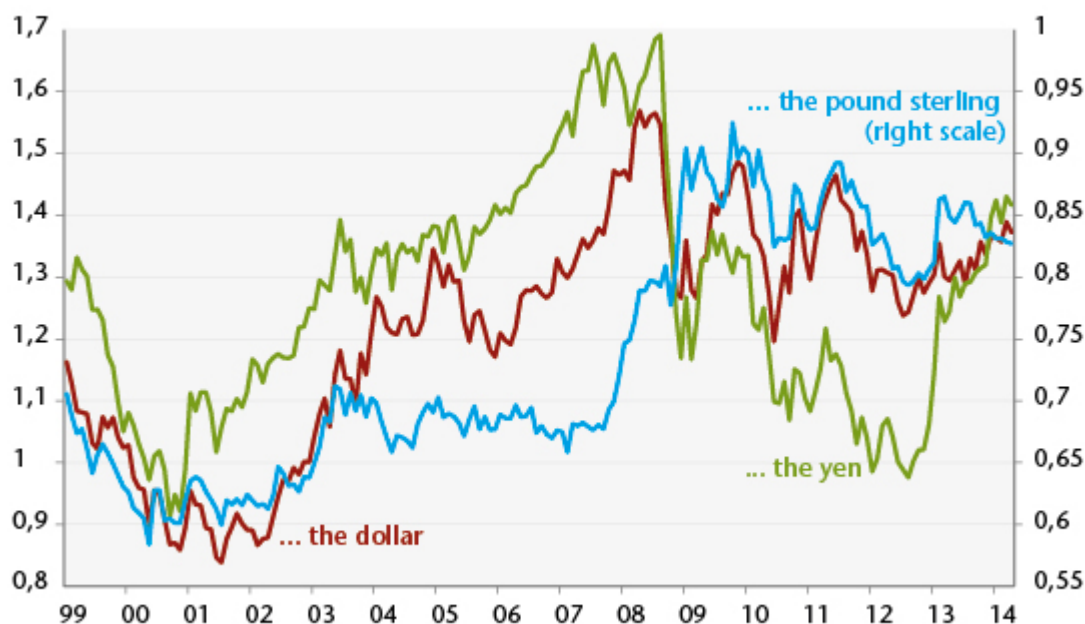
What is a weaker euro likely to mean for the French economy?

By [Bruno Ducoudré](#) and [Eric Heyer](#)

Faced with the rising risk of deflation in the euro zone, which has been reinforced since mid-2012 by the continued appreciation of the euro against other currencies, the heads of the European Central Bank have begun to change their tone in their communications with the financial markets: [they are now evoking the possibility of conducting a new round of quantitative easing](#). These measures are likely to lower the exchange rate of the euro. This would provide valuable support for the euro zone economies by shoring up their price competitiveness vis-à-vis competitors outside the zone, in a context where fiscal consolidation policies will continue to dampen [the growth expected in the zone in 2014 and 2015](#). What are the likely consequences for the French economy from reducing the euro's value against other currencies? We briefly review past episodes of exchange rate changes, and then present the impact expected from a 10% depreciation of the euro against other currencies using the *emod.fr* model. These effects are more moderate than those projected by the government.

Quantitative easing measures have been used extensively by the US Federal Reserve, the Bank of England and the Bank of Japan. Since mid-2012, the balance sheets of these three banks has continually increased, by respectively 6.5 percentage points of GDP, 1.3 GDP points and 15.3 GDP points. During this same period, the ECB balance has on the contrary declined by 8.4 GDP points. This difference in strategy has led to a continued rise in the strength of the euro: now at 1.38 dollars, the euro has seen its value against the dollar increase by 12% since June 2012. During the same period, the single currency has appreciated 49% against the yen and about 3% against the pound sterling (Figure 1).

Figure 1. Exchange rate of the euro against...

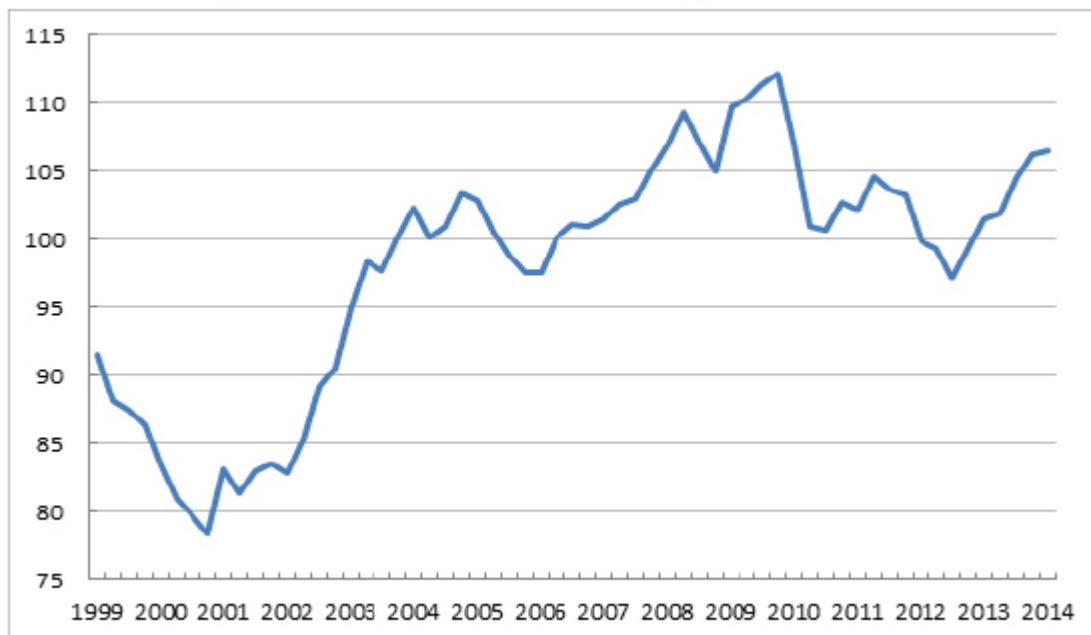


Source : Datastream.

The nominal effective exchange rate of the euro, which weights the different exchange rates depending on the structure of trade in the euro zone, has thus appreciated by 9.5% since the third quarter of 2012 (Figure 2). This appreciation, combined with austerity policies and the competitive disinflation carried out within the euro zone, has held down GDP growth in the zone, which was negative in 2012 and 2013, as well as inflation. The absence of inflationary pressures and the past appreciation of the euro have now given the ECB leeway to try

to influence the course of the euro against other currencies.

Figure 2. Nominal effective exchange rate of the euro



Source : OECD.

What would be the impact of a devaluation of the euro against all currencies?

The depreciation of the euro would have a dual effect:

- **An income effect:** a weak euro would increase the prices of imports. This would result in higher energy costs, a rise in companies' prices of production and a loss of household purchasing power;
- **A substitution effect:** a weak euro would decrease the prices of exports and increase their volume. Depreciation would also decrease the competitiveness of rival manufacturers, causing a decline in imports in favour of domestic production.

These opposite effects would apply only to trade outside the euro zone. Trade with our European partners would not be directly impacted, as the prices of imports and exports to and from this area would remain unchanged. On the other hand, intra euro zone trade would be impacted by a weaker euro. But this involves the channel of addressed demand.

Table 1. Impact on the French economy of a 10% depreciation in the exchange rate of the euro against all currencies combined

(Difference with the reference scenario in %)	n	n+1	n+2	n+8
GDP	0,3	0,4	0,5	0,0
Total waged employment (1000s)	22	53	74	34
Household consumer prices	0,9	1,4	1,9	3,9
Public financing capacity (% of GDP)	0,0	0,2	0,3	0,2

Note: The euro's depreciation would be favourable to short-term activity due to an improvement in France's price competitiveness relative to countries outside the euro zone. The positive impact of the euro's depreciation on the activity of our euro zone partners and the negative impact on our partners outside the zone are taken into account.

Source : *emod.fr*

As is summarized in Table 1, a 10% depreciation of the euro against all currencies leads to a gain in price competitiveness for French exports vis-à-vis the rest of the world. Other countries in the euro zone would benefit from the same gain in competitiveness across all export markets. In this case, the impact on activity would amount to 0.3% in the first year, 0.5% after three years, and none after nine years. The increase in demand due to this improvement in the activity of our European partners would be broadly offset by a reduction in demand addressed to France from the rest of the world. As for the labour market, this depreciation would create 22,000 jobs in the first year and 74,000 jobs after 3 years. The public deficit would in turn improve by 0.3 GDP point within 3 years.

These results, while more moderate than those [published by the DG Treasury\[1\]](#), are nonetheless significant and are welcome in an economic situation like today's that is marked by sluggish growth and the risk of deflation. A depreciation of the single currency would also undercut the process of competitive deflation engaged in by countries in the euro zone.

[1] The publication of the DG Treasury argues that a 10% decrease in the effective exchange rate of the euro (against all currencies) would do the following: increase our GDP by

0.6 percentage point of GDP in the first year and 1.2 GDP points after three years; create 30,000 jobs in the first year and 150,000 jobs within three years; and reduce the government deficit by 0.2 GDP point in the first year and 0.6 GDP point after three years.