

# How many euros per job created?

By Guillaume Allègre, [@g\\_allegre](#)

The Responsibility Pact, the CICE competitiveness tax break, reductions on social security charges ... is it possible to reduce the evaluation of such measures to the cost in euros of each job created? While such an assessment is obviously important, the final figure is often subject to misinterpretation or misuse in the public debate, sometimes in perfectly good faith. For some commentators, a very high cost per job created, generally higher than the average real cost of a public (or private) job, represents a waste of public money that would be better used elsewhere, for nurseries, education or the national police.

This kind of logic is based on a misinterpretation of the billions involved. To understand this, let's do the following thought experiment: take two tax measures, *A* and *B*, which are intended to reduce the cost of labour in order to generate jobs. Measure *A* creates 200,000 jobs and costs the State and government *ex post* (that is to say, after taking into account the jobs created and interaction with the social security and tax systems) 20 billion and 1 euros. The cost per job created is thus 100,000 euros, which seems excessive. Measure *B* creates 180,000 jobs and has an *ex post* cost of 20 billion euros, 111,111 euros per job, which is even worse. At first glance, there's no point in implementing either Measure *A* or *B*: the cost per job created is far too great. Now, suppose it is also possible to enact Measure  $-A$  or  $-B$  which, conversely to *A* and *B*, push up the cost of labour (through higher payroll taxes) with symmetrical effects on employment. Suppose also that the impact on employment and the cost are additive when two measures are implemented at the same time. It now seems clear that we should implement  $[A-B]$ <sup>[1]</sup>: reducing the cost of

labour by  $A$  and increasing it by  $-B$  would create 20,000 jobs for a cost of 1 euro, or 0.00005 euros per job created! The ratio of the cost of a job created between Measure  $A$  and Measure  $[A-B]$  is 2 billion to 1 ( $= 100,000/0.00005$ )! Someone not paying attention might then say: Measure  $A$  must certainly not be implemented.

	Number of jobs created	Ex post cost of the measure	Cost per job created
A	200 000	20 000 000 001	100 000
B	180 000	20 000 000 000	111 111
$[A-B]$	20 000	1	0,00005

Since Ricardo, economists have known that it is often the relative advantages that count and not the absolute advantages: alone,  $A$  is not of much interest, but combined with  $-B$  it is very powerful, just as in poker a 2 of Hearts in a hand does not have the same value when it is with Jacks as when it is with the 2s of Spades, Clubs and Diamonds. Economic policy measures cannot be evaluated in isolation: they must be evaluated in their interaction with all the instruments that have already been implemented or are simply there.

In addition to the failure to take into account macroeconomic dynamics and the financing, another limitation of reasoning in terms of cost per job created is that it does not always consider the questions: who pays the bill, and who gets what? Expenditures by the State (for childcare, education or the national police) are not equivalent to tax expenditures: if they are funded, the former reduce the disposable income of households, while the latter do not (they are a transfer between households, between businesses or between households and businesses). As a consequence, it is misleading to compare the two types of expenditure only in terms of jobs created. In effect, the jobs created are simply an indirect consequence of a tax expenditure (the direct effect is the transfer from the State to households and businesses); if the measure is funded, as in  $[A-B]$ , the jobs created are a second-order effect related to the different behavioural responses to  $A$  and  $-B$ . In

contrast, a structural increase in government spending (and therefore in the tax burden) has the first-order effect of increasing the consumption of public goods and reducing the consumption of private goods. If you reason only in terms of jobs, there is a risk of ending up with full employment but in a completely socialized economy. To evaluate this type of transfer, parameters other than job creation also need to be considered. In particular it is necessary to take into account well-being (what is the utility of nurseries or spending on education and national police versus private spending?) and incentive effects (what is the effect of higher social contributions on economic incentives to meet consumer needs?). It is also necessary to think in terms of the tax burden. [A–B] can create jobs only by organizing transfers within households and / or businesses. The relevant questions are therefore: who are the *ex post* winners and losers (taking into account the jobs created and changes in prices and wages)? Do these transfers reduce or increase inequality? Do they violate horizontal equity (equal taxation on equal abilities to pay)? Are they likely to affect long-term growth (via the structure of employment, capital-labour substitution, etc.)?

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## **A fiscal policy to promote structural reform – lessons from the German case**

By [Eric Heyer](#)

“France should copy Germany’s reforms to thrive”, Gerhard Schröder entitled [an opinion piece in the \*Financial Times\* on 5](#)

[June 2013](#). As for the European Commission (EC), its latest annual recommendations to the Member states, released on 29 May, seem to take a step back from its strategy of a rapid and synchronized return to balancing the public finances, which has been in place since 2010. The EU executive's priority now seems to be implementation of structural reforms of the labour and services markets in the euro zone countries. These countries will of course continue to consolidate their public finances, but the EC has given them an extra year or two to do this. While, for example, France will further consolidate its accounts over the coming two years (the fiscal effort demanded of the French government by the EC comes to 0.8 percent of GDP, or 16 billion euros per year), it has been given another two years to bring its deficit below 3% of GDP (2015 instead

**Tableau. New fiscal targets after postponement**

		2013	2014	2015	2016
<b>France</b>	Government deficit (% of GDP)	3,9	3,6	2,8	
	Fiscal impulse (GDP points)	-1,3	-0,8	-0,8	
<b>Spain</b>	Government deficit (% of GDP)	6,5	5,8	4,2	2,8
	Fiscal impulse (GDP points)	-1,1	-0,8	-0,8	-1,2
<b>Netherlands</b>	Government deficit (% of GDP)	3,6	2,8		
	Fiscal impulse (GDP points)	-0,6	-0,7		

*Source: European Commission.*

of 2013).

This change in course – or at least in tone – by the EC, which had emphasized the enactment of extreme austerity reforms, should be welcomed. However, it is important to consider whether the new environment, in particular the fiscal situation, will be favourable enough to ensure that the structural reforms are effective. An examination of the economic context in which Germany introduced its reforms in the early 2000s, which became a benchmark for the countries of southern Europe, provides some important lessons. While the purpose here is not to go into these reforms in depth, it is nevertheless useful to remember that they were enacted while the German economy had a substantial trade deficit (-1.8 percent of GDP in 2000 against a surplus of 1.4 percent for France at that same time) and was considered a “low achiever” in Europe. These reforms led to a significant

reduction in the share of wages in value added, boosting the margins of German business, and helped to quickly restore the competitiveness of the German economy: by 2005, Germany was once again generating a large trade surplus while France ran a deficit for the first time since 1991. The non-cooperative character of the the euro zone ([OFCE, 2006](#)) and the steep increases in Germany in poverty – ([Heyer, 2012](#)) and Figure 1 – and in wealth inequality ([de Grauwe et Yi, 2013](#)) were the hidden fruit of this strategy. Europe’s “low achievers” today are the southern European countries, and the pressure to take steps to boost competitiveness has shifted from Germany to France, Italy and Spain. Despite this parallel, the question remains: is the economic environment similar today? Figures 1 and 2 summarize the economic situation in Germany at the time the structural reforms were implemented. Two main points stand out:

1. These reforms were carried out **in a context of strong global growth**: the world experienced average growth of over 4.7% per year in 2003-2006 (Figure 1). By comparison, the figure for growth is likely to be less than 3% over the next two years;
2. In addition, the fiscal situation of the German economy in the early 2000s was not good: in 2001, the general government deficit for Germany exceeded 3%, and came close to 4% in 2002, the year before the enactment of the first Hartz reform. Government debt then exceeded the threshold of 60% of GDP allowed by the Maastricht Treaty for the first time. Despite this poor fiscal performance – with public debt approaching 70% in 2005 – it is interesting to note that the German government continued to maintain a highly expansionary fiscal policy for as long as the reforms had not been completed: in the period 2003-2006, the fiscal impulse was positive at on average 0.7 GDP point each year (Figure 2). Thus, during this period **the German government supported its structural reforms with a**

highly accommodative fiscal policy.

Figure 1. Growth, unemployment rate and poverty rate in Germany

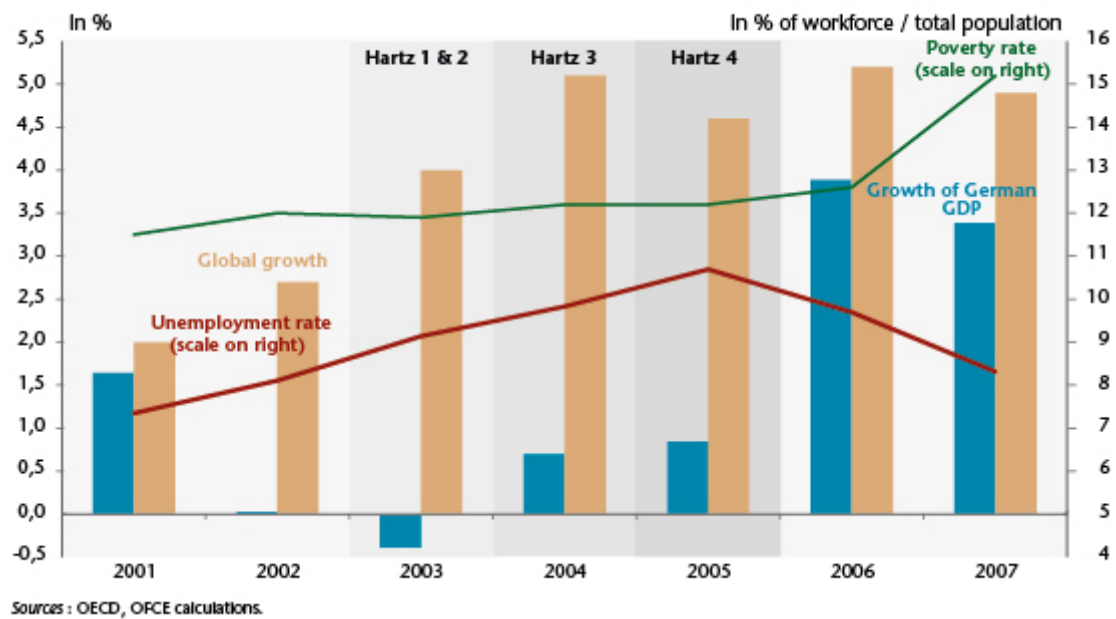
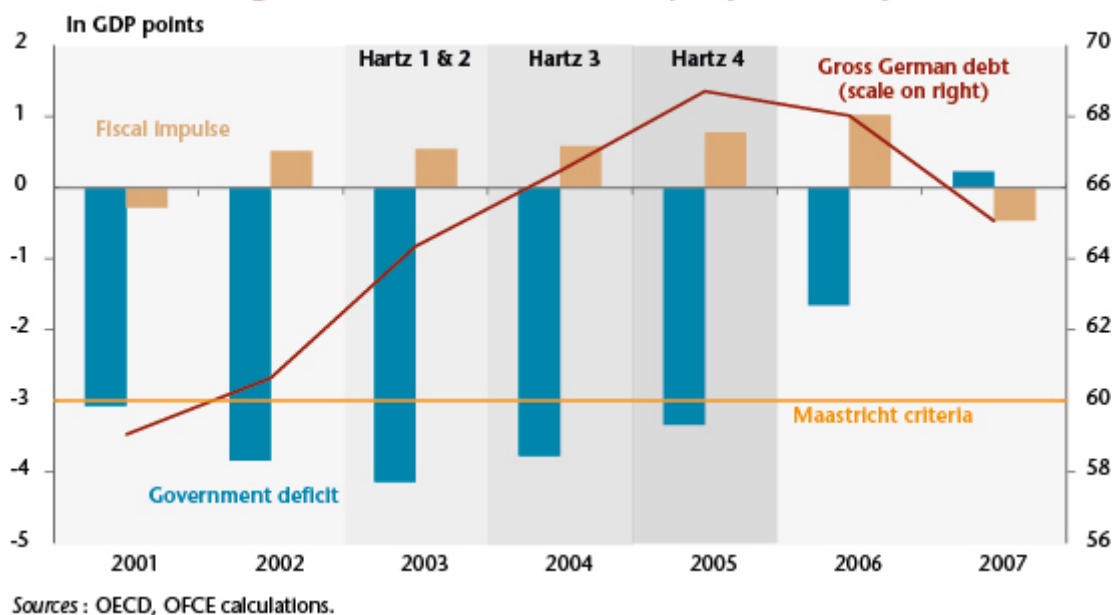


Figure 2. State of deficit and fiscal policy in Germany



Thus not only was the structural reform of the labour market conducted under Schröder implemented in a very favourable economic environment (strong global growth and a strategy that differed from the other European countries), but it was also accompanied by a particularly accommodative fiscal policy, given in particular the poor state of Germany's public finances. This situation differs greatly from contemporary conditions:

1. Global growth is likely to be under 3% over the coming two years;
2. The EC is asking a large number of European countries to implement the same structural reforms simultaneously, which in a highly integrated euro zone limits their effectiveness; and
3. Despite the extra time being granted for deficit reduction, fiscal policy will remain very tight: as is indicated in Table 1, the fiscal impulses for France and Spain will still be very negative (-0.8 GDP point per year) as the structural reforms in these countries are being implemented.

So while the pressure to boost the competitiveness of the countries of southern Europe is similar to that facing Germany in the early 2000s, the external environment is less favourable and there is greater pressure to reduce the public debt. On this last point, the German example teaches us that it is difficult to juggle structural reforms to boost business competitiveness with efforts to reduce the public debt.

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## The debacle of austerity

By [Xavier Timbeau](#)

*This text summarizes [the OFCE's October 2012 forecasts](#).*

The year 2012 is ending, with hopes for an end to the crisis disappointed. After a year marked by recession, the euro zone will go through another catastrophic year in 2013 (a -0.1% decline in GDP in 2013, after -0.5% in 2012, according to our forecasts – see the table). The UK is no exception to this trend, as it plunges deeper into crisis (-0.4% in 2012, 0.3% in 2013). In addition to the figures for economic growth,

unemployment trends are another reminder of the gravity of the situation. With the exception of Germany and a few other developed countries, the Western economies have been hit by high unemployment that is persisting or, in the euro zone, even rising (the unemployment rate will reach 12% in the euro zone in 2013, up from 11.2% in the second quarter of 2012). This persistent unemployment is leading to a worsening situation for those who have lost their jobs, as some fall into the ranks of the long-term unemployed and face the exhaustion of their rights to compensation. Although the United States is experiencing more favourable economic growth than in the euro zone, its labour market clearly illustrates that the US economy is mired in the Great Recession.

Was this disaster, with the euro zone at its epicentre, an unforeseeable event? Is it some fatality that we have no choice but to accept, with no alternative but to bear the consequences? No – the return to recession in fact stems from a misdiagnosis and the inability of Europe's institutions to respond quickly to the dynamics of the crisis. This new downturn is the result of massive, exaggerated austerity policies whose impacts have been underestimated. The determination to urgently rebalance the public finances and restore the credibility of the euro zone's economic management, regardless of the cost, has led to its opposite. To get out of this rut will require reversing Europe's economic policy.

The difficulty posed by the current situation originates in widening public deficits and swelling public debts, which reached record levels in 2012. Keep in mind, however, that the deficits and public debts were not the cause of the crisis of 2008-2009, but its consequence. To stop the recessionary spiral of 2008-2009, governments allowed the automatic stabilizers to work; they implemented stimulus plans, took steps to rescue the financial sector and socialized part of the private debt that threatened to destabilize the entire



global financial system. This is what caused the deficits. The decision to socialize the problem reflected an effort to put a stop to the freefall.

The return to recession thus grew out of the difficulty of dealing with the socialization of private debt. Indeed, in the euro zone, each country is forced to deal with financing its deficit without control of its currency. The result is immediate: a beauty contest based on who has the most rigorous public finances is taking place between the euro zone countries. Each European economic agent is, with reason, seeking the most reliable support for its assets and is finding Germany's public debt to hold the greatest attraction. Other countries are therefore threatened in the long-term or even immediately by the drying up of their market financing. To attract capital, they must accept higher interest rates and urgently purge their public finances. But they are chasing after a sustainability that is disappearing with the recession when they seek to obtain this by means of austerity.

For countries that have control of their monetary policy, such as the United States or the United Kingdom, the situation is different. There the national savings is exposed to a currency risk if it attempts to flee to other countries. In addition, the central bank acts as the lender of last resort. Inflation could ensue, but default on the debt is unthinkable. In contrast, in the euro zone default becomes a real possibility, and the only short-term shelter is Germany, because it will be the last country to collapse. But it too will inevitably collapse if all its partners collapse.

The solution to the crisis of 2008-2009 was therefore to socialize the private debts that had become unsustainable after the speculative bubbles burst. As for what follows, the solution is then to absorb these now public debts without causing the kind of panic that we were able to contain in the summer of 2009. Two conditions are necessary. The first condition is to provide a guarantee that there will be no

default on any public debt, neither partial nor complete. This guarantee can be given in the euro zone only by some form of pooling the public debt. The mechanism announced by the ECB in September 2012, the Outright Monetary Transaction (OMT), makes it possible to envisage this kind of pooling. There is, however, a possible contradiction. In effect this mechanism conditions the purchase of debt securities (and thus pooling them through the balance sheet of the ECB) on acceptance of a fiscal consolidation plan. But Spain, which needs this mechanism in order to escape the pressure of the markets, does not want to enter the OMT on just any conditions. Relief from the pressure of the markets is only worthwhile if it makes it possible to break out of the vicious circle of austerity.

The lack of preparation of Europe's institutions for a financial crisis has been compounded by an error in understanding the way its economies function. At the heart of this error is an incorrect assessment of the value of the multipliers used to measure the impact of fiscal consolidation policies on economic activity. By underestimating the fiscal multipliers, Europe's governments thought they could rapidly and safely re-balance their public finances through quick, violent austerity measures. Influenced by an extensive economic literature that even suggests that austerity could be a source of economic growth, they engaged in a program of unprecedented fiscal restraint.

Today, however, as is illustrated by the dramatic revisions by the [IMF](#) and the [European Commission](#), the fiscal multipliers are much larger, since the economies are experiencing situations of prolonged involuntary unemployment. A variety of empirical evidence is converging to show this, from an analysis of the forecast errors to the calculation of the multipliers from the performances recorded in 2011 and estimated for 2012 ([see the full text of our October 2012 forecast](#)). We therefore believe that the multiplier for the euro zone as a whole in 2012 is 1.6, which is comparable to

the assessments for the United States and the United Kingdom.

Thus, the second condition for the recovery of the public finances is a realistic estimate of the multiplier effect. Higher multipliers mean a greater impact of fiscal restraint on the public finances and, consequently, a lower impact on deficit reduction. It is this bad combination that is the source of the austerity-fuelled debacle that is undermining any prospect of re-balancing the public finances. Spain once again perfectly illustrates where taking this relentless logic to absurd lengths leads: an economy where a quarter of the population is unemployed, and which is now risking political and social disintegration.

But the existence of this high multiplier also shows how to break austerity's vicious circle. Instead of trying to reduce the public deficit quickly and at any cost, what is needed is to let the economy get back to a state where the multipliers are lower and have regained their usual configuration. The point therefore is to postpone the fiscal adjustment to a time when unemployment has fallen significantly so that fiscal restraint can have the impact that it should.

Delaying the adjustment assumes that the market pressure has been contained by a central bank that provides the necessary guarantees for the public debt. It also assumes that the interest rate on the debt is as low as possible so as to ensure the participation of the stakeholders who ultimately will benefit from sustainable public finances. It also implies that in the euro zone the pooling of the sovereign debt is associated with some form of control over the long-term sustainability of the public finances of each Member State, *i.e.* a partial abandonment of national sovereignty that in any case has become inoperative, in favour of a supranational sovereignty which alone is able to generate the new manoeuvring room that will make it possible to end the crisis.

## OFCE growth forecasts, October 12

Annual growth in GDP, %

	2011	2012	2013
Euro zone	1,5	-0,5	-0,1
Germany	3,1	0,8	0,6
France	1,7	0,1	0,0
Italy	0,5	-2,4	-1,1
Spain	0,4	-1,4	-1,2
Netherlands	1,1	-0,2	0,3
Belgium	1,8	-0,1	0,9
Finland	2,8	0,8	1,1
Austria	2,7	1,0	0,5
Portugal	-1,7	-2,8	-1,2
Greece	-6,2	-6,2	-3,7
Ireland	0,8	-0,4	-0,1
United Kingdom	0,9	-0,4	0,3
United States	1,8	2,2	0,9
Japan	-0,7	2,4	1,3

Sources : National calculations, OFCE forecasts October 2012.

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# The governance of public finances: from the Fiscal pact to France's Organic law

by [Henri Sterdyniak](#)

So the French government has had Parliament enact an “Organic law relating to the planning and governance of public finances” (*loi organique relative à la programmation et à la gouvernance des finances publiques*), which translates into French law the European Fiscal pact (the Treaty on stability, coordination and governance) that France had made a commitment to ratify. This Law can be assessed from two points of view: from the perspective of how well it conforms to the Treaty or from the viewpoint of its own relevance, *i.e.* will it improve France's fiscal policy?

In fact, the government has chosen – as the Constitutional Council had provided it with the possibility of so doing – a minimalist approach to taking into account the Treaty. The new budgetary procedure is not incorporated into the Constitution, and as we shall see, the Treaty provides for certain automatic binding procedures that the Organic law tempers or does not mention.

The Organic Law has three sections, dealing respectively with the budget plan (*loi de programmation des finances publiques – LPFP*), the High Council on the Public Finances (*Haut Conseil des finances publiques*), and a correction mechanism.

### **The Budget Plan**

Article 1 of the Organic Law stipulates: “In accordance with the objective of balanced government accounts as set out in Article 34 of the Constitution, the LPFP sets the medium-term targets of the government administrations referred to in Article 3 of the TSCG.”

Article 34 of the Constitution, adopted on 31 July 2008, set out only a medium-term non-binding target. It has had little influence on the fiscal policy adopted since then. In times of crisis, the multi-year guidelines quickly cease to have an influence. This was the case, for example, in 2009. The 2009 deficit, which was set at 0.9% of GDP by the four-year budget plan passed in January 2008, and 3.9% of GDP according to the January 2009 plan, ultimately amounted to 7.5%. Should we give up this flexibility?

Moreover, how can the budget plan “set a target” when the target flows from Article 3 of the Treaty, which clearly states that the target should be a structural deficit of less than 0.5% of GDP and that a path for an adjustment to ensure a rapid convergence toward equilibrium will be proposed by the European Commission?

Doesn't the ambiguity of this article actually reflect an

attempt to reconcile the irreconcilable: the sovereignty of Parliament in budgetary matters with France's commitment to follow the recommendations of the Commission?

Article 1 of the Organic Law continues: "The budget plan (LPFP) determines the trajectory of the successive annual actual balances and structural balances... The structural balance is the cyclically-adjusted balance net of one-off and temporary measures." Article 3 states that the period covered is at least three years.

Thus, the Law takes no account of the experience of the Stability and Growth Pact (SGP): it is impossible to fix a trajectory for the public finances, in terms of the structural and actual deficit, for a period of three years. In January 2008, France was committed to having a balanced budget in 2012. It won't even get close. Should commitments be made that are impossible to keep?

This is impossible for two reasons. First, unpredictable economic fluctuations make it necessary to constantly adapt economic policy. In case of a deep crisis, as since 2009, it is necessary to make use of both economic stabilizers and discretionary measures (which increase what is called the structural deficit). If taken seriously, the Treaty prohibits any policy to boost activity during a downturn in activity. In the autumn of 2008, according to the Commission France had a structural deficit of 3.2% of GDP. If the Treaty had been in force, it would have had to reduce this quickly to 2.5% in 2009. In fact, France has moved to a structural deficit of 6% of GDP, according to the Commission's assessment, in other words, 3.5 percentage points higher. Is the government wrong to have promoted activity, or to have come to the rescue of the banks? Should it have embarked on a tough austerity policy to offset the fall in tax revenue?

The text is, of course, ambiguous. On the one hand, it sets out that the structural deficit does not include "one-off and

temporary” measures. Assistance to banks is undoubtedly a one-off, but why not all the 2009 stimulus measures, or in the opposite direction, the 75% income tax assessment which is scheduled for 2 years? Who decides? On the other hand, the Treaty recognizes that a country may deviate from its target or its adjustment path in the event of “exceptional circumstances” which, since the revision of the Growth and Stability Pact, can be interpreted as negative growth or a large output gap. However, the Commission refuses to recognize that most euro zone countries have actually been in this situation since 2009, and it is insisting on imposing rapid deficit reduction policies on them.

On the other hand, a State has no economic reason to set itself a standard for balancing the public purse. According to the true “golden rule of public finance”, which was stated by the economist Paul Leroy-Beaulieu in the late nineteenth century, it is legitimate to finance public investment through debt. In the case of France, a structural deficit of around 2.4% of GDP is legitimate.

As in the Treaty, Article 1 of the Organic Law refers to the structural balance, the balance that would exist if France were at its potential output, the maximum output consistent with stable inflation. But the size of this potential output, which cannot simply be observed, is a subject of debate among economists. Different methods produce different results, which are subject to sharp revisions. France’s structural balance in 2012 is 3.6% according to the French government, 3% according to the European Commission, 2.8% according to the OECD, and according to us 0.5%, since the crisis has caused us to lose 8% of GDP compared to our growth trend. The Treaty requires the use of the Commission’s method. Is this scientifically legitimate? Can France call into question this assessment?

Article 5 states that the potential growth assumptions should be presented in an appendix, but the definition of potential growth is even more questionable than that of potential

output. For example, the latest budget bill (*projet de loi de finances – PLF*) expects potential growth of 1.5% per year up to 2017 for France, thus abandoning forever the expectation of making up the 8 points of activity lost to the crisis.

The Organic Law simply forgets Article 4 of the Treaty (which requires a country with a debt of over 60% of GDP to reduce the gap by one-twentieth per year). It also ignores Article 5, which states that a country subject to an Excessive Deficit Procedure (EDP) is to be placed under supervision, and has to submit to the EU Council and Commission annual budget plans and a list of the structural reforms that it will implement in order to make a sustainable correction to its deficit. It is this article that obliges France, like many other EU countries, to do all it can to get down to a 3% deficit by 2013, regardless of the economic situation, since, in case of an EDP, the constraint pertains to the actual balance and not the structural balance. It forgets Article 7, which states that, in this context, the decisions of the Commission are obligatory (member countries can oppose it only with a qualified majority, with the country concerned not voting).

The LPFP will cover a period of four to five years, but will be voted upon again each year, so that the constraint thus introduced can be changed by a vote on a new budget plan. This has been the case in France for as long as the Fiscal Pact has existed. Thus, the LPFP does not introduce any supplementary constraint itself, other than what is already required by European legislation.

### **The High Council of Public Finance**

The Organic Law sets up a High Council of Public Finance, which will advise on the macroeconomic forecasts underlying the budget bill (LPF), the bill financing social security, the adjustment budget bills, the stability program that France must provide to the European authorities, and the budget plan (LPFP). It will assess whether France has been meeting its



European commitments, and verify that the LPF (budget bill) is consistent with the trajectory announced in the budget plan (LPFP). It will give its opinion on any evocation of “exceptional circumstances”.

Chaired by the President of France’s Court of Audit (Cour des comptes), the High Council consists of four members from the Court of Audit and four members appointed for their expertise in public finance by the Presidents of the National Assembly, the Senate and the two finance commissions. This predominance of the Court of Audit is problematic. The judicial officers from the Court of Audit are not *a priori* experts in macroeconomics, and they are often, based on their function, more concerned with balancing the public finances than with growth and employment. For instance, the latest reports from the Court of Audit underestimate the output gap, support the thesis that the fiscal multiplier is close to zero, and believe that it is better to reduce public spending than to increase taxes. We would like to be certain that the composition of the High Council and its work and reports reflect the diversity of opinion that exists on fiscal policy.

More fundamentally, it is questionable whether the High Council has room for flexibility in its assessments. Will it have the right to conclude that the path of adjustment is too restrictive, and that the medium-term objective is not realistic? What strategy will be advocated by the High Council in the event of an economic slowdown: an expansionary policy to support growth or an austerity policy to restore the public finances?

Assume, for example, that the government has a budget for 2013 based on growth of 1.2%, resulting in a deficit of 3%. The High Council believes that growth will instead be only 0.6%, causing a decline in tax revenues, and thus a deficit of 3.3%. It will advocate doing whatever is necessary to achieve a 3% deficit. Assuming that the fiscal multiplier is 1, it will be necessary to come up with 12 billion in tax increases (or

spending cuts), or 0.6% of GDP, to have an *ex post* deficit of 3%, but no growth. There is thus a great risk that this will lead to pro-cyclical policies. This will of course be mitigated when France is longer be subject to an EDP, as the High Council can then reason in terms of the structural deficit, but this will persist because everything will then depend on evaluating the structural deficit.

Lastly, there is the question of what legitimacy the High Council will have. The choice of fiscal policy must be subject to democratic procedures. The assessment of economic policy is part of a scientific, democratic debate. Should it be entrusted to a High Council, composed mainly of judicial experts, rather than economists on the one hand and representatives of the nation on the other?

The High Council will of course only give advice, which neither the government nor parliament are obliged to follow, but the risk is great that these opinions will affect the financial markets and the Commission and that it would be risky for the government to ignore them.

### **The correction mechanism**

To ensure that countries do indeed follow the adjustment path, the Treaty requires countries to provide an automatic correction mechanism if deviations are observed with respect to this path. In the minds of the negotiators of the North European countries and members of the Commission, this mechanism should provide that if a deviation of 1% of GDP is seen in year N, the Constitution provides that, automatically, a certain tax (e.g. VAT) would be raised by 0.5 GDP point and certain expenditures (e.g. social benefits) would be reduced by 0.5 GDP point.

In fact, Chapter 3 of France's Organic Law provides that the High Council is to report such a gap, the government is to set out the reasons for this discrepancy and then take it into

account in drawing up the next budget bill. Parliament's rights are respected, but fortunately the character of being automatic is not guaranteed.

## **Conclusion**

In the spirit of its founders, the fiscal treaty must put an end to the possibility of autonomous national fiscal policies. Fiscal policies should become automatic. The goal of fiscal policy should be balancing the budget, just as the goal of monetary policy should be fighting inflation; growth and employment are to be sought by means of free market structural reforms.

The Organic Law seems to be an ambiguous compromise. France is ratifying the Treaty, but implementing it only reluctantly. It's a safe bet that, as with the Stability Pact, there will be great tension in the euro zone between purists who demand the strict application of the Treaty and those who do not want to sacrifice growth to it.

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# **Youth “jobs of the future”: What impact on employment and government finances?**

[Éric Heyer](#) and [Mathieu Plane](#)

The bill aimed at creating 150,000 “jobs for the future” [*emplois d'avenir*] for unemployed youth will be submitted to

Parliament in October 2012. These 150,000 “jobs for the future” are to be reserved primarily for young people from deprived areas. What will be the net impact on employment and public finances?

These full-time jobs, which are planned to last a maximum of five years and are paid at least the minimum wage (SMIC), will be 75% funded by the State, with the rest of the cost being borne by local authorities, associations, foundations and business. According to the Minister of Labour and Employment, Michel Sapin, the goal is to create 100,000 jobs starting in 2013.

### ***The ex-ante cost of the measure***

The gross annual cost of a “jobs for the future” contract paid at the SMIC on the basis of a 35-hour full-time week is 24,807 euros. The cost per job for the public finances is 12,831 euros for 75% of the gross wage and 4,807 euros for the exemption from employer social contributions. To this should be added the remaining cost for the employer, or 7,276 euros, when the employer is not a public entity. Based on the assumption that two-thirds of the “jobs for the future” created would be in the non-market sector and one-third in the market sector, the total average annual cost for the public finances therefore comes to 23,015 euros per contract. When fully implemented, the cost of creating 150,000 “jobs for the future” is estimated at 3.45 billion euros a year.

### ***The impact of the measure***

By assuming the creation of 100,000 subsidized jobs in the non-market sector and 50,000 in the market sector, the impact would be as follows:

With relatively weak deadweight and substitution effects in the non-market sector (20% according to Fontaine and Malherbet, 2012), 100,000 “jobs for the future” would lead to the net creation of 80,000 jobs over the presidential term.

The *ex-ante* annual cost to the public finances for 100,000 “jobs for the future” in the non-market sector would be 0.12 GDP point, but *ex post* this would be only 0.07 GDP point because of the extra income – and thus tax and social security revenue – generated by the jobs created.

The state aid (75% of the gross salary) allows a reduction in the cost of labour of 52% at the SMIC level, *i.e.* a total reduction of 71% of the actual cost of a minimum wage job if one includes the reductions in charges. With the impact of employment elasticities at a maximum labour cost at the level of the SMIC (1.2 according to a DGTPE study in 2007), the 50,000 “jobs of the future” in the market sector would generate 27,300 jobs. The *ex-ante* cost to the public finances would be 0.05 GDP point, and 0.03 GDP point *ex post*.

Ultimately, the measure would eventually create 107,300 jobs (about 25% of these in the market sector), *i.e.* an annual net creation of 72%. The *ex-ante* cost for the public finances would be 0.17 GDP point, but the *ex-post* impact of the measure on the public balance would be only -0.1 GDP point because of the extra tax and social security revenue generated by the jobs created and the consequent income gains (Table 1).

**Table 1. Impact at 5 years of the measure on employment and the public finances**

Création of...	Jobs (1 000)	Net creation (%)	<i>Ex ante</i> public balance (in GDP points)	<i>Ex post</i> public balance (in GDP points)
... 100,000 in the non-market sector	80 000	80 %	0.12	0.07
50,000 in the non-market sector	27 300	55 %	0.05	0.03
<b>Total (150,000 jobs for the future)</b>	<b>107 300</b>	<b>72 %</b>	<b>0.17</b>	<b>0.10</b>

Source : OFCE calculations.

According to statements by the Minister of Labour and Employment, two-thirds of the “jobs for the future” will be set up in 2013. To assess the impact of this measure over the presidential term, we started from the assumption that 25,000 full-time “jobs for the future” with a term of 5 years would be created each quarter from the beginning of 2013 until

mid-2014.

Based on this profile for the implementation of the “jobs for the future”, the net new job creation expected in 2013 would be 71,600, with 35,700 in 2014, and then 0 from 2015 to 2017. The *ex-post* impact on the public balance would be 0.04 GDP point in 2013 and 0.06 point in 2014, *i.e.* a cumulative impact on the public finances of 0.1 GDP point over time.

**Table 2. Impact of the measure on employment and the public finances from 2013 to 2017**

	2013	2014	2015	2016	2017
Jobs for the future (1000s)	100 000	50 000	0	0	0
Net job creation (1000s)	71 600	35 700	0	0	0
<i>Ex-ante</i> annual cost (billion euros)	1.44	3.31	3.45	3.45	3.45
<i>Ex-ante</i> impact on public balance (GDP pts)	0.07	0.09	0.01	0.00	0.00
<i>Ex-post</i> impact on public balance (GDP pts)	0.04	0.06	0.00	0.00	0.00

Source: OFCE calculations.

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# Social action, but no end of

# the crisis

## Evaluation of the five-year economic programme (2012-2017)

By [Eric Heyer](#), [Mathieu Plane](#), [Xavier Timbeau](#)

The initial decisions of the five-year programme are coming amidst an extremely difficult and very uncertain economic situation. In a recent [OFCE Note](#) (No. 23 of 26 July 2012), we first analyze the macroeconomic context for François Hollande's five-year programme and the XIVth legislature. This analysis details the likely consequences for the next five years of the strategy currently being implemented in Europe. We evaluate both the cost to the public finances as well as the impact on economic activity, employment and the distribution of income. In part two, we analyze the public policy choices being given priority by the new government, including both those aimed at the young (generation contracts, jobs of the future), at some seniors (revision of the pension reform), and at the middle and lower classes (allowance for the start of school, boost to the minimum wage, Livret A bank accounts, rent control, revised taxation of overtime), as well as those intended to revive certain public expenditures that are deemed essential (public jobs in education, the justice system and the police in the "public finance" section, and public early childhood services).

François Hollande was elected President of the French Republic at a time when France and Europe are going through an unprecedented crisis. Unemployment in metropolitan France has increased by over 2 percentage points since the crisis began and is now (in ILO terms, 9.6% of the workforce in first quarter 2012) approaching the record levels of 1997 (10.5%). Gross domestic product per capita in terms of purchasing power has fallen since 2008 by 3%. If the growth trend for the five years preceding the crisis had continued at that same rate from 2008 until early 2012, GDP per capita would now be 8%

higher than it is. The current account has deteriorated during the crisis by 1.5 GDP points (25.7 billion euros, 10 billion of which is for the oil bill), thus worsening France's net balance of trade by 7.8 GDP points. The public debt increased by 577 billion (nearly 30 GDP points), and at the beginning of 2012 represented almost 90% of GDP. Industry has paid a heavy price for the crisis (almost 300,000 jobs lost), with all signs indicating that the job losses and closures of industrial sites might be irreversible.

Yet this dire situation, which can be chalked up to the crisis that began in 2008, is not over. Due to the impact of austerity policies implemented at a time of panic at seeing financing of the public debt dry up, the sovereign debt crisis is threatening the euro zone with a prolonged recession in 2012 and 2013. And the even worse scenario looming on the horizon – the disintegration of the euro zone – would transform the threats of recession into the risk of a major depression.

Assessments of the situation differ depending on the elements available. Some measures have been implemented by decree, while others are being discussed by the legislature, but the proposed bills do permit a quantitative analysis. Others are in the planning stage, with the main trade-offs still to be made, so our assessment tries to explore the main points.

Our assessment of the economic strategy for the five-year programme does not stop there. The outlines of the premises for a strategy to end the crisis can now be seen. The deficit reduction commitments and the initial steps taken in this direction in the budget packages in July 2012, such as those announced during the budget orientation debate of June 2012, point to a strategy whose first step is the achievement of a reduction in the public deficit to 3% of GDP by the end of 2013, regardless of the cost. Based on this fiscal virtue, this amounts to a strategy to end the crisis by stabilizing the state of the public accounts, thereby reassuring the



financial markets and other economic agents and establishing the conditions for a strong future recovery. This strategy is based on cutting public expenditures and raising taxes (see the “public finance” section, government tax proposals and the taxation of the oil companies).

This strategy for ending the crisis is risky, to say the least, because it does not take full account of the crisis facing Europe today. It might be justified if we were already on course to end the crisis and if the point were simply to set priorities. But Europe remains in a situation of extreme uncertainty, living in the expectation of a massive failure of one or another Member State in the euro zone, fearing the collapse of this or that financial institution, and suffering the consequences of a spiral of austerity that is being fueled by rising sovereign interest rates. In this situation, everything is coming together to strengthen the existence of a liquidity trap and to generate high fiscal multipliers. Given this, *ex ante* reductions in the deficit through tax hikes and spending cuts is weighing heavily on activity, and thus limiting or even cancelling out any actual deficit reductions. The factors pushing up the public debt are not being reversed, and the reduction in activity is heightening the risk that the unsustainable private debt will be socialized. The increase in sovereign interest rates is being fueled by an inability to meet deficit reduction targets and by rising public debt, and is thus pushing public deficits higher, forcing even more austerity.

One response to this dynamic that is bringing about the collapse of the euro would be one form or another of pooling public debts in Europe. This would require relatively complete control of the budgets of member countries by a federal body with strong democratic legitimacy. A response like this would therefore mean “more Europe”, and would make it possible to define “more moderate” austerity policies for France as well as its major trading partners. It would make putting an end to

involuntary mass unemployment and the liquidity trap prerequisites to an improvement in the public finances. It would also make it possible to ensure the sustainability of public finances without leading to the lost decades that are now gestating.

In the first part of the Note, we analyze the macroeconomic context for François Hollande's five-year programme and the XIVth legislature. This analysis details the likely consequences for the next five years of the strategy currently being implemented in Europe. The value of the fiscal multiplier is a critical parameter, and we show that the current strategy is valid only if the multipliers are low (*i.e.* on the order of 0.5). However, a slew of empirical evidence indicates that, in the exceptional situation we are experiencing today, the budget and fiscal multipliers may be larger than 0.5 (between 1 and 1.5, see the Note). We detail in a second part the measures taken in the Supplementary Budget Act of July 2012 (for 2012) and the elements outlined in the budget orientation debate in preparation for the Budget Act for 2013 and for the period 2012-2017. To succeed in reducing the public deficit to 3%, it seems that there must be over 10 billion euros in additional tax revenue or in savings on expenditure, *ex ante*.

We then present an evaluation of eleven measures. Guillaume Allègre, Marion Cochard and Mathieu Plane have estimated that the implementation of the *contrat de génération* ["generation contract"] could create between 50,000 and 100,000 jobs, at the cost of a strong deadweight effect. Eric Heyer and Mathieu Plane point out that in the short term, subsidized *emplois avenir* ["jobs for the future"]-type contracts can help to reduce unemployment. Eric Heyer shows that the revision of taxation on overtime will help to cut the public deficit by 4 billion euros, without hurting the labour market. Guillaume Allègre discusses the consequences of increasing the *Allocation de rentrée scolaire* [allowance for the start of

school] and shows that it mainly benefits the lowest five deciles in terms of standard of living. Henri Sterdyniak analyzes the possibilities for fiscal reform. The point is not to evaluate the government's proposals for fiscal reform, but to provide a comprehensive overview of the current system's margin for change and its inconsistencies. Henri Sterdyniak and Gérard Cornilleau evaluate the increased opportunities for retiring at age 60 and analyze the possible paths to a more large-scale reform of the pension system. H el ene P erivier evaluates the possibilities for an early childhood public service, the eventual cost of which could be covered in part by an increase in activity that would generate more than 4 billion euros. Eric Heyer and Mathieu Plane analyze the impact of a boost in the minimum wage (SMIC) and conclude that, given the small spillover of increases in the SMIC onto the rest of the wage structure, the impact on the cost of labour is limited by the greater reduction in social charges on low wages. While the effect on employment is small, it would cost the public purse 240 million euros. Sabine Le Bayon, Pierre Madec and Christine Rifflart evaluate rent control. Herv e P el eraux discusses the compensation of Livret A bank accounts and the impact of doubling their ceiling. C eline Antonin and Evens Salies evaluate the new taxes on the oil companies, which could provide 550 million euros in tax revenue in 2012, at the risk that this tax might ultimately be passed on to the end consumer.

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## **Europe's banks: leaving the zone of turbulence?**

By [Vincent Touz ](#)

The 2008 crisis almost endangered the entire global financial system. Thanks to support from governments and central banks, the banking sector has recovered and once again appears to be solid financially. In the aftermath of the crisis, the public finances of the Southern euro zone countries – Portugal, Italy, Spain and Greece – and Ireland (the “PIIGS”) have, in turn, been severely weakened. Greece was forced to suspend payments, and the risk of default is still hanging over the others. Since early 2011, bank liabilities in these economies have become a significant concern of the financial markets. Despite good stress tests, this fear intensified in August 2011. European banks then entered a new period of turmoil, and the European Central Bank was forced to lend them more than 1,000 billion euros for 3 years at a rate of 1% in order to avoid a major credit crunch.

As part of their investments abroad and through their foreign branches, Europe’s banks hold liabilities from the PIIGS countries through lending to the banking sector, to the public sector (sovereign debts and credits) and to households and private non-bank enterprises. France is one of the countries that is most heavily exposed to the PIIGS (public and private sectors combined), with a total commitment by the banking system in the third quarter of 2011 of about 437 billion euros (see table), or 21.9% of GDP. Germany’s exposure, at about 322 billion euros (12.5% of GDP), is smaller. The exposure of the UK banking system is comparable and is valued at 230 billion euros, or 13.3% of GDP. In comparison, the Japanese and US banks hold little debt: 59 billion euros (1.4% of GDP) for Japan and 96 billion (0.9% of GDP) for the United States. In the course of the financial crisis, Europe’s banks have pulled back from these countries (1). According to the statistics of the Bank for International Settlements (Figure 1), the reduction in exposure was most pronounced in Greece (-55% since Q1 2007) and lowest in Portugal (-15%). Divestments of the debt of Spain (-29%), Italy (-33%) and Ireland (39%) have been comparable and are at an intermediate level compared to

the previous two.

Guarantee funds can be drawn on if a bank goes bankrupt, but generally their provisions are insufficient to support a "big" bank in difficulty. According to the principle of "too big to fail", the state must intervene to avoid bankruptcy. Possible avenues of action include acquiring some of the bank's capital, nationalizing it by refloating it, or facilitating its long-term refinancing through the purchase of bonds. A bank failure has to be avoided at all costs, because it is frequently accompanied by panic, with collateral damage that is difficult to predict or contain. The mere fact that a State announces credible support for a bank or a banking system is often sufficient to avert a panic. If the States were to come to the rescue of the banks in the case of the Greek default, the macroeconomic implications of a 50% default on all private and public debts seem relatively minor, since it would require, for example in the case of France, a cost of around 17 billion euros, an amount that is much less than 1% of GDP (see table). By contrast, a 50% default of all the PIIGS would require 220 billion euros in support from France (11% of French GDP). The macroeconomic cost beforehand might seem high, but it is not insurmountable. Unfortunately, the spontaneous failure of one or more PIIGS would lead to an uncontrollable chain reaction whose overall macroeconomic costs could be considerable.

This financial crisis is also hitting the life insurance companies, right in the midst of a period of reform in prudential regulations. The banking sector has just managed to come up to Basel II standards and will steadily have (until 2019) to adopt Basel III (2), while the insurance industry is changing rapidly towards Solvency II (3). These two regulatory reforms are leading to an increasing need for capital just as the financial crisis is undermining balance sheets and putting greater pressure on capital ratios. While equity capital can be used to withstand a financial crisis, at the same time

regulations can compel recapitalizations in very difficult refinancing conditions. This is an undesirable pro-cyclical result of the prudential regulations.

The risk of a default on payments by some PIIGS has made financial analysts pay particularly close attention to the solvency and profitability of European banks. However, the results of the stress tests (4) on the European banks published in mid-July 2011 were considered good. The hypotheses used are far from being optimistic. In the euro zone (and respectively in the other countries), they point to a fall in the growth rate of 2 points (2.4 points respectively) in 2011 and 2 points (1.9 points respectively) in 2012 compared to a reference scenario. In the euro zone, this entry into recession (-0.5% in 2011 and -0.2% in 2012) would be accompanied by higher unemployment (0.3 point in 2011 and 1.2 points in 2012), a lower inflation rate (-0.5 point in 2011 and -1.1 points in 2012), a sharp drop in property prices, a rise in long-term rates as well as discounts on sovereign debt (5) of up to 30%. The objective of this "stressed" scenario is to test the capacity of the banks to be able to maintain a "core Tier 1" ratio greater than 5% (6). Under these extreme assumptions, only 8.9% of the 90 banks tested achieved a ratio that was below the 5% ceiling that would trigger a de facto recapitalization to meet the target (7). The four French banks succeeded on the stress tests without difficulty, as they maintain high ratios: 6.6% for Societe Generale, 6.8% for the Banque populaire-Caisse d'épargne, 7.9% for BNP Paribas and 8.5% for Crédit Agricole. The countries where failures were observed include Austria (1 bank), Spain (5 failures) and Greece (2 failures). In view of the stress tests, the European banking system could therefore be considered as capable of withstanding a major economic crisis.

After the second aid package to Greece on 21 July 2011, and with ongoing pressure on the other sovereign debts, worry

seized the stock markets, and European bank stocks fell sharply from August to December 2011 (Figure 2). These stock market changes were in complete contradiction with the positive results of the stress tests. There are three possible ways to interpret the reaction of the financial markets:

- An actual crisis would be much sharper than the hypotheses of the stress tests;
- The stress test methods are not adequate for estimating the consequences of a crisis;
- The markets get swept up in the slightest rumors and are disconnected from basics.

For now, with respect to the most pessimistic forecasts, it does not seem that the stress test hypotheses are particularly favorable. However, they have weaknesses for assessing systemic financial crisis, in that each bank does not include in its assessment the damage brought about by the application of the scenario to other banks or the consequences for the credit market. There is no feedback from the financial interconnections. Moreover, the economic crisis can greatly increase the default rates of private companies. This point may have been underestimated by the stress tests. Note also that the tests are performed at an internal level, which can also lead to different assessments of the consequences of certain scenarios. In addition, the stress tests evaluate the financial soundness of the banks, but de facto, a bank, although solvent, can see its stock price fall in times of crisis for the simple reason that its expected profitability decreases. Most importantly, the runaway financial markets are due to the lack of a consensus on the decisions taken within the European Union on finding a definitive solution to the debt crisis but also to the fact that the statutes of the European Central Bank prohibit it from participating in public debt issues. These uncertainties reinforce the volatility of the stock price of banks that are particularly exposed to PIIGS, as evidenced by the strong correlation between CDS on private banks and on sovereign debt in the euro zone (8).

With the beginning of a solution on Greek debt, the stock market listings of European banks have been rising since January 2012. Hopefully the agreement of 21 February 2012 on Greek sovereign debt will calm the storm that hit the bond markets. The operation provides that private investors agree to give up 107 billion euros of the 206 billion of debt they hold and that the euro zone States agree a new loan of 130 billion. The agreement is a swap of debt. The old bonds are exchanged against new ones at a discount of 53.5% of the face value (9) and at a new contractual interest rate. The write-down was not a surprise for the banks, which have already set aside provisions for the losses. The operation was a clear success (10), as 83% of the holdings were voluntarily offered for exchange on 9 March (11). The level of participation was increased to more than 95% by carrying through a compulsory exchange with creditors who had not responded positively to the operation (collective action clauses for debt held under Greek law). After this exchange, the European states, the IMF, and the ECB will hold "more than three-quarters of Greek debt" (12), which means that any new crisis of Greek sovereign debt would have little impact on private investors. A new source of uncertainty comes from the CDS that were taken out for the purpose of hedging or speculation ("naked CDS"). Initially, the International Swaps and Derivatives Association (ISDA) (13) announced on 1 March that this exchange was not a "credit event". On 9 March, it revised its judgment (14). The ISDA now believes that the collective action clauses are forcing owners to accept the exchange, which constitutes a credit event. The Greek default on payments is a legally recognized event, and the CDS are thus activated. According to the ISDA, the net exposure of CDS to Greece would amount to only 3.2 billion dollars. To estimate the overall cost of the CDS for the financial sector, the residual value of the bonds would have to be subtracted from that amount. Given the inability of Greece to resume growth, the sustainability of its remaining debt is not guaranteed, and the risk of contagion persists. In any event, the public debt of the Southern euro zone countries



and Ireland are now considered risky assets, which is a factor that is weakening the European banking sector. In this respect, since late March the recent rise in interest rates on Italian and Spanish public debt has provoked a decline in the stock prices of European banks (Figure 2).

The ongoing financial crisis is weakening the banking sector in the euro zone, which could lead it to reduce its exposure to risk: a major credit crunch is thus to be feared. The latest ECB survey covering 9 December 2011 to 9 January 2012 (15) with regard to the lending conditions set by banks is not very reassuring. Tighter conditions are expected by 35% (against 16% last quarter) of banks on business loans and by 29% (against 18% last quarter) of banks on consumer loans. In light of this prospect, on 21 December 2011 the ECB conducted a long-term refinancing operation. This was a huge success, with 489 billion euros in credits granted to the banking sector. The funds were loaned at 1% for a period of 3 years. Although it is still difficult to assess the impact of this measure, ECB president Mario Draghi said in February that this injection of liquidity had clearly avoided a major credit crunch. On 29 February 2012, the ECB launched a second long-term refinancing plan (16). The subscription was very substantial, with 530 billion euros disbursed. It is therefore reasonable to think that a credit crunch will be avoided.

In conclusion, the banking sector's escape from the zone of turbulence depends on four key factors:

- 1) Only a long-term return to growth across the euro zone as a whole will make it possible to consolidate the public purse and reduce the number of business failures (17), thereby de facto reducing banks' exposure to the risk of default, with responsibility incumbent on the European governments and the ECB to identify and implement the "right" policy mix and the appropriate structural measures.

- 2) The Greek State is insolvent; this failure in public finances must not be allowed to spread to other economies,

since the banking crisis is also a test of the strength of financial solidarity in the euro zone, and it remains to be seen whether the Germans are more inclined to support Spain or Italy in case of a risk of default than they were with Greece.

3) The banking crisis has brought to the fore the procyclical effects of the prudential regulations, which need to be corrected.

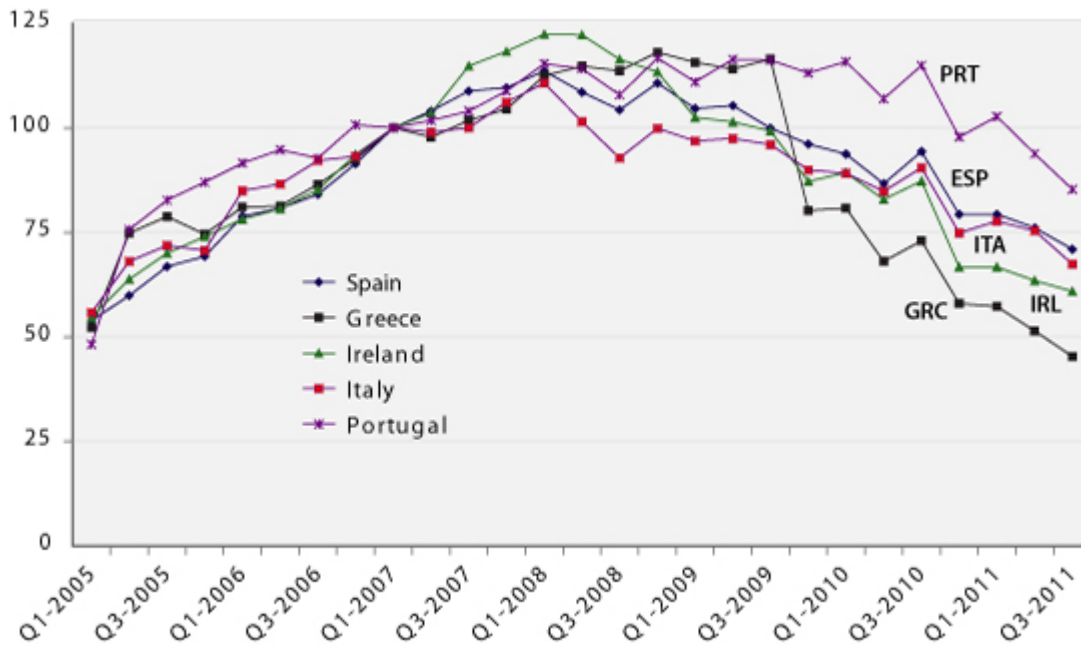
4) The maneuvering room of governments as first responders in a crisis has become very limited due to their massive debt. If there is a new major shock, the ECB could have no other choice but to be the lender of last resort.

#### Exposure of the national bank sector to the PIIGS 3rd quarter 2011 (billion euros)

Creditor country	DEU	FRA	GBR	JPN	USA
<b>SPAIN</b>					
Bank	44,3	25,0	13,4	2,9	13,0
Public sector	18,6	19,1	4,3	7,0	3,7
Private non-bank sector	50,7	57,9	48,0	7,5	17,0
<b>Total</b>	<b>113,6</b>	<b>102,0</b>	<b>65,7</b>	<b>17,4</b>	<b>33,7</b>
<b>GREECE</b>					
Banks	0,7	0,4	0,7	0,2	0,9
Public sector	8,0	5,1	1,5	0,1	1,0
Private non-bank sector	4,5	28,3	6,0	0,5	2,3
<b>Total</b>	<b>13,2</b>	<b>33,8</b>	<b>8,2</b>	<b>0,8</b>	<b>4,2</b>
<b>IRELAND</b>					
Banks	14,1	6,9	12,7	1,1	6,4
Public sector	2,0	1,8	3,3	0,5	1,3
Private non-bank sector	55,6	11,7	80,8	12,2	23,2
<b>Total</b>	<b>71,7</b>	<b>20,5</b>	<b>96,8</b>	<b>13,9</b>	<b>30,8</b>
<b>ITALY</b>					
Banks	28,4	26,3	5,5	1,9	6,8
Public sector	31,4	58,1	6,0	17,5	7,2
Private non-bank sector	42,4	178,6	31,7	6,3	9,3
<b>Total</b>	<b>102,1</b>	<b>262,9</b>	<b>43,3</b>	<b>25,7</b>	<b>23,3</b>
<b>PORTUGAL</b>					
Banks	6,2	4,4	2,3	0,1	1,1
Public sector	5,6	3,8	1,2	0,3	0,6
Private non-bank sector	9,4	10,0	13,0	0,6	1,8
<b>Total</b>	<b>21,2</b>	<b>18,2</b>	<b>16,5</b>	<b>1,0</b>	<b>3,5</b>
<b>TOTAL PIIGS</b>					
Banks	93,6	63,0	34,6	6,3	28,2
Public sector	65,6	87,9	16,3	25,4	13,9
Private non-bank sector	162,6	286,5	179,6	27,1	53,6
<b>Total</b>	<b>321,8</b>	<b>437,4</b>	<b>230,4</b>	<b>58,8</b>	<b>95,6</b>
<b>% of GDP</b>	<b>12,5</b>	<b>21,9</b>	<b>13,3</b>	<b>1,4</b>	<b>0,9</b>

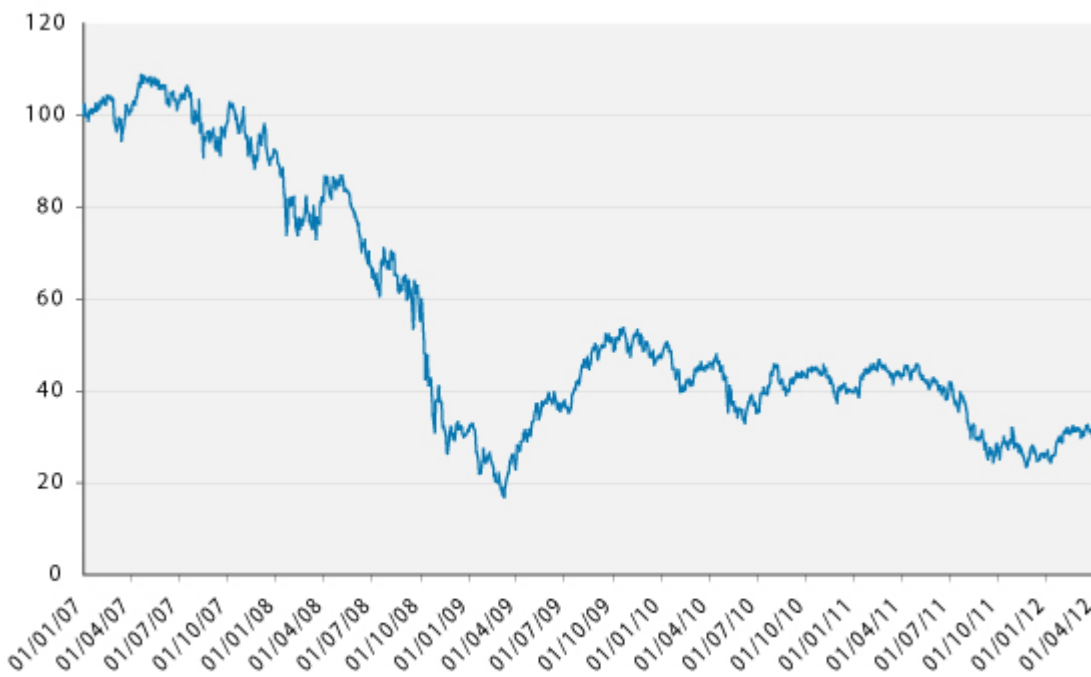
Sources: Banque des règlements internationaux – Consolidated banking statistics / ultimate risk basis – and author's calculations.

**Graphique 1. Foreign debt held by European banks (Base 100 = 1st quarter 2007)**



Sources : Banque des règlements internationaux – Consolidated banking statistics /ultimate risk basis – and author's calculations.

**Figure 2. Stock market index of European banks (base 100 = 1 January 2007)**



Sources : Datastream (FTSE World Europe Banks).

[1] Note that a financial depreciation (capital loss) on the balance sheet value of assets in the PIIGS implies an automatic reduction in the exposure to these economies.

[2] [http://www.bis.org/speeches/sp100921\\_fr.pdf](http://www.bis.org/speeches/sp100921_fr.pdf)

[3]

[http://ec.europa.eu/internal\\_market/insurance/solvency/background\\_fr.htm](http://ec.europa.eu/internal_market/insurance/solvency/background_fr.htm).

[4] *European Banking Authority*, 2011, [http://stress-test.eba.europa.eu/pdf/EBA\\_ST\\_2011\\_Summary\\_Report\\_v6.pdf](http://stress-test.eba.europa.eu/pdf/EBA_ST_2011_Summary_Report_v6.pdf).

[5] European Banking Authority (2011), *Methodological Note – Additional guidance*, June 2011.

[6] The minimum level required by Basel II for the Core Tier 1 ratio is only 2%, which rises to 4.5% under Basel III (in force in 2013). This ratio measures the proportion of risk-weighted assets covered by equity capital.

[7] For a bank whose ratio falls to  $x\%$ , the recapitalization requirement corresponds to  $(5\%-x)/x$  % of post-shock equity capital. Hence if  $x=4\%$ , the recapitalization requirement would correspond to 25% of the equity capital.

[8] “The correlation between interest rates on public debt and on private debt will make it difficult to resolve the sovereign debt crisis in the euro zone”, *Flash marchés*, Natixis, 14 March 2011 – N° 195, <http://cib.natixis.com/flushdoc.aspx?id=57160>.

[9] For example, each old bond with a face value of 100 euros is exchanged for a new one worth 46.5 euros. The EFSF guarantees 15 euros and the Greek state 31.5 euros.

[10]

<http://www.minfin.gr/portal/en/resource/contentObject/id/baba4f3e-da88-491c-9c61-celfd030edf6>.

[11] In light of the holders of public debt who are not subject to Greek law and who are refusing to take part in the operation, the deadline of 9 March (see

<http://fr.reuters.com/article/frEuroRpt/idFRL6E8F540020120405>) was put off to 4 April and then to 20 April. The Greek state considers that this refusal to exchange will not be sufficient to block the operation, as, given the collective action clauses, voluntary or required participation amounts to at least 95.7%. With regard to the recalcitrant investors, the Greek state has the choice of waiting a little longer, meeting its contractual commitments (continued reimbursement of the face value and interest as initially scheduled), make a new exchange offer (but this must be equitable with respect to those who accepted the previous offer) or default, with the risk of pursuit in the international courts.

[12] Olivier Garnier, "Comprendre l'échange de dette publique grecque", *Le Webzine de l'actionnaire – Analyses*, Société Générale, 13 March 2012, <http://www.societegenerale.com/actiorama/comprendre-l%E2%80%99echange-de-dette-publique-grecque>.

[13]

[http://www.isda.org/dc/docs/EMEA\\_Determinations\\_Committee\\_Decision\\_0103201202.pdf](http://www.isda.org/dc/docs/EMEA_Determinations_Committee_Decision_0103201202.pdf).

[14] <http://www2.isda.org/greek-sovereign-cds/>

[15] The Euro Area Bank Lending Survey, 1February 2012, [http://www.ecb.int/stats/pdf/blssurvey\\_201201.pdf](http://www.ecb.int/stats/pdf/blssurvey_201201.pdf).

[16]

[http://www.ecb.int/press/pr/date/2011/html/pr111208\\_1.en.html](http://www.ecb.int/press/pr/date/2011/html/pr111208_1.en.html).

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# Must balancing the public finances be the main goal of economic policy

By [Henri Sterdyniak](#)

The financial crisis of 2007-2012 caused a sharp rise in public deficits and debt as States had to intervene to save the financial system and support economic activity, and especially as they experienced a steep drop in tax revenues due to falling GDP. In early 2012, at a time when they are far from having recovered from the effects of the crisis (which cost them an average of 8 GDP points compared to the pre-crisis trend), they face a difficult choice: should they continue to support activity, or do whatever it takes to reduce public deficits and debt?

[An in-depth note expands on nine analytical points:](#)

- The growth of debt and deficits is not peculiar to France; it occurred in all the developed countries.
- France's public bodies are certainly indebted, but they also have physical assets. Overall the net wealth of government represented 26.7% of GDP in late 2010, or 8000 euros per capita. Moreover, when all the national wealth is taken into account (physical assets less foreign debt), then every French newborn has an average worth at birth of 202 000 euros (national wealth divided by the number of inhabitants).
- In 2010, the net debt burden came to 2.3% of GDP, reflecting

an average interest rate on the debt of 3.0%, which is well below the nominal potential growth rate. At this level, the real cost of the debt, that is, the primary surplus needed to stabilize the debt, is zero or even slightly negative.

– The true “golden rule” of public finances stipulates that it is legitimate to finance public investment by public borrowing. The structural deficit must thus be equal to the net public investment. For France, this rule permits a deficit of around 2.4% of GDP. There is no reason to set a standard for balancing the public finances. The State is not a household. It is immortal, and can thus run a permanent debt: the State does not have to repay its debt, but only to guarantee that it will always service it.

– The public deficit is detrimental to future generations whenever it becomes destabilizing due to an excessive increase in public spending or an excessive decrease in taxation, at which point it causes a rise in inflation and interest rates and undermines investment and growth. This is not the situation of the current deficit, which is aimed at making adjustments to provide the necessary support for economic activity in a situation of low interest rates, due to the high level of household savings and the refusal of business to invest more.

– For some, the 8 GDP points lost during the crisis have been lost forever; we must resign ourselves to persistently high unemployment, as it is structural in nature. Since the goal must be to balance the structural public balance, France needs to make an additional major effort of around 4 percentage points of GDP of its deficit. For us, a sustainable deficit is about 2.4 GDP points. The structural deficit in 2011 is already below that figure. It is growth that should make it possible to reduce the current deficit. No additional fiscal effort is needed.

– On 9 December 2011, the euro zone countries agreed on a new

fiscal pact: the Treaty on Stability, Coordination and Governance of the European Monetary Union. This Pact will place strong constraints on future fiscal policy. The structural deficit of each member country must be less than 0.5% of GDP. An automatic correction mechanism is to be triggered if this threshold is exceeded. This constraint and the overall mechanism must be integrated in a binding and permanent manner into the fiscal procedures of each country. Countries whose debt exceeds 60% of GDP will have to reduce their debt ratio by at least one-twentieth of the excess every year.

This project is economically dangerous. It imposes medium-term objectives (a balanced budget, a debt rolled back to below 60% of GDP) that are arbitrary and are not *a priori* compatible with the necessities of an economic equilibrium. Likewise, it imposes a fiscal policy that is incompatible with the necessities of short-term economic management. It prohibits any discretionary fiscal policy. It deprives governments of any fiscal policy instrument.

– As the rise in public debts and deficits in the developed countries came in response to mounting global imbalances, we cannot reduce the debts and deficits without addressing the causes of these imbalances. Otherwise, the simultaneous implementation of restrictive fiscal policies in the OECD countries as a whole will lead to stagnating production, falling tax revenues and deteriorating debt ratios, without managing to reassure the financial markets.

– A more balanced global economy would require that the countries in surplus base their growth on domestic demand and that their capital assumes the risks associated with direct investment. In the Anglo-American world, higher growth in wage and social income and a reduction in income inequalities would undercut the need for swelling financial bubbles, household debt and public debt. The euro zone needs to find the 8 GDP points lost to the crisis. Instead of focussing on government



balances, the European authorities should come up with a strategy to end the crisis, based on a recovery in demand, and in particular on investment to prepare for the ecological transition. This strategy must include keeping interest rates low and public deficits at the levels needed to support activity.