

# The shortfall in European investment

[Sébastien Bock](#), [Aya Elewa](#), [Sarah Guillou](#), [Mauro Napoletano](#), [Lionel Nesta](#), [Evans Salies](#), [Tania Treibich](#)

Since Robert Solow's early work, we have known that long-term economic growth does not come from a larger capital stock or increased employment, but from technical progress, identified as the unobserved part of growth. This unobserved element – the Solow residual – explained 87% of US growth in the first half of the 20th century. Since then, theories of endogenous growth have shown that it is above all intangible investment, particularly investment in R&D or human capital, which, as a source of positive externalities, ensures long-term growth.

Information and communication technologies (ICT) have focused the attention of researchers and statisticians since the late 1990s. Although they have not always lived up to their promise of productivity gains – the Solow paradox – they are undeniably the lifeblood of all the technologies of the 21st century, and are the weapons of competitiveness for all sectors, especially digital services. Taking an interest in investment in these technologies is an essential part of any discussion of growth and living standards.

In this post, we focus on three types of investment, one tangible, and the other two intangible, which may be at the root of the European economic backwardness relative to the United States analysed in greater detail in our Policy brief "[Documenting the widening transatlantic gap](#)". We are looking at investment in ICT equipment (servers, routers, computers, etc.), investment in research and development (R&D), and

investment in ICT services such as software, programs and databases.[\[1\]](#) These three types of investment stand out from other tangible investments (in transport equipment, machinery, buildings, farmland) and intangible investments (in training, intellectual property, organisation) because of their particular dynamics, revealing a growing and sometimes spectacular lag between the eurozone and the United States.

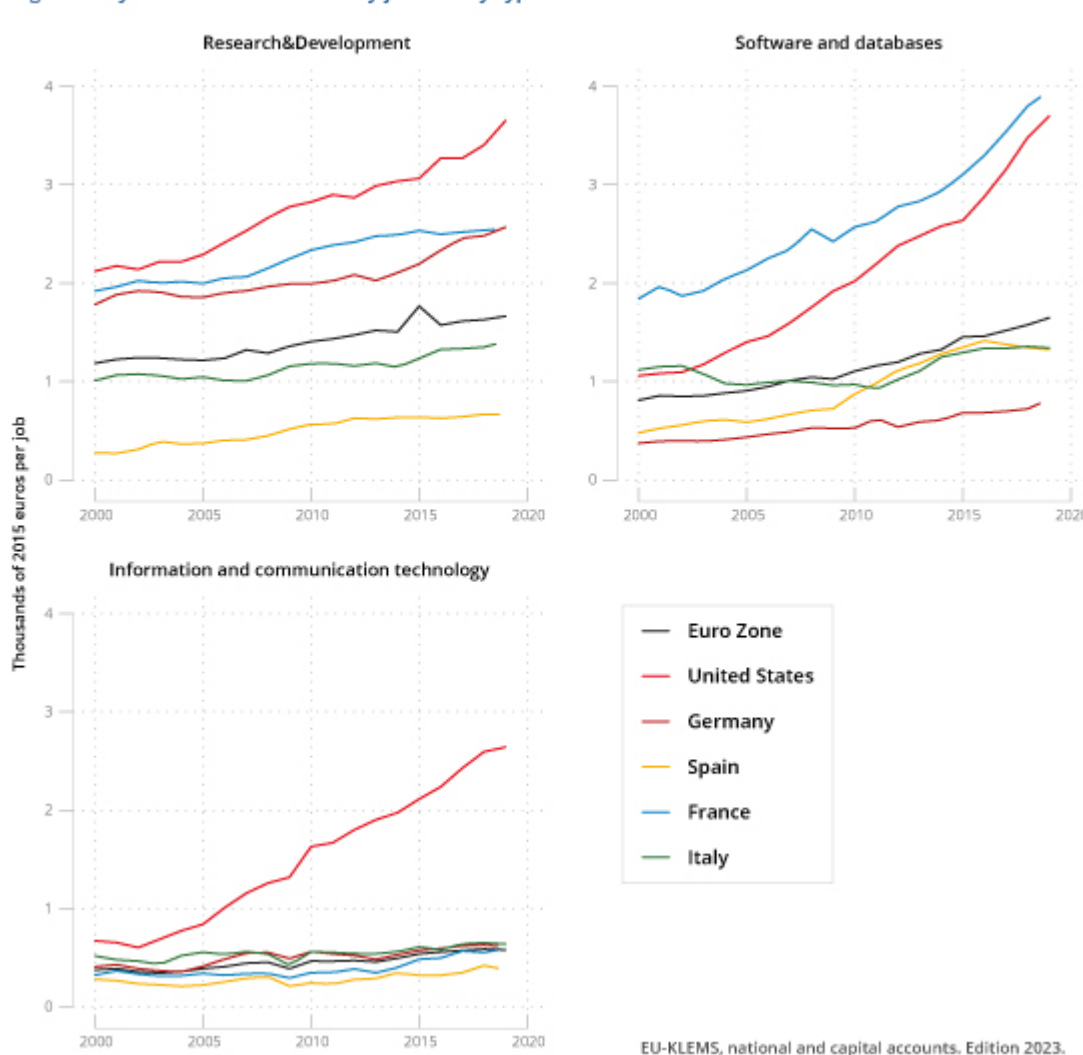
Let's first look at the dynamics of investment.

Figure 1 shows investment per job for these three types of investment in the United States, the eurozone and the four major eurozone countries from 2000 and 2019. It appears that the investment effort in the United States is greater for each of them.

- In terms of R&D investment, the gap between the United States and the eurozone, which was already wide in the early 2000s, is widening in absolute terms (from €1,000 to €2,000 per job over the period) to represent more than twice the European effort in 2019. What we find most worrying is that this widening gap is the result of uniform behaviour on the part of the main European economies. For both Germany and France, this gap, which was rather small until 2005, is multiplied by 10 for France and by 5 for Germany at the end of the period.
- Concerning investment in software and databases, and leaving aside the French case[\[2\]](#), there is no reason to be optimistic. The US-EZ gap in investment per job in software and databases has increased 12-fold, from €200 to €2,400 over the two decades. France stands out in terms of volume, but the trend is for French investment to double while US investment triples.
- Concerning investment in ICT equipment, the American singular achievement is even more impressive. Initially close to European levels, this investment is growing steadily in the United States, while remaining constant

in the eurozone. The comparison is eloquent here, since investment per job remains at between 500 and 700 euros per year over the entire period in the eurozone, whereas it reaches 2,500 euros in the United States, a nearly five-fold increase over the period in question.

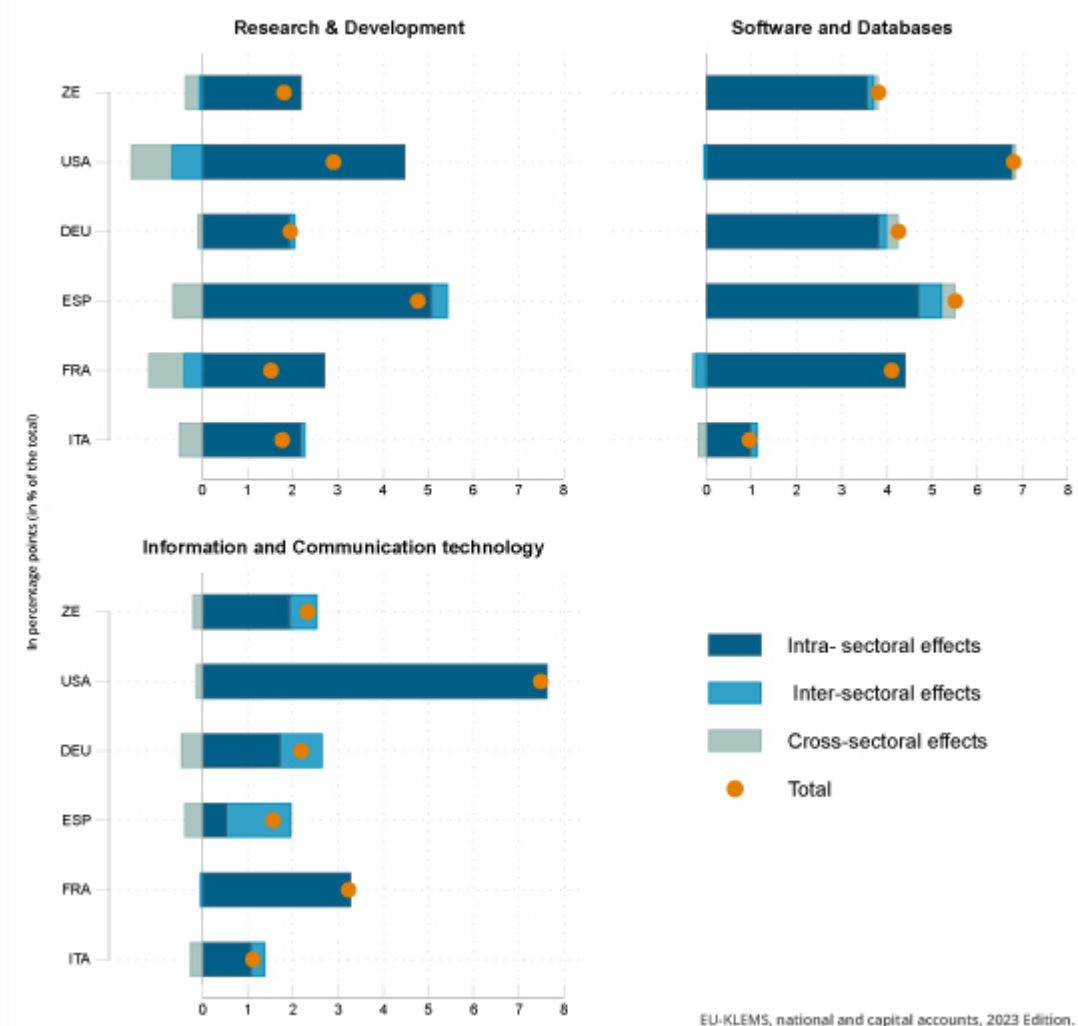
Figure 1. Dynamics of investment by job and by type of investment



Overall, the private investment gap between the eurozone and the United States stood at around 150 billion euros in 2000, rising to over 600 billion euros in 2019. Where does this US vigour come from, and above all, how can we explain Europe's apathy? The first question we might ask is the role of the productive specialisation of economies. After all, if the sectors that are growing in the US are those that invest the most in R&D, software and ICT equipment, we should see greater composition effects in the US than in the eurozone. This would imply that the growth observed is not the result of American

behaviour that is increasingly inclined towards investment but is above all the result of an advantageous sectoral positioning for the United States. Let's now decompose investment growth by distinguishing between intra- and inter-sectoral effects.

Figure 2. Intra- and inter-sectoral contributions to the average annual growth rate of investment per job (by type of investment, 2000-2019) (in % of the total)



By positing aggregate investment per job as the sum of investment per job in each sector weighted by the share of employment in those sectors, the growth rate of aggregate investment per job can be decomposed as the sum of intra-sectoral effects, inter-sectoral effects and cross-sectoral effects over the period.

The first effect captures the source of change linked to the increase in investment (per job) taking place within each sector. This internal effect may be the result of companies

increasing their investment between 2000 and 2019, market share reallocations within sectors, or firms entering and leaving the market. The second effect, the cross-sectoral effect, is the result of structural change in economies, understood as changes in the sectoral structure of economies. The cross-sectoral effect is the combination of the first two effects.

Figure 2 presents the results of this decomposition, distinguishing between the effects within each sector and those between sectors. We can immediately see that it is the intra-sectoral effect that explains the growth in per capita investment, and this applies across all economies and all types of investment. In other words, the explanation that structural change is taking place in such a way as to favour growth in investment per job in the United States and not in Europe can be rejected. Not only are the sectoral structures of the economies not that far apart, but above all the investment growth is clearly the result of an investment intensification within sectors. We therefore need to understand the origin of the US-EZ investment gap as the result of investment behaviour that changes over time.

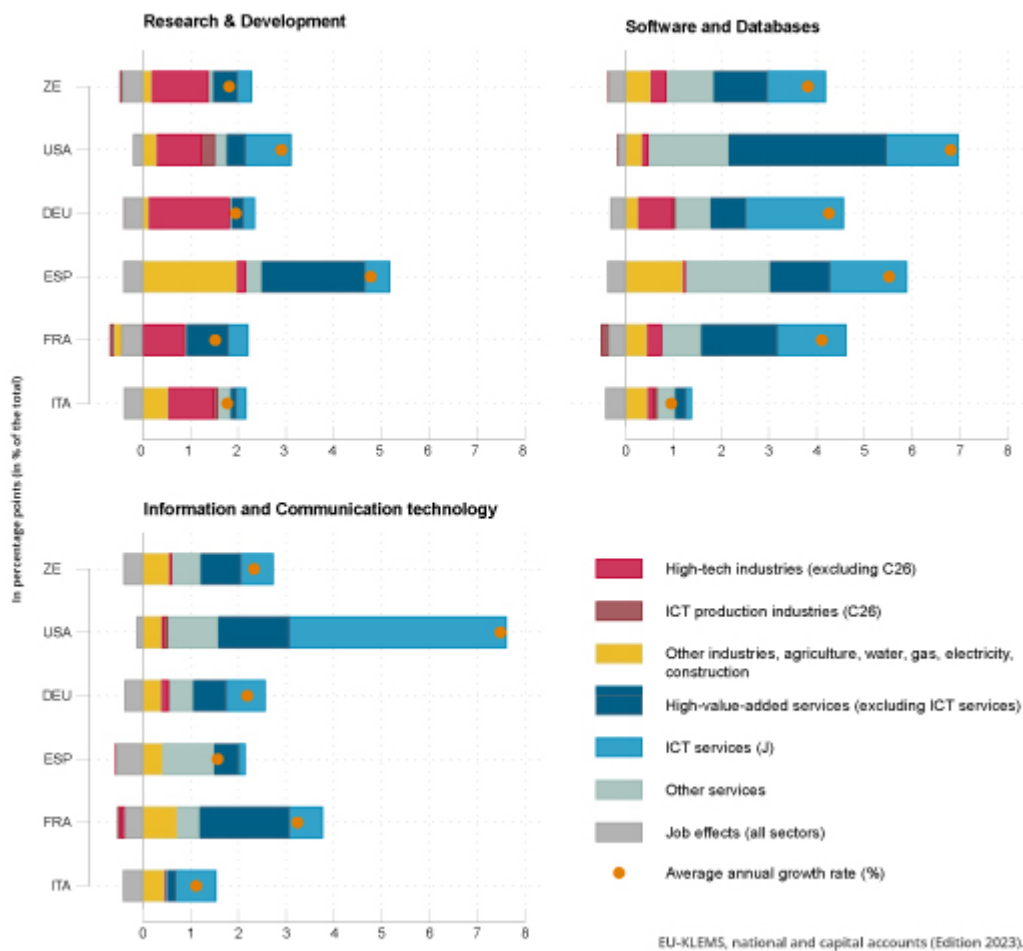
To reveal them, we use another decomposition, where the growth rate of investment per job is the result of the growth rate of investment minus the growth rate of employment. Next, we decompose the investment growth rate as the sum of the sectoral growth rates, weighted by each sector's share of total investment, at the start of the period. We classify all the sectors that make up the market economy by type of sector as follows: (i) high-tech industries (excluding ICT production); (ii) ICT production industries; (iii) other industries, agriculture, water, gas, electricity, construction; (iv) high-value-added services (excluding ICT services); (v) ICT services; (vi) other services. This classification seems relevant to us because it distinguishes ICT production activities (whether manufactured or services)

from other sectors that use ICTs as inputs in their production.

Figure 3 shows the results by type of investment. Let's look first at R&D investment. The case of Spain may seem surprising in terms of the growth observed, but this is above all the result of a catch-up effect. Indeed, as figure 1 shows, it is in Spain that investment per job is the lowest throughout the period under consideration. This growth is essentially driven by high value-added services and 'low-tech' industries. In the other countries, growth in investment per job is mainly driven by high-tech industries. This is particularly true of the eurozone in general, and Germany and Italy in particular. The differential between the US and European growth rates (excluding Spain) is mainly the result of major investment by the ICT services sectors. Here we see above all the famous GAFAMs.[\[3\]](#) The exploitation of gigantic databases combined with the rise of artificial intelligence – and the impressive possibilities it offers – are prompting the GAFAMs to invest massively in R&D in order to make the most of these new technologies.

Growth in investment in databases and software is mainly due to the services sector in general, whatever the country. What distinguishes the US from other countries is the significant contribution made by high value-added services. This suggests that ICTs are spreading more rapidly throughout the economic activities in the United States than in Europe. Italy stands out for its low growth rate, with services making virtually no contribution to the growth of this investment. The case of Spain is, once again, the expression of a catch-up effect, as shown in Figure 1.

Figure 3. Sectoral contribution to the average annual growth rate of investment per job (by type of investment, 2000-2019)



Finally, the US-EZ comparison of the sources of growth in investment in ICT equipment is particularly enlightening. Over and above the difference in growth rates, we note that the contribution of the sectors is relatively similar between the two regions of the world, except for ICT services. In the eurozone, the contribution of ICT services to growth in investment in ICT equipment remains low, whereas in the United States it is 4.5 percentage points, which alone explains the difference observed. Our interpretation is that the specific dynamics of investment in ICT equipment observed in Figure 1 is the result of massive investment by ICT services, i.e. essentially by GAFAMs and sisters (Intel, Nvidia...). In other words, intangible investment in R&D and software/databases is evolving in tandem with tangible investment in ICTs, which complements it and makes it operational or even productive.

Three results to remember :

1. The investment effort in the United States is greater than in the eurozone for the three types of investment considered: R&D, ICT equipment and ICT services (software and databases).
  - a. The gap between the United States and the eurozone is widening for all types of investment.
  - b. In 2019, investment in ICT equipment per job will be five times higher in the United States than in the eurozone.
  
2. It is the intra-sectoral effect that explains the growth in investment per job, in all economies, and for all types of investment.
  - a. The gap between the United States and the eurozone is therefore not because of changes in specialisation (over the last 20 years), but rather to changes within sectors.
  - b. The origin of the investment gap the contribution of ICT services to growth in investment in ICT equipment is the result of investment behaviour that changes over time.
  
3. There are significant differences between countries in terms of sectoral contributions to growth in investment per job.
  - a. In the eurozone, growth in R&D investment is being driven mainly by high-tech industries. In the United States, it is mainly ICT services that are driving this growth;
  - b. What distinguishes the United States from other countries is the significant contribution of high value-added services to the growth in investment in databases and software;
  - c. The difference in investment in ICT equipment is



mainly due to investment by the services sector.

It is as if, in the United States, the ICT services sector – including the five American giants – was responsible for the observed differential, with its heavy investment in R&D and digital equipment. The other service sectors (essentially high value-added services) are integrating these innovations into their production processes by investing in software and databases. The US case thus offers a high degree of coherence through the complementarity between sectors that produce and sectors that use ICT services. The overall impression is one of rapid digitisation of the economy, driven by GAFAMs and spreading to the entire US production base.

The European case does not offer the same picture, and is worrying for two reasons. Firstly, the lack of investment in ICT services means that the economy is digitised more slowly. Secondly, the absence of a leading company in the field of digital services limits investment in R&D and digital equipment. With the future promises of artificial intelligence and quantum computing, there is every reason to believe that, without the combination of upstream sectors supplying ICT services and equipment and downstream sectors adopting these innovations, Europe will find it more difficult to capture the fruits of the announced digitisation of the economy.

The challenge is therefore immense. Catching up would mean increasing private investment [\[4\]](#) in Europe by €630 billion a year (or more than 5% of the eurozone's GDP), for the assets considered here alone (ICTs, R&D, software and databases), and assuming that US investment remains constant. This is equivalent to an increase in investment of €61 billion for France, €57 billion for Germany, €28 billion for Italy and €16 billion for Spain. But this is not just a quantitative problem, far from it. Without a radical change in the investment behaviour of public and private players, and

institutional innovation in European governance<sup>[5]</sup> , this paradox is likely to persist in Europe, which, by remaining anchored in the productions of the 20th century, is clearly at risk of technological decline.

---

[1] It should be remembered that these investments may result from in-house production or be purchased from external suppliers.

[2] Guillou and Mini have highlighted the enigmatic French peculiarity in software and databases, which persists despite the differences in accounting between countries. See “[A la recherche de l’immatériel : comprendre l’investissement de l’industrie française](#)“, La Fabrique de l’industrie (2019).

[3] As a reminder, the GAFAMs are : Google (now Alphabet), Amazon, Facebook (Meta), Apple and Microsoft.

[4] The private sector corresponds to sectors with NACE codes from A to N.

[5] On this point, see the recent report by Fuest, D. Gros, P.-L. Mengel, G. Presidente and J. Tirole, “[EU Innovation Policy: How to escape the middle technology trap](#)“, April 2024, A Report by the European Policy Analysis group.

---

**Why – and how – to make Next  
Generation EU (NGEU)**

# sustainable

[Frédéric Allemand](#), [Jérôme Creel](#), [Nicolas Leron](#), [Sandrine Levasseur](#) and [Francesco Saraceno](#)

The Next Generation EU (NGEU) instrument was created during the pandemic to finance the recovery and, above all, to ensure the resilience of the European Union (EU). Since then, with the war in Ukraine and its various consequences, the shocks hitting the EU continue to accumulate, in a context where it is also necessary to accelerate the ecological transition and the digitalization of the economy. Russia's invasion of Ukraine has put defence matters back on the front burner, while inflation is giving rise to heterogeneous reactions from member states, which is not conducive to economic convergence, not to mention the monetary tightening that is destabilizing some banks. The Biden administration's subsidies to US industry have all the hallmarks of a new episode in the trade war, to which the European Commission has responded by temporarily relaxing the rules on state aid. In this uncertain environment, where one shock is following another, the idea of making the NGEU instrument permanent instead of temporary has gained ground. European Commissioner [P. Gentiloni](#), for example, mentioned the idea as early as 2021; it was raised at a conference of the [Official Monetary and Financial Institutions Forum](#) in 2022; it appeared at the conclusion of an article by [Schramm](#) and de Witte, published in the [Journal of Common Market Studies](#) in 2022; and it was mentioned publicly by [Christine Lagarde](#) in 2022. There is, however, little consensus on this issue, especially in Germany, where, after the Constitutional Court's decision in favour of the NGEU on 6 December 2022, the Minister of Finance, Christian Lindner, reminded us that the issuance of common debt (at the heart of the NGEU) must remain an "[exception](#)". As the debate remains open, in a [recent study](#) for the Foundation for European Progressive Studies (FEPS), we assessed the economic

and political relevance that the implementation of a permanent NGEU-type instrument would entail, as well as the technical and legal difficulties involved.

The implementation of the NGEU has already raised delicate questions of coordination between member states regarding the allocation of funds to the Commission's various structural priorities (how much to the ecological transition? how much to digitalization?) and between the countries themselves, since the question of a "fair return" never fails to resurface in the course of negotiations. Adding to these coordination difficulties, the first part of our study raises the question of the *democratic legitimacy* of EU policies when supranational priorities limit the autonomy of national parliaments, starting with fiscal policy, the "material heart" of democracy. The problem of democratic accountability is not new if one considers that supranational rules, such as the Stability and Growth Pact, impose limits on the power of parliaments to "tax and spend". In fact, the intrinsic logic of coordination is to force political power to conform to functional (macroeconomic) imperatives, which inevitably leads to a form of depoliticization of fiscal and budget policy. The perpetuation of the NGEU must therefore be seen as an opportunity to remedy the depoliticization of EU policies and to move towards a "political Europe" by establishing a supranational level for the implementation of a European fiscal policy.

This part of the study also reminds us that while the implementation of the NGEU has been of paramount importance in stimulating a post-pandemic recovery, the economic results are still uncertain since the funds were allocated only relatively recently<sup>[1]</sup>. It also reveals a change in the mindset of EU policymakers. For the first time, joint borrowing and some risk-sharing have become features of a European fiscal plan.

It would be wrong, however, at this stage to see the NGEU as a “Hamiltonian” moment or as the founding act of a federal Europe: the NGEU is limited in scope and duration; it does not take over the past debts of the member states; and it has not created a common spending (investment) capacity. And this is perhaps both its main weakness and its main area for improvement. The pandemic and the strong economic response to it by European states have indicated that they can share common, crucial goals: recovery, resilience, the ecological transition and digitalization. What is missing, however, is a central fiscal capacity to better link the long-term challenges with an instrument adapted to this kind of horizon. Hence the idea of making the NGEU permanent.

As a preamble to a possible long-term establishment of the NGEU, another part of the study raises the issue of determining the main task of a permanent central budgetary instrument. One obvious answer is the provision and financing of European public goods (broadly defined to include the areas of security and environmental protection) that member states may not provide in sufficient quantity, due to a lack of resources and/or externalities. Regarding the provision of public goods, it should be recalled that the preferences of EU citizens are fairly homogeneous within the Union, and that there is a growing demand for some needs to be met at the EU level. For example, [86% of EU citizens are in favour of making investments in renewable energy at the EU level](#). Even the production of military equipment by the EU is increasingly supported by citizens, with 69% “agreeing or strongly agreeing”. The provision of public goods at the EU rather than the national level would also allow for very tangible economies of scale, for example in the field of infrastructure. Last but not least, this would be justified by the instrument’s capacity to “make Europe” through concrete actions and strengthen the feeling of being European. Any debate on a central budgetary capacity would of course have to be conducted in parallel with that on the reform of the

Stability and Growth Pact in order to guarantee the creation of a fiscal space (or additional margins of manoeuvre) in the EU.

The study then points out that there are few options for creating a central budgetary capacity within the current institutional framework. The treaties define a budgetary framework (centred on the multi-annual financial framework, the MFF) for the EU that ties spending to the ability to raise funds, thus severely limiting the ability to raise debt in normal times. The creation of special financial instruments and the decision to spend beyond the MFF ceilings are explicitly linked to exceptional circumstances and cannot be a solution for the recurrent provision of public goods. The 0.6 percentage point increase in the own resources ceiling to 2 percent of GNI [\[2\]](#) ensured that the unprecedented level of borrowing respected the constitutional principle of a balanced budget.

However, [this increase was approved only because of its exceptional and temporary nature](#), as the ceiling on own resources for payments is to be reduced to 1.40 percent of GNI once the funds are repaid and the commitments cease to exist. Even if permanent funding were to be allocated to the NGEU instrument, its capacity to intervene would remain limited. In accordance with its legal basis (Article 122 TFEU), the NGEU is a tool for crisis management whose activation is linked to the occurrence or risk of exceptional circumstances. As a matter of principle, European legislation prohibits the EU from using funds borrowed on the capital markets to finance operational expenditure.

The study examines other legal arrangements that could contribute to the financing of public goods, but whatever legal basis is chosen, (a) the EU does not have a general multi-purpose financial instrument that it could activate, in addition to the general budget, to finance actions and projects over the long term; and (b) the EU cannot grant funds

to finance actions outside its area of competence, i.e., it cannot substitute itself for member states in areas where the latter retain competence for their policies. Therefore, if a central budgetary capacity is to be created, it would be necessary to revise the treaties or establish new intergovernmental arrangements (along the lines of the European Stability Mechanism).

Based on the second option, the study proposes that a European public investment agency be created as a first step towards the creation of a central budgetary capacity. This agency would have the function of planning and implementing investment projects, in cooperation with the member states. Under EU legislation, the agency would not have full control over policy choices but would act mainly within the limits set by the roadmaps of the EU institutions. Nevertheless, it would have the administrative capacity to design public investment projects that the Commission currently lacks, and it could be given control over allocating grants, developing technical guidelines, monitoring cross-compliance, etc.

The last part of the study reminds us, nonetheless, that even substantial progress in developing a central budget capacity should not obscure the need for national budget policies to be implemented as well, and that close coordination between them is needed. While increasing powers are being transferred to the European level in the area of public goods, as can be seen for example with the European Green Pact and with the targeting of NGEU spending towards greening and digitalization, there is still a need to coordinate national governments' policies with each other and with the policies implemented at the central level. Policy coordination, which necessarily limits the autonomy of national parliaments, raises the question of the democratic legitimacy of EU policies and may lead to a form of depoliticization of fiscal policy. This would become even more problematic if the EU were to transfer to the supranational level some of the decisions

about which public goods to provide and from whom to finance them. To avoid delinking the strengthening of European macroeconomic policy on public goods with the democratic dimension of this orientation, nothing less than a quantum leap in the creation of a political Europe, with two democratic levels, is probably needed, with genuine *European democracy* -- because it would be based on a real European parliamentary fiscal power, which would in turn be linked to the preferences of the European electorate -- but fully *articulated with the national democracies* with their recovered fiscal margins.

---

[1] The inconsistency between the need to revive the European economy after the pandemic and a very gradual disbursement of funds is discussed by [Creel \(2020\)](#).

[2] GNI: Gross national income, defined as GDP plus net income received from abroad for the compensation of employees, property, and net taxes and subsidies on production.

---

## How will US fiscal policy affect pressure on prices?

by [Elliot Aurissergues](#), [Christophe Blot](#) and [Caroline Bozou](#)

The latest inflation figures for the United States confirm the trends seen over the last few months. In October 2021, consumer prices rose by 6.2% year-on-year. While rising prices is a global phenomenon, among the industrialized countries this has been particularly marked

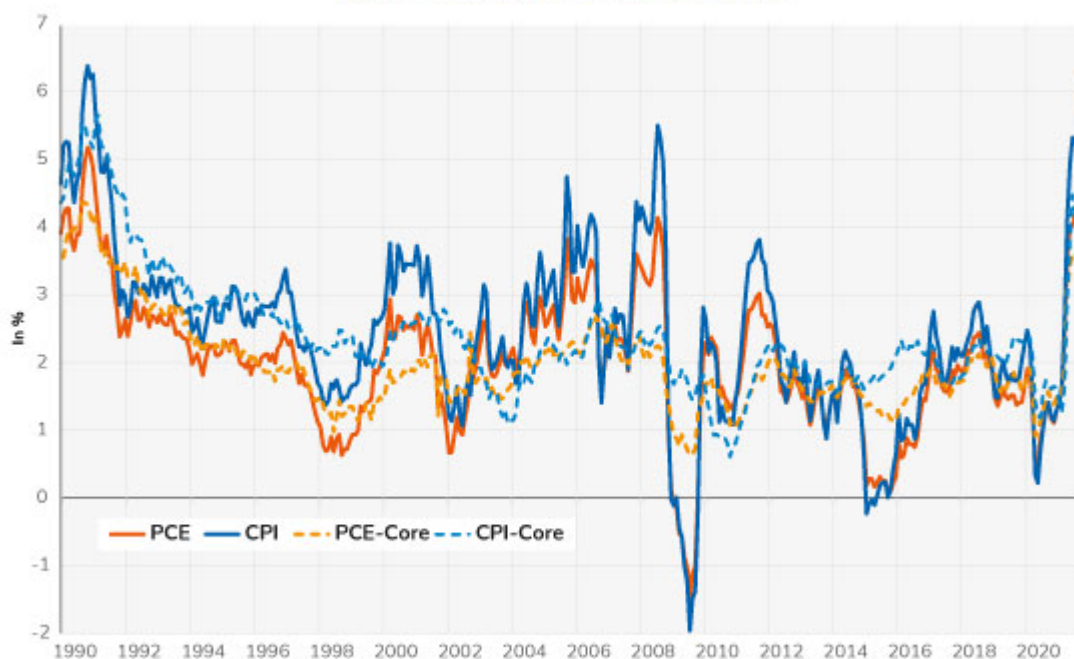


in the US. Inflation in the euro zone over the same period was 4.1%. This level of increase in inflation has not been seen since the late 1990s, so it is attracting considerable attention in the US policy debate, not least because it echoes a controversy that began early in Joe Biden's mandate over the fiscal stimulus passed in March 2021. Although inflation is being driven in part by rising energy prices, the fact remains that tensions have rapidly increased. Excluding energy and food components, inflation has exceeded 4% since June 2021, suggesting a risk of overheating for the US economy. While the European macroeconomic context does not allow us to identify an equivalent risk for the euro zone, the fact remains that a sustained rise in US inflation could have repercussions for the zone. Beyond the impact on competitiveness, the dynamics of US inflation could influence decisions on rate changes and the conduct of monetary policy by the Federal Reserve and the European Central Bank.

Regardless of the indicator – consumer price index or consumption deflator – prices have clearly accelerated since March 2021 (**see the figure**)[\[1\]](#). The energy component is undoubtedly important, but it does not fully explain this dynamic, since the latest figures for the underlying indices, i.e. adjusted for energy and food prices,

show a year-on-year increase of 4.6% for the CPI and 3.6% for the consumption deflator [2]. Note too that this development reflects a catch-up from 2020, when inflation was particularly moderate in the context of the pandemic and the sudden halt in activity. Thus, on average over 2020 and 2021, up to October, the consumption deflator has risen by 2.1%, in line with the target adopted by the Federal Reserve [3]. The recent tensions obviously reflect the dynamics of the post-lockdown global economic recovery, which the United States is clearly part of, and which has led to strong pressure on energy prices, but also on supplies, as evidenced by the supply difficulties for certain goods and the soaring cost of maritime freight.

Figure 1. Inflation in the United States



Bureau of Economic Analysis, Bureau of Labor Statistics.

Beyond these global factors, there is the question of an inflationary phenomenon that may be intrinsically linked to US economic

policy. Even before the recent discussions on the 2022 budget vote, the measures taken to deal with the Covid crisis first by the Trump administration and then by the Biden administration amount to a grand total of USD 5.2 trillion, representing more than 23 points of GDP for the year 2019. This spending over 2020 and 2021 represents an unprecedented level of stimulus over the last forty years. While there was undoubtedly a consensus on the need for the measures proposed by Biden and approved by Congress in March 2021, their magnitude nevertheless caused a great deal of debate, as the recovery was already underway and the economy was already benefiting, as it still is today, from the fiscal support measures voted in 2020 and from a highly expansionary monetary policy[4]. Could this expansionary economic policy – both fiscal and monetary – be causing the economy to overheat, fuelling the return of inflation, as economists such as Lawrence Summers and Olivier Blanchard fear, or, on the contrary, is the effect on inflation being overestimated, as other analyses suggest? We plunge into this debate in an [OFCE Policy Brief](#), specifying in particular the conditions that could lead to a sustainable increase in inflation. The risk will depend on the size of the multipliers measuring the effect of the stimulus plans on activity and unemployment, the position of the US economy relative to its potential, and

changes in inflation expectations, all of which are subject to some uncertainty.

---

[1] The consumer price index (CPI) is calculated from a survey of the prices of a basket of average goods consumed by a representative household. The consumption deflator is derived from the national accounts and represents the price system that allows the transition from consumption in value to consumption in volume. See [La désinflation importée](#) [Imported Deflation] in *OFCE Review*, 2019, No. 162, for more details on the difference between these two measures of inflation.

[2] Unadjusted for energy and food prices, the consumption deflator rose by 4.4%. The data for the deflator refer to the month of September, while the publication of the consumer price indices is more rapid, the latest figures published being those for October.

[3] The consumer price deflator is the indicator used by the Federal Reserve to assess price stability in the United States.

[4] Two other projects were then announced: an infrastructure investment plan (*American Jobs Plan*) and a household package (*American Families Plan*). These are not crisis-specific measures, but measures that are supposed to mark the direction of fiscal policy over the next eight years. These plans are currently being discussed in Congress as part of the 2022 budget vote.

---

# Should the ECB be concerned about the recent rise in inflation?

by [Christophe Blot](#), Caroline Bozou and [Jérôme Creel](#)

In August 2021, inflation in the euro area reached 3% year-on-year. This level, which has not been seen since November 2011, exceeds the European Central Bank's target of 2%. This recent momentum is being driven partly by oil prices, but there has been a simultaneous rebound in underlying inflation, which excludes the energy and food price indices from the calculation.

Inflation in the United States is also returning to levels not seen for several years, fuelling the debate on a potential return of inflationary risks. Given the central banks' mandate to maintain price stability, it is legitimate for them to examine the sources of renewed inflation. In a recent paper in preparation for the [Monetary Dialogue between the European Parliament and the ECB](#),

we discuss the temporary rather than permanent nature of this episode of inflation.

The recent development of inflation cannot be dissociated from the overall economic situation, which today is still strongly affected by the health crisis. After a sharp fall in activity – GDP contracted by 6.5% in 2020 – the macroeconomic performance of the euro area remains erratic. The crisis has been unprecedented both in terms of its scale and in terms of its sectoral characteristics and the nature of the shocks that have hit the euro area economies. The Covid-19 crisis has in reality been characterised by a simultaneous negative shock to both supply and demand (see [Dauvin and Sampognaro, 2021](#)).

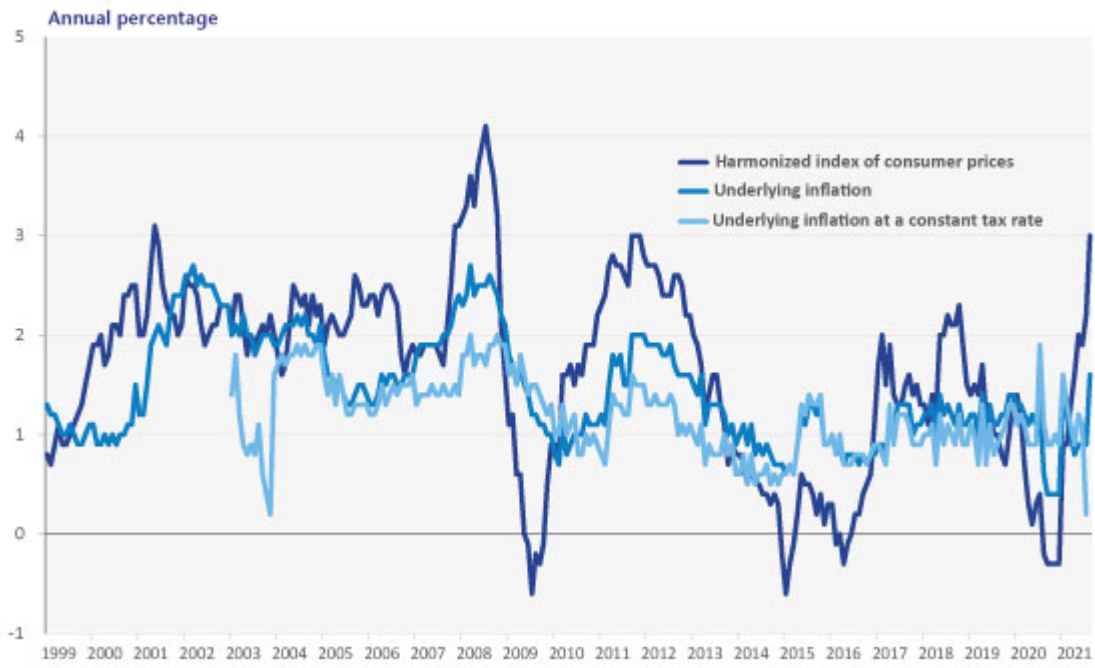
The factors driving current inflation appear to be temporary in nature. Indeed, a review of recent data suggests that the rise in inflation is mainly due to energy prices, to changes in Value-Added Tax rates and to the recovery from the most dramatic one-year recession since World War II (Figure 1). However, at a disaggregated level, it appears that for most goods, prices are often below the December 2019 level, while prices for some services are higher (Figure 2).

Nevertheless, there are many factors that could influence inflation over the medium term, and they leave some uncertainty about future pressure. The demand shock from the European fiscal stimulus and from labour market pressures is likely to be small. The inflationary cost of a fall in euro area unemployment is now very low – there is talk of a

flattening of the Phillips curve, see [Bobeica, Hartwig, and Nickel, 2021](#)) – and job vacancies, though high, are below the levels of 2018 when there were no fears of a return of inflation. However, agents' dissaving behaviour is generating inflationary pressures that could herald a more uncertain path. A surge in demand could fuel future price increases, especially if the difficulties in supply adjustment observed recently in certain sectors were to persist. As for supply difficulties and the rising cost of maritime transport, the latter's strong correlation with oil prices suggests this will fall over the next two years (see the [US Energy Information Administration](#) bulletin).

However, if we take a longer view, we can see that the upturn in inflation in no way makes up for the many years during which inflation fell below the 2% target (Figure 3). Thus, as long as the surge observed in recent months remains contained, this return of inflation could be seen as good news for the ECB, enabling it to finally reach its target and even possibly make up for past under-adjustments.

Figure 1. Inflation in the euro area



Source: Eurostat.



Figure 2. Breakdown of price rises and falls since December 2019

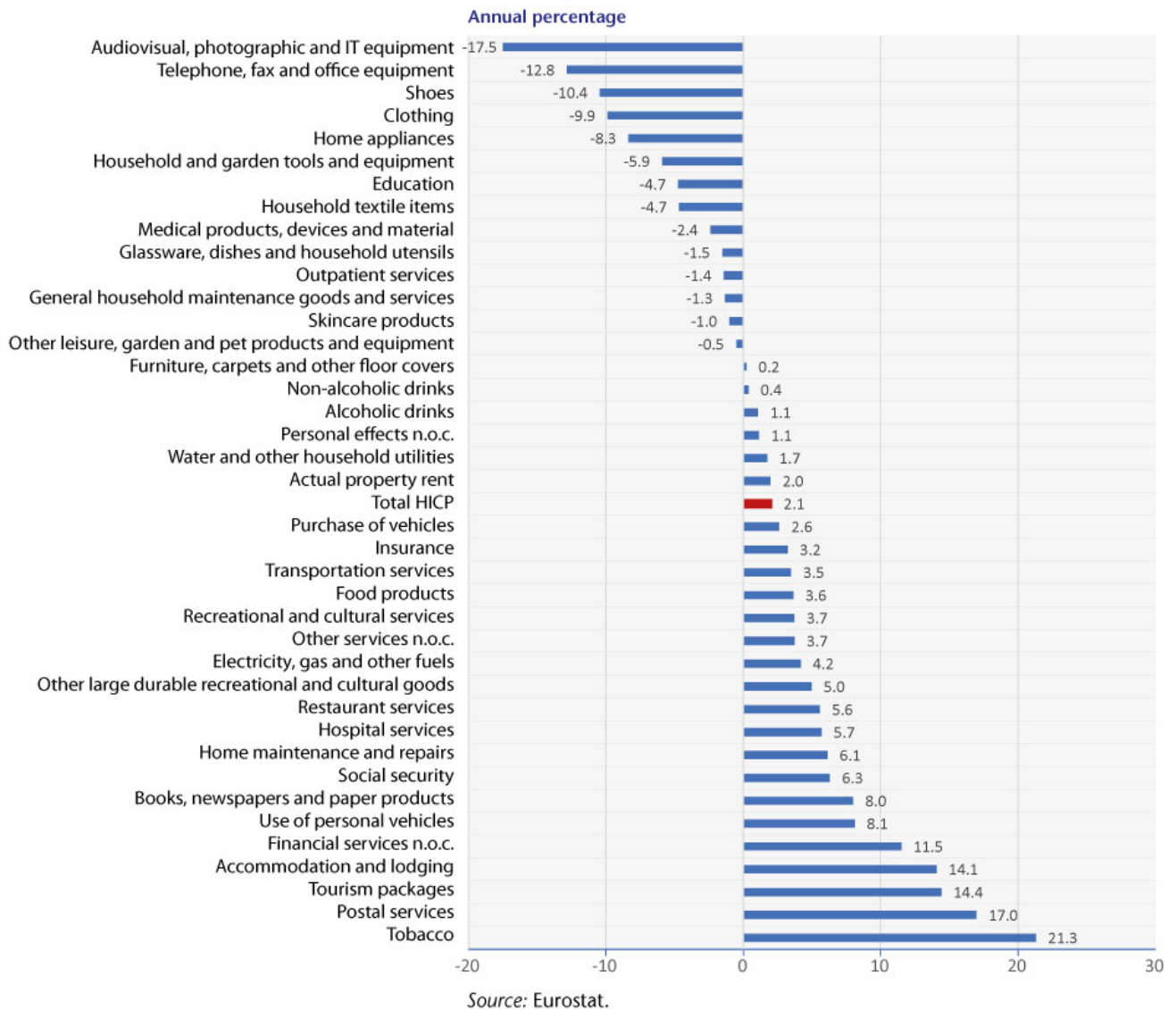
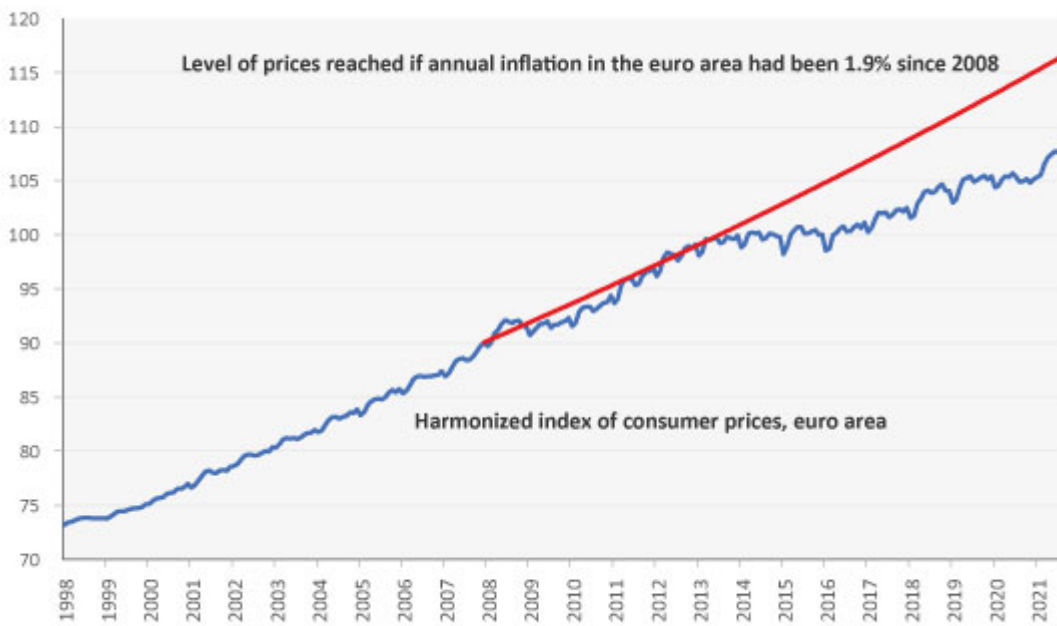


Figure 3. Actual and targeted price levels, euro area



---

# What factors drove the rise in euro zone public debt from 1999 to 2019?

by [Pierre Aldama](#)

*Between 1999 and 2019, the eve of the Covid-19 pandemic, the public debts of the 11 oldest euro zone members had risen by an average of 20 percentage points of GDP. This increase in public debt is commonly attributed to structural budget deficits, particularly those in the pre-crisis period and in the “South”. But how much of the stock of public debt in 2019 can be attributed to structural deficits, and how much to GDP growth, interest payments or cyclical deficits? In this post, we use the December 2020 edition of the OECD’s Economic Outlook to break down the changes in public debt into its main factors: structural and cyclical primary balances, the interest burden, nominal GDP growth and stock-flow adjustments. This shows that the structural deficits generally contributed less than is commonly assumed, and that the increase in public debt over the period was largely the result of the direct and indirect consequences of the double-dip recession in the euro zone.*

On the eve of the Covid-19 crisis, the 11 oldest euro zone countries had an average level of public debt (in the Maastricht sense) of 92% of GDP. Between 1999 and 2019, the public debt in these 11 countries increased by an average of 20 percentage points of GDP, although with considerable heterogeneity (Figure 1). On the one hand, a group of so-called virtuous countries – Germany, the Netherlands, Austria, Finland and Ireland – reduced their debt ratios to their 1999 level of 60% of GDP or even lower. In contrast to this were the countries whose public debt increased – France, Spain, Greece and Portugal – or remained at a high level – Belgium and Italy. Can we simply deduce from this that there are some countries that acted like the proverbial ant and others like the grasshopper? Probably not.

Indeed, not all countries entered the European Monetary Union (EMU) with the same level of debt: their starting point therefore biases observation insofar as it does not inform about the structural or cyclical factors or to the interest burden associated with the fiscal policy in place from 1999 to 2019. Is the rise in public debt in the “grasshopper” countries largely attributable to the accumulation of structural deficits, or on the contrary, to cyclical factors and the impact of the recessions in the euro zone (2008-2010 and 2011-2013)?

This post uses the December 2020 edition of the

OECD's *Economic Outlook* to break down the changes in public debt into the main components: structural and cyclical primary balances, the interest burden, nominal GDP growth and stock-flow adjustments. This shows that the contribution of structural deficits is generally lower than commonly assumed and that the increase in public debt over the period largely results from the direct and indirect consequences of the double-dip recession in the euro zone.

### **The accounting decomposition of public debt dynamics**

The change in public debt (as a percentage of GDP) between year  $t$  and year  $t-1$  can be broken down into five main factors, using the following equation:

$$\Delta d_t = \frac{r_t}{1+y_t} d_{t-1} - \frac{y_t}{1+y_t} d_{t-1} + sp_t^{cyc} + sp_t^{struc} + afs_t$$

where  $r_t / (1+y_t) d_{t-1}$  is the effect of the interest burden,  $-y_t / (1+y_t) d_{t-1}$  is the effect of nominal GDP growth (and the sum of the two terms is the infamous snowball effect [1] of public debt),  $sp_t^{cyc}$  is the cyclical component of the primary budget balance (excluding the interest burden),  $sp_t^{struc}$  is the structural primary balance (adjusted for the output gap) and  $afs_t$  represents the stock-flow adjustments, i.e. transactions on the assets and liabilities of general government that are not accounted for in the primary

balance.

By aggregating each of these terms, we calculate the contributions to the total change in public debt between 1999 and 2019 (Figure 2) and year by year (Figure 3). Finally, Figures 4A and 4B present breakdowns of the public debt similar to Figure 2 but over two sub-periods: 1999-2008 and 2008-2019.

Figure 1. Public debt/GDP in the Maastricht sense from 1999 to 2019, in GDP points

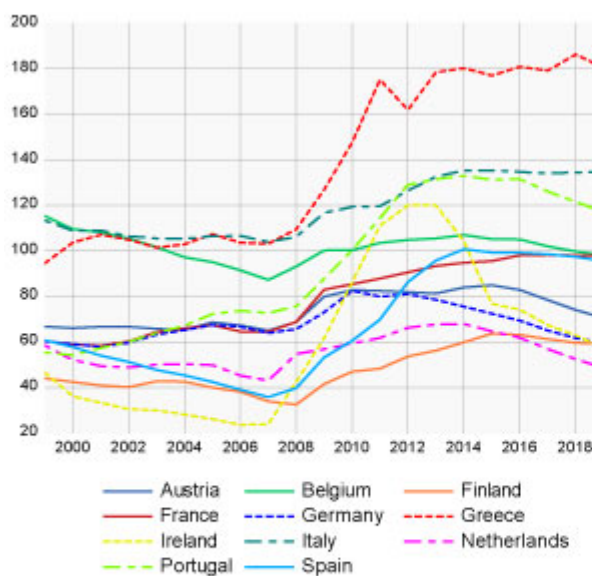
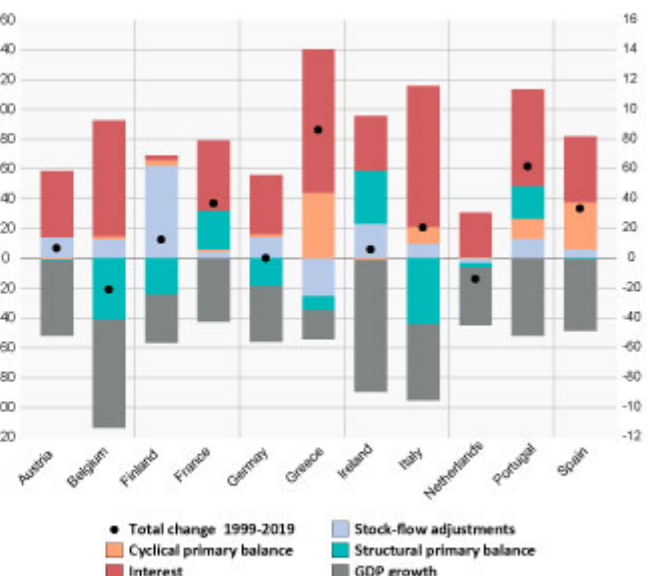


Figure 2. Breakdown in the change in public debt from 1999 to 2019, in GDP points



Notes: For each country, the total change from 1999 to 2019 in the public debt/GDP ratio is broken down between the effects of the interest burden, of GDP growth, of cyclical and structural primary surpluses (+) and deficits (-), and finally of stock-flow adjustments (i.e. of transactions on the assets and liabilities of general government that are not accounted for in the primary balance).

Source: OECD Economic Outlook 2020/2, author's calculations.

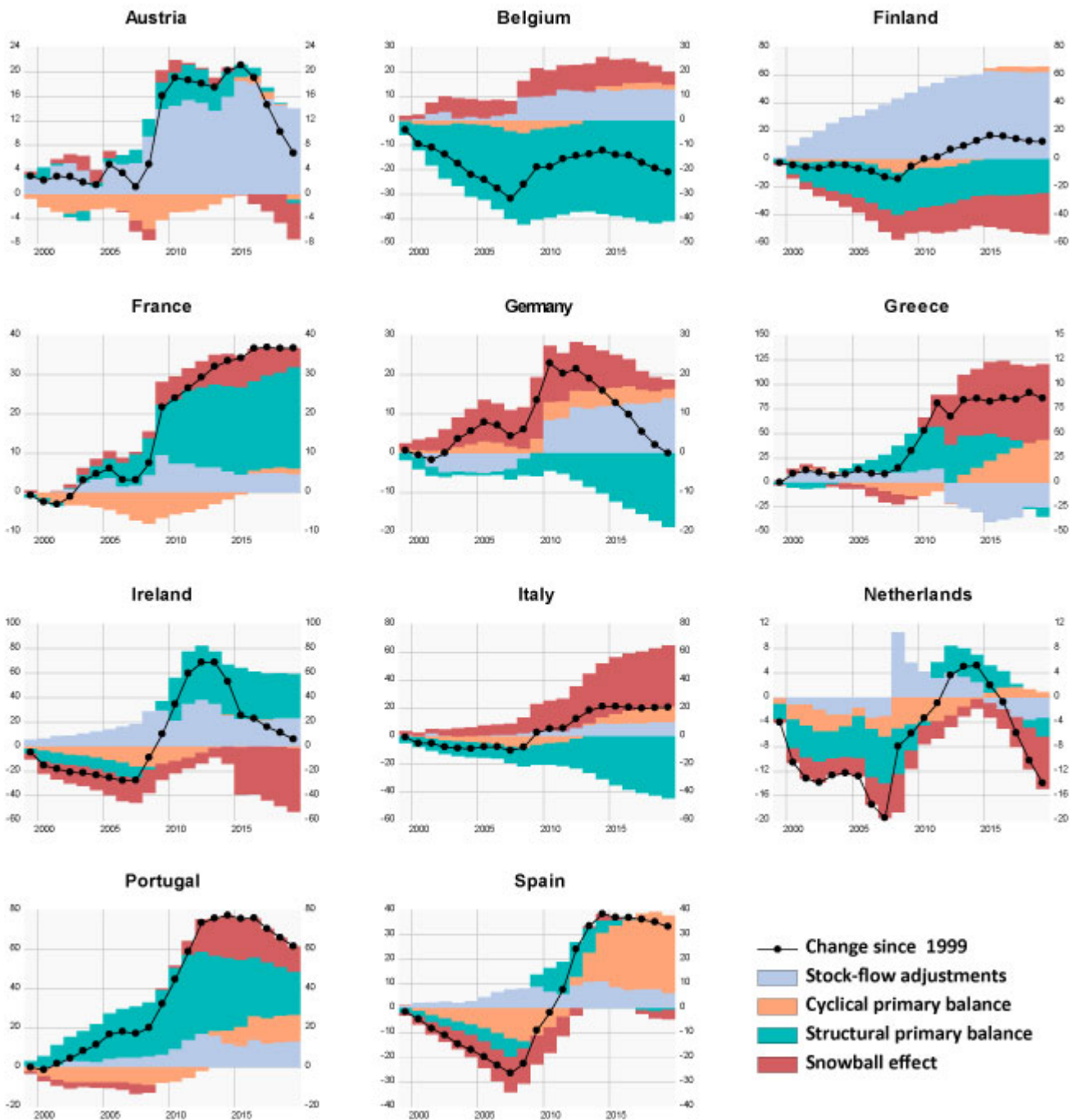
## The scars of the double recession of 2008-2010 and 2011-2013 in the euro zone

The rise in public debt in the EMU is largely explained by the cyclical effects of the double recession of 2008-2010 and 2011-2013 (Figure 3). Between 2008 and 2019, in the three countries with the largest increases in public debt (Greece, Spain, Portugal), the rise in debt is due largely to cyclical primary deficits and the snowball effect. Greece is a

striking example: the snowball effect accounts for almost 3/5 of the increase in public debt between 1999 and 2019, and this is concentrated mainly between 2008 and 2019, with the collapse of the level of GDP. In contrast, the apparent Irish “miracle” is actually due to massive nominal growth in 2015, which in turn is explained by [the relocation of existing intangible assets in Ireland by multinationals](#).

Moreover, any positive contribution of *structural* deficits to debt growth during the 2008-2010 crisis is in fact an optimal countercyclical response of fiscal policy during the recession, and cannot be interpreted as a lack of fiscal seriousness *per se*. This was the case, however, in fewer than half of the countries studied: Spain, the Netherlands, France, Austria, and Ireland, and for the other countries this largely reflects the pro-cyclical character of discretionary fiscal policies in the euro zone over the period ([Aldama and Creel, 2020](#)).

Figure 3. Change in the public debt/GDP ratios and cumulative contributions since 1999, in GDP points



Notes: For each country, the total change from 1999 to 2019 in the public debt/GDP ratio is broken down between the effects of the interest burden, of GDP growth, of cyclical and structural primary surpluses (+) and deficits (-), and finally of stock-flow adjustments (i.e. of transactions on the assets and liabilities of general government that are not accounted for in the primary balance).

Sources: OECD Economic Outlook 2020/2, author's calculations.

Finally, in general, the contribution of the stock-flow adjustments increases sharply after the 2008 crisis, mainly due to the banking sector rescue plan. In the case of Greece, the negative contribution of these adjustments largely corresponds to the 2012 default.

## Northern surpluses vs. Southern structural

## deficits in the euro zone?

Over the period 1999-2019, it appears that only three countries (France, Ireland and Portugal) showed a positive contribution of structural primary deficits to the rise in public debt. Remarkably, both Greece and Italy stand out from these countries with a negative contribution due to their structural primary surpluses, as shall be seen later, due in particular to the structural fiscal adjustment carried out since 2010 in the case of Greece. Belgium, which was heavily indebted at the time of its entry into the EMU (114% of GDP), is also characterised by the strong negative contribution of its structural primary balance to debt growth.

Figure 4A. Breakdown in the change in the debt between 1999 and 2008, in GDP points

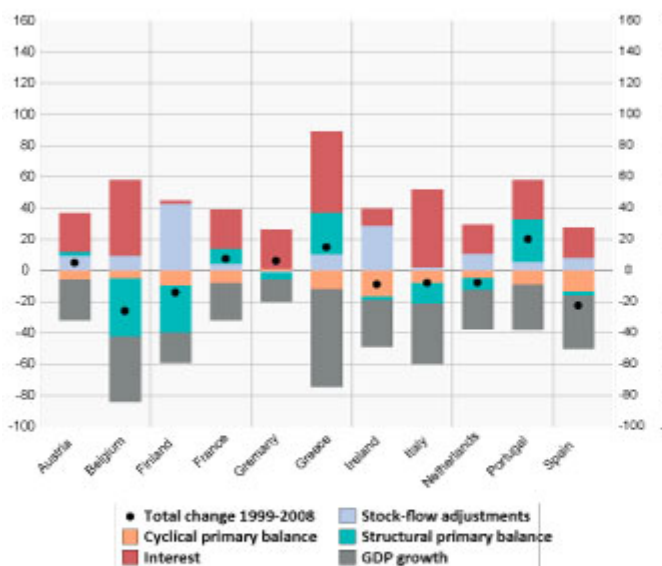
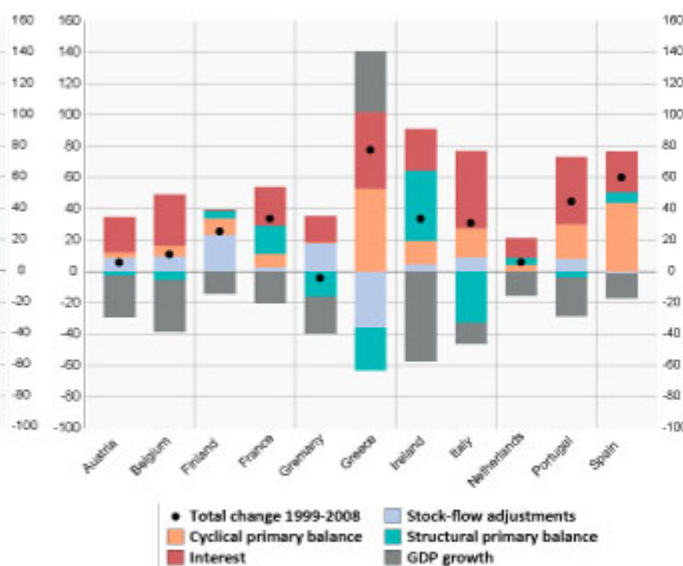


Figure 4B. Breakdown in the change in the debt between 2008 and 2019, in GDP points



Notes: For each country, the total change from 1999 to 2019 in the public debt/GDP ratio is broken down between the effects of the interest burden, of GDP growth, of cyclical and structural primary surpluses (+) and deficits (-), and finally of stock-flow adjustments (i.e. of transactions on the assets and liabilities of general government that are not accounted for in the primary balance).

Sources: OECD Economic Outlook 2020/2, author's calculations.

In the case of Greece, we observe in particular the sharp decline in the contribution of the structural primary balance, which even becomes negative in 2019: in other words, by 2010 Greece has



more than offset the effect of its previous structural primary deficits. Even more remarkably, Italy has pursued a very tight fiscal policy *over the entire period*, in so far as the (negative) contribution of its structural primary surplus has steadily increased in absolute terms. Portugal lies in between, and started to run structural primary surpluses, without cancelling out the effect of its pre-2010 deficits. Ireland, sometimes presented as the “good pupil” in the euro area following the 2010 crisis, did not have post-crisis structural surpluses that offset the structural deficits run up during the crisis (the contribution to the change in debt was stable).

Focusing on the pre-2008 period (Figure 4A) and the so-called Southern countries, again only Greece and Portugal saw a positive contribution of their structural deficits to debt growth, while the contribution of the primary structural surpluses in Ireland, Italy and Spain was negative.

On the Franco-German side, the divergence is clear. German fiscal rigour appears almost extreme: even following the 2008-2010 crisis, the federal government’s primary structural balance did not contribute positively to debt growth, reflecting a very weak countercyclical discretionary policy (the German structural balance increased by 1 GDP point in 2010).

Conversely, in the case of France, a large part of the variation in public debt can be explained by the structural deficits recorded *both before and after* 2008 (Figures 4A and 4B), although this slowed down in the second half of the 2010s (Figure 3). Thus, of the 37 GDP points of public debt accumulated since 1999, almost 26 points came from structural deficits accumulated over the period.

Of course, the distinction between the structural balance and the cyclical balance is critically based on the estimation of the level of “potential” GDP, i.e. of full utilization of production factors, without inflationary pressures. This measure is subject to great uncertainty, and there have been many criticisms, such as that it is too sensitive to the macroeconomic cycle and to demand shocks ([Coibion et al. 2018](#); [Fatas and Summers 2018](#)). Some studies suggest that the level of potential activity may be underestimated. This likely bias in potential GDP estimates points to the need for a note of caution about any definitive interpretation of the structural vs. cyclical nature of budget deficits or surpluses. [\[2\]](#)

\*\*\*

While public debt has increased overall in the euro zone since 1999, a large part of this growth is explained by the direct and indirect consequences of the 2008 crisis, through cyclical deficits, the aggravation of the snowball effect and the *structural* weakness

of growth in certain Southern European countries.

On the contrary, most of the more indebted countries today ran high primary structural surpluses over the period, such as Italy and Belgium. Greece has even more than offset the positive contribution of its past structural deficits. This is the reason why a reading grid that is still overly used, that of the North versus the South, or of fiscal strictness versus fiscal leniency, cannot stand up to a simple accounting analysis of the dynamics of public debt.

---

[1] The snowball effect of public debt is the effect of the differential between the interest rate paid on the accumulated stock of debt and the economy's growth rate. If this differential is positive, then for a given primary budget balance public debt tends to increase mechanically; conversely, if it is negative, public debt tends to decrease mechanically.

2] However, using *the OECD Economic Outlook* has the advantage of providing a homogeneous approach across countries, and therefore a relatively uniform bias between them. Moreover, the measure of potential GDP used by the OECD is [less cyclical than the measures used by the IMF and the European Commission](#).

---

# It seems like it's raining billions

[Jérôme Creel](#), [Xavier Ragot](#), and [Francesco Saraceno](#)

The second meeting of the Eurogroup did the trick. The Ministers of Finance, after having once again laid out their divisions on the issue of solidarity between euro area Member States on Tuesday 7 April 2020, reached an agreement two days later on a [fiscal support plan](#) that can be put in place fairly quickly. The health measures taken by the Member States to limit the spread of the Covid-19 pandemic will enjoy better short-term financing, which is good news. The additions to Europe's tools for dealing with the crisis will be on the order of 500 billion euros – this is certainly not negligible, and note that this comes on top of the efforts already put in place by governments – but this corresponds mainly to a new accumulation of debt by the Member States. The net gain for each of them, as we shall see, is actually quite marginal.

The Eurogroup will propose the creation of a credit line (Pandemic Crisis Support) specifically dedicated to the management of the Covid-19 crisis within the framework of the

European Stability Mechanism (ESM), without strict conditionality (meaning that recourse to the credit line will not imply any control on the part of the EMS over the future management of the Member State's public finances). The creation of the credit line was inspired by the proposal by [Bénassy-Quéré et al. \(2020\)](#), the [advantages and disadvantages](#) of which we presented to the Eurogroup meeting on 9 April 2020. The amount allocated to this credit line represents around 2% of the GDP of each euro area Member State, or nearly 240 billion euros (in 2019 GDP).

The lending mechanism proposed by the European Commission to supplement the partial unemployment programmes of the Member States – [it goes under the name of SURE](#) – will clearly see the light of day and will be endowed with 100 billion euros. For the record, the three main beneficiaries of SURE cannot receive a combined total of more than 60 billion euros in loans.

Finally, the European Investment Bank (EIB) will grant an additional 200 billion euros, mainly to small and medium-sized enterprises in the EU Member States. In total, the euro area countries will have 480 billion euros in additional financing capacity.

Table 1 below presents a breakdown by country of the amounts in play. As part of the 240 billion euros of Pandemic Crisis Support, Germany will be able to benefit from

a borrowing capacity of nearly 70 billion euros, France nearly 50 billion euros, and Italy and Spain 35 and 25 billion euros respectively. These amounts correspond to 2% of the 2019 GDP of each country. At this point, there is no indication of whether the Member States will draw on this capacity. The advantage in doing so depends crucially on the difference between the interest rate at which they can finance their health and economic expenses without using the EMS and the interest rate on loans made by the EMS. The financing cost without going through the EMS is the interest rate on the country's public debt. The cost of financing through Pandemic Crisis Support is the interest rate at which this credit line is itself financed, that is to say, at the lowest rate on the market, i.e. the German rate. So it is obvious that Germany has no interest in using this credit line. Of the 240 billion euros allocated to Pandemic Crisis Support, the 70 billion euros for Germany is thus useless. For countries other than Germany, the use of Pandemic Crisis Support depends on the difference between their interest rate and Germany's rate, the infamous spread. If the spread is positive, using the EMS effectively reduces the cost of borrowing. But as shown in Table 1, the gain enabled by Pandemic Crisis Support is rather low. For Greece, whose spread vis-à-vis Germany is the highest in the euro zone, the gain would come to around 0.04% of GDP in 2019, i.e. a 215

basis point spread multiplied by the amount allocated to Greece for Pandemic Crisis Support (3.8 billion euros, which corresponds to 2% of its GDP of 2019), all relative to its 2019 GDP. For Italy, the gain is on the same order: 0.04% of its GDP. Expressed in euros, Italy stands to gain 700 million euros. For France, whose spread vis-à-vis Germany is much lower than that of Italy, the gain could be 200 million euros, or 0.01% of its GDP in 2019.

Assuming that the amounts allocated by the EIB are prorated to the country's size (measured by its GDP in 2019), and that Spain, Italy and France benefit from 20 billion euros each under SURE, the total interest rate savings would reach, respectively, 680 million, 1.5 billion and 430 million euros (0.05%, 0.08% and 0.02% of GDP). At a time when it seems to be raining billions, these are not big savings. Unless you think of it as a metaphor. Like rain before it falls, the billions of euros are not really euros before they fall.

**Table 1. Distribution of amounts allocated as part of Pandemic Crisis Support (PCS), and each country's potential gains, including from the use of additional EIB and SURE financing**

	Max amount of PCS	10-year spreads	Max. gain from use of PCS and other additional financing				
	Billion euros	Base points	PCS	EIB*	SURE**	Total	Total
			Million euros				% of GDP
Germany	68,5	0	0	0	0	0	0
Austria	8	43	34,3	20,9	5,8	61,0	0,02
Belgium	9,4	52	49,1	30,0	8,3	8,8	0,02
Cyprus	0,4	204	9,0	5,5	1,5	16,0	0,07
Spain	24,8	113	280,7	171,3	226,0	678,0	0,05
Estonia	0,6	nd	nd	nd	nd	nd	nd
Finland	4,8	40	19,3	11,8	3,2	34,3	0,01
France	48,3	44	212,6	129,8	88,0	430,4	0,02
Greece	3,8	215	81,5	49,7	13,7	145,0	0,08
Ireland	6,9	55	38,0	23,2	6,4	67,5	0,02
Italy	35,5	195	693,1	423,1	390,0	1506,2	0,08
Latvia	0,6	nd	nd	nd	nd	nd	nd
Lithuania	1,0	nd	nd	nd	nd	nd	nd
Luxembourg	1,3	nd	nd	nd	nd	nd	nd
Malta	0,3	90	2,4	1,5	0,4	4,2	0,03
Netherlands	16,1	26	41,9	25,6	7,1	74,6	0,01
Portugal	4,2	124	52,3	31,9	8,8	93,0	0,04
Slovakia	1,9	77	14,5	8,9	2,4	25,9	0,03
Slovenia	1,0	107	10,3	6,3	1,7	18,3	0,04

\* Assuming that the use of additional EIB financing is fully distributed in proportion to the country's relative GDP compared to that of the EU (in 2019).

\*\* Assuming that Italy, Spain and France obtain 20 billion euros each and that the remaining 40 billion euros are distributed in proportion to the relative GDP of the countries compared to that of the euro zone (in 2019).

Sources: Ameco (PIB 2019), Financial Times (Spreads, 10 April 2020).

# Europe's fiscal rules – up for debate

By [Pierre Aldama](#) and [Jérôme Creel](#)



At the euro zone summit in December 2018, the heads of state and government hit the brakes hard on the reform of fiscal governance: among the objectives assigned to the euro zone's common budget that they are wishing for, the function of economic stabilization has disappeared. This is unfortunate, since this function is the weak point of the fiscal rules being pursued by the Member States.

In a [recent article](#), we assessed how governments use the fiscal tools at their disposal to respond to information about trends in the public debt or the economic cycle that is at their disposal when they make their budgetary decisions. Thus, instead of evaluating the properties of fiscal rules using data that may well be revised retrospectively, we evaluated them "in real time".[\[1\]](#)

Three main results emerged from our study. On the one hand, European governments ensure that their public debts are sustainable by improving their fiscal balance when the public debt increases. On the other hand, we found a trend towards fiscal consolidation at the bottom of the cycle in the euro area: fiscal policy is then rather destabilizing. Finally, euro area Member states have adopted a behaviour that was not found in the non-European countries in our sample: the euro zone Member states, unlike the others, continued to stabilize their public debts at the bottom of the cycle and during the crisis years. Thus the fiscal policy in the euro zone countries appears rather clearly to be untimely and inappropriate.

The results obtained as a whole for the euro area argue for a reform of Europe's fiscal rules, but not necessarily in the sense most commonly accepted. The issue of stabilizing the public debt does not seem to be essential in so far as this is already being taken care of by the fiscal policies being implemented. Rather, what is needed is to rebalance these fiscal policies in favour of macroeconomic stabilization, especially if no common mechanism – such as a euro zone budget

– has been set up for this purpose. European fiscal policies need to be more flexible and less prescriptive, with a focus on the dynamics of macroeconomic stabilization. Since no progress is envisaged at the European level, national automatic stabilizers need to be reinforced, increasing tax progressivity and the responsiveness of social spending to changes in economic activity in order to deal with the next cyclical downturn, both individually and collectively.

[1] One of if not the first article that focuses on evaluating fiscal policy using “real-time” data is by Golinelli and Momigliano ([Journal of Policy Modeling, 2006](#)). This literature is summarized in Cimadomo ([Journal of Economic Surveys, 2016](#)).

---

## The euro-isation of Europe

By Guillaume Sacriste, Paris 1-Sorbonne and Antoine Vauchez, CNRS and Paris 1-Sorbonne

In the latest article in [La Revue de l'OFCE \(no. 165, 2019\), accessible here in French](#), the authors analyze the emergence of a new European government, that of the euro, built to a great extent on the margins of the EU's existing framework. In noting this, the article takes stock of a process of the transformation of Europe (the European Union and Member States), which we call here the “Euro-isation of Europe”, in three dimensions: 1) the creation at its core of a powerful pole of Treasuries, central banks and national and European financial bureaucracies; 2) the consolidation of a European system of surveillance of the economic policies of the Member

States; 3) the gradual re-hierarchisation of the political priorities and public policies of the European Union and the Member States around the priority given to financial stability, balanced budgets and structural reforms. The article thus makes it possible to redefine the nature of the “constraints” that the management of the single currency is imposing on the economies of the Member States, constraints that are less legal than socio-political, less external and overarching than pervasive and diffuse, and ultimately closely linked to the key position now occupied by the transnational network of financial bureaucracies in defining European issues and policies.

---

## **Italy's debt: Is the bark worse than the bite?**

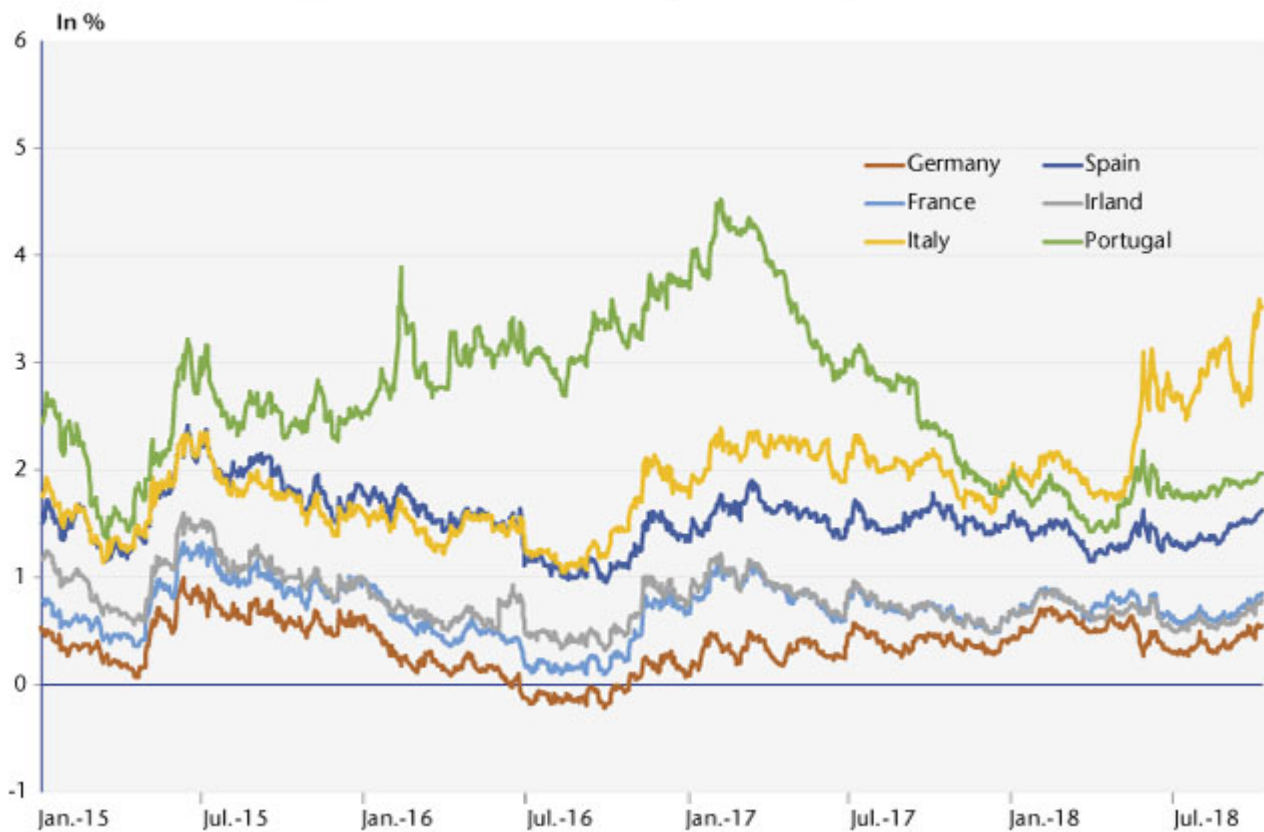
By [Céline Antonin](#)

The spectre of a sovereign debt crisis in Italy is rattling the euro zone. Since Matteo Salvini and Luigi di Maio came to power, their headline-catching declarations on the budget have proliferated, demonstrating their desire to leave the European budgetary framework that advocates a return to an equilibrium based on precise rules<sup>[1]</sup>. Hence the announcement of a further deterioration in the budget when the update of the [Economic and Financial Document](#) was published at the end of September 2018 frayed nerves on the financial markets and triggered a

further hike in bond rates. (graphic).

But should we really give in to panic? The crucial question is just how sustainable the Italian public debt really is. Looking up to 2020, the situation of the euro zone's third-largest economy is less dramatic than it might appear. Stabilizing interest rates at the level of end September 2018 would leave the public debt largely sustainable. It will decline in 2019, from 131.2% to 130.3% of GDP. Given our assumptions [2], only a very sharp, long-lasting rise in bond interest rates in excess of 5.6 points would lead to an increase in the public debt ratio. In other words, the bond rate would have to exceed the level reached at the peak of the 2011 sovereign debt crisis. Should such a situation occur, it's hard to believe that the ECB would not intervene to reassure the markets and avoid a contagion spreading through the euro area.

Figure. Interest rate on 10-year sovereign bonds



Source: Datastream.

A

very strong fiscal stimulus in 2019

Changes in the public debt ratio depend heavily on the assumptions adopted. The ratio varies with the general government balance, the GDP growth rate, the deflator, and the apparent interest rate on the public debt (see calculation formula below).

In budgetary matters, despite their differing views, the two parties making up the Italian government (La Ligue and the 5 Star Movement) seem to agree on at least one point: the need to loosen budget constraints and boost demand. In any case the government contract, published in May 2018, was unequivocal. It announced a fiscal shock amounting to approximately 97 billion euros over 5 years, or 5.6% of GDP over the five-year period. But although the measures have been gradually reduced, the draft presented to the Italian Parliament plans for a public deficit of 2.4% of GDP for 2019, far from the original target of 0.8% set in the Stability and Growth Pact forwarded to the European Commission on 26 April 2018. We assume that the 2019 budget will be adopted by the Parliament, and that the deficit will indeed be 2.4% of GDP. We therefore anticipate a positive fiscal impulse of 0.7 GDP point in 2019. This stimulus breaks down as follows:

- A decrease in compulsory taxation of 5 billion, or 0.3 GDP point, linked to the gradual introduction of the “flat tax” of 15% for SMEs, a measure supported by the League. The extension of the flat tax to all businesses and households was postponed until later in the mandate, without further clarification;

- An increase in public spending, calculated roughly at 7 billion euros, or 0.4 GDP point. Let’s first mention the flagship measure of the 5 Stars Movement, the introduction of a citizens’ pension (in January 2019) and a citizens’ income (in April 2019), for an estimated total amount of 10 billion euros. The citizens’ pension will supplement the pension of all pensioners, bringing it to 780 euros per month. For the working population, the principle is similar – supplementing the salary up to 780 euros – but subject to conditions:

recipients will have to take part in training and accept at least one of the first three job offers that are presented to them by the Job Centre. The revision of the pension reform, which provides for the “rule of 100”, will also allow retirement when the sum between a person’s age and the years worked reaches 100, in certain conditions. This should cost 7 billion euros in 2019. Finally, an investment fund of 50 billion euros is planned over 5 years; we are expecting an increase in public investment of 4 billion euros in 2019. To finance the spending increase without pushing the public deficit above 2.4%, the government will have to save 14 billion euros, equivalent to 0.8 GDP point. For the moment, these measures are very imprecise (further rationalization of spending and tax amnesty measures).

For 2020, the Italian government has declared that the public deficit will fall to 2.1% of GDP. However, to arrive at this figure, given our growth assumptions, would require tightening up fiscal policy somewhat, which is not very credible. We therefore assume a quasi-neutral fiscal policy in 2020, which means that the deficit would remain at 2.4% of GDP.

With a very positive fiscal stimulus in 2019, annual growth (1.1%) should be higher than in 2018. This acceleration is more visible year-on-year: growth in Q4 of 2019 will be 1.6%, compared with 0.6% in Q4 of 2018. Although low, this level is nevertheless higher than the potential growth rate (0.3%) in 2019 and 2020. The output gap is in fact still large and leads to 0.4 GDP point of catch-up per year. Spontaneous growth<sup>[3]</sup> thus amounts to 0.7 GDP point in 2019 and 2020. In addition, we anticipate a much stronger fiscal impulse in 2019 (0.7 GDP point) than in 2020 (0.1 GDP point). Other shocks, such as oil prices or price competitiveness, will be more positive or less negative in 2020 than in 2019.

Changes in the public debt ratio also depend on developments in the GDP deflator. However, prices should remain stable in 2019 and 2020, due in particular to wage moderation. Thus,

nominal growth should be around 2% in 2019 and 2020.

Finally, we assume that the interest rate on the debt will stay at the level of the beginning of October 2018. Given the maturity of the public debt (seven years), the rise in rates forecast for 2019 and 2020 will be very gradual.

### Reducing the public debt up to 2020

Under these assumptions, the public debt should decline continuously until 2020, falling from 131.2% of GDP in 2018 to 130.3% in 2019 and then to 129.5% in 2020 (table). In light of our assumptions, the public debt will fall in 2019 if the apparent interest rate remains below 3.5% of GDP, i.e. if the debt-service charge relative to GDP is less than 4.5%.

**Table. Changes in the public debt to GDP ratio based on our hypotheses**

	2017	2018	2019	2020
Public debt /GDP ( $d_t$ )	131.8%	131.2%	130.3%	129.5%
Apparent interest rate on the debt ( $i$ )	2.9%	2.7%	2.9%	3.0%
GDP growth in value ( $g$ )	2.2%	2.1%	2.3%	2.1%
<i>GDP growth in volume</i>	1.6%	1.0%	1.1%	1.0%
<i>GDP deflator</i>	0.6%	1.1%	1.2%	1.1%
Primary deficit in % of GDP ( $s_t$ )	1.5%	1.8%	1.5%	1.6%
<i>Public deficit in % of GDP</i>	-2.3%	-1.8%	-2.4%	-2.4%
<i>Debt-service charge in % of GDP</i>	3.8%	3.6%	3.8%	4.0%
Projected public debt/GDP ( $d_{t+1}$ )	131.2%	130.3%	129.5%	129.1%
<i>Apparent interest rate stabilizing the debt</i>	3.4%	3.4%	3.5%	3.3%
<i>Primary deficit stabilizing the debt</i>	0.9%	0.8%	0.8%	1.1%
<i>Public deficit stabilizing the debt</i>	-2.9%	-2.7%	-3.1%	-2.8%

Sources: AMECO, author's calculations..

Note : Changes in the public debt depend not only on the primary deficit, but also on the apparent interest rate and the growth rate, according to the formula:  $d_{t+1} = d_t \frac{(1+i)}{(1+g)} - s_t$  which  $g$  = growth rate of nominal GDP,  $i$  = apparent interest rate on the debt,  $s$  = primary public deficit / GDP,  $d$  = public debt / GDP.

Reading note: the public debt/GDP ratio in 2017 was 131.8% and should fall to 131.2% in 2018.

However, for the apparent interest rate to rise from 2.7% in 2018 to 3.5% in 2019, given the 7-year maturity on the debt, the interest rate charged by markets would have to rise by about 5.6 points on average over the year, for one year. While this scenario cannot be excluded, it seems certain that the ECB would intervene to allow Italy to refinance at lower cost and avoid contagion.

Still, even if interest rates do not reach this level, any additional rise in interest rates will further limit the Italian government's fiscal manoeuvring room, or it will lead to a larger-than-expected deficit. Also, the deficit forecast by the government is based on an optimistic assumption for GDP growth of 1.5% in 2019; if growth is weaker, the deficit could widen further, unsettling nerves on the market and among investors and jeopardizing the sustainability of the debt.

[\[1\]](#) L. Clément-Wilz (2014), "Les mesures 'anti-crise' et la transformation des compétences de l'Union en matière économique" ["'Anti-crisis' measures and the transformation of the competences of the EU in economic matters"], *Revue de l'OFCE*, 103.

[\[2\]](#) For more information, see the forthcoming 2018-2020 forecast for the global economy, *Revue de l'OFCE*, (October 2018).

[\[3\]](#) Spontaneous growth for a given year is defined as the sum of potential growth and the closing of the output gap.

---



# How can Europe be saved? How can the paradigm be changed?

By [Xavier Ragot](#)

There are new inflections in the debate over the construction of Europe. New options from a variety of economic and political perspectives have seen the light of day in several key conferences and workshops, though without the visibility of public statements. The debate is livelier in Germany than in France. This is due probably to the caricature of a debate that took place during France's presidential elections, which took the form of "for or against the single currency", while the debate needed was over how to orient the euro area's institutions to serve growth and deal with inequalities.

Two conferences were held in Berlin one week apart that considered opposing options. The first tackled the consequences of a country leaving the euro area; the second examined an alternative paradigm for reducing inequalities in Europe. In other words, the two conferences covered almost the entire spectrum of conceivable economic policies.

## **Sowing fear: the end of the euro area?**

The first question: What would happen if one or more countries left the euro area? Should we hope for this, or how could we prevent it? A [conference](#) held on March 14 under the title "Is the euro sustainable – and what if it isn't?" brought together the heads of influential institutes like Clemens Fuest, one of the five German "wise men", Christoph Schmidt, and economists frequently seen in the German media like Hans-Werner Sinn, as well as economists like Jeromin Zettelmeyer. The presence of the OFCE, which I represented, hopefully helped to serve as a reminder of some simple but useful points.

This first conference sometimes played with the ambiguity of

the issue, with some contributions seeming to wish for an end to the euro area while others were more analytical in order to show the risks. The voice of Hans-Werner Sinn stood out during this discussion for its radical stance. Without going so far as to wish that Germany left the euro area, Sinn insisted in a systematic (and skewed) way that Germany was suffering under Europe's monetary policy. He insisted in particular on the role of Germany's hidden exposure to the debt of other countries through the European Central Bank and TARGET2, which books the surpluses and deficits of the national central banks vis-à-vis the ECB. The TARGET2 balance shows that the southern European countries are running a deficit, while Germany has a substantial surplus of almost 900 billion euros, which represents 30% of German GDP. These amounts are very significant, but do not in any way represent a cost for Germany.

In the most extreme case of a national central bank's failure to pay (i.e. an exit from the euro area), the loss would be shared by all the other states independently of the surpluses. The TARGET2 balances are part of Europe's monetary policy, which is aimed at achieving a goal that was agreed on: an average inflation level of 2%. This target has not been hit for many years. Moreover, this policy has led to low interest rates that benefit Germans who pay low interest charges on their public debt, as Jeromin Zettlemeyer pointed out. Finally, Germany's large trade surplus shows that the lack of an exchange rate mechanism in the euro area has benefited Germany significantly. Recall that the volume of Germany's exports exceeded China's in 2016, according to the German institute Ifo!

My presentation was based on the OFCE's numerous studies of the European crisis. The OFCE has published an [analytical note](#) on the effects of an exit from the euro area, showing all the related costs. The studies by [Durand and Villemot](#) provide the analytical basis for providing orders of magnitude. How much

would Germans' wealth decline if the euro area were to collapse? The result is, in the end, not very surprising. The Germans would be the greatest losers, with a loss of wealth on the order of 15% of GDP. These figures are of course very tentative and need to be interpreted with the utmost care. The collapse of the euro area would plunge us into unexplored territory, which could surprise us with unexpected sources of instability.

After these preliminary elements, the heart of my presentation was then focused on a simple point. The real challenge facing us is to build coherent labor markets within the euro area, while reducing inequalities. Following on the common monetary policy, the coordination of fiscal policy that was carried out so painfully after 2014 and the aberrations associated with the recessionary fiscal policy (austerity), the main question facing Europe over the next ten years is to develop coherent labor markets. Indeed, Germany's wage moderation, the result of the difficulties with reunification in the early 1990s, has been a powerful destabilizing force in Europe, as was shown in an [article by Mathilde Le Moigne](#). What is called the supply problem in France is in fact the result of divergences within Europe on the labor market in the wake of Germany's wage moderation. [I proposed that the European Parliament](#) initiate a Europe-wide discussion of national wage dynamics in order to bring about the convergence of wages in a non-deflationary way while avoiding high unemployment in southern Europe. This co-ordination of economic policy on the labor market is designated by the English term "wage stance". Co-ordination of changes in minimum wages and in regulated wages, which orients the direction of wage changes in labour negotiations, are tools for the co-ordination of labor markets.

A second tool is of course the establishment of a [European system of unemployment insurance](#), which would be much less complex than one might think. A European unemployment insurance would aim to be complementary to national

unemployment insurance, and not a replacement. National unemployment insurance systems are actually heterogeneous because, on the one hand, the labour markets are distinct, and on the other hand national preferences differ. Unemployment insurance systems are for the most part the result of historical social compromises.

How should this relatively radical German stance against Europe be interpreted today? Perhaps it represents the discontent of economists who are losing influence in Germany. It might seem paradoxical, but many German economists and observers are adjusting to recognize the necessity of building a different Europe, one not based on rules, but leaving room for political choices within strong institutions – i.e. for agile, well respected institutions rather than rules. This position is associated with France in the European debate: choices rather than rules. The German coalition agreement that paved the way for an SPD/CDU government has placed the issue of Europe at the center of the agreement, but with a great deal of vagueness about the content. Certain developments will test the relevance of this hypothesis, in particular the issue of a euro area minister and the nature of the decision-making rules within the key crisis-resolution mechanism, the European stability mechanism.

### **Europe: Changing the software / model / paradigm / narrative**

A second, more confidential conference proved to be even more exciting, with the presence of the European Climate Foundation on the climate issue, the INET institute on developments in economic thought, and the OFCE on European imbalances. The aim of the conference was to reflect on a shift in the paradigm, or narrative, and come up with a new articulation between politics and economics, the state and the market, in order to think sustainable growth in terms of both the climate and society. A narrative is a vision of the world conveyed by simple language. Thus the “neoliberal” narrative is built on positive words like “competition”, “markets” and “freedom” as

well as negative words like “profit”, “interventionism” and “egalitarianism”, which allowed the creation of a language. Donald Trump produces an equally effective narrative: “giving power back to the people”, “America first”; this narrative marks the return of politics to a mode that assumes an underlying nationalism.

How could another narrative be built that has a central focus on the evidence for the fight against global warming and the aggravation of inequality and financial instability?

For one day economists who are renowned in Europe spoke about artificial intelligence, global warming, current forms of economic and industrial policies, the dynamics of credit and financial bubbles, and more. Empirical work at the forefront of current research as well as reflections about the possibility of a coherent storyline were combined in the promise of an alternative narrative. It was just the start. The possibility of a renewal of thought that transcended political divisions and spoke about what was essential came to light: how could the economy be placed at the service of a political project that aims not to rebuild borders to exclude but to imagine our common humanity?

These two conferences show the vitality of the European debate, which is presented from an overly technical perspective in France. The *raison d'être* of the euro is a common project. It is at this level that we need to conduct the discussion leading into the 2019 European elections.