

# An ever so fragile recovery

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

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

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

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

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

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

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# Greece: When history repeats itself

By [Jacques Le Cacheux](#)

The duration of the Greek crisis and the harshness of the series of austerity plans that have been imposed on it to straighten out its public finances and put it in a position to meet its obligations to its creditors have upset European public opinion and attracted great comment. The hard-fought agreement reached on Monday 13 July at the summit of the euro zone heads of state and government, along with the demands made prior to the Greek referendum on 5 July, which were rejected by a majority of voters, contain conditions that are so unusual and so contrary to State sovereignty as we are used to conceiving of it that they shocked many of Europe's citizens and strengthened the arguments of eurosceptics, who see all this as proof that European governance is being exercised contrary to democracy.

By requiring that the creditors be consulted on any bill affecting the management of the public finances and by requiring that the privatizations, with their lengthy list dictated by the creditors, be managed by a fund that is independent of the Greek government, the euro zone's leaders have in reality put Greece's public finances under supervision. Furthermore, the measures contained in the new austerity plan are likely to further depress the already depressed domestic demand, exacerbating the recession that has racked the Greek economy in 2015, following a brief slight upturn in 2014.

**Impoverishment without adjustment**

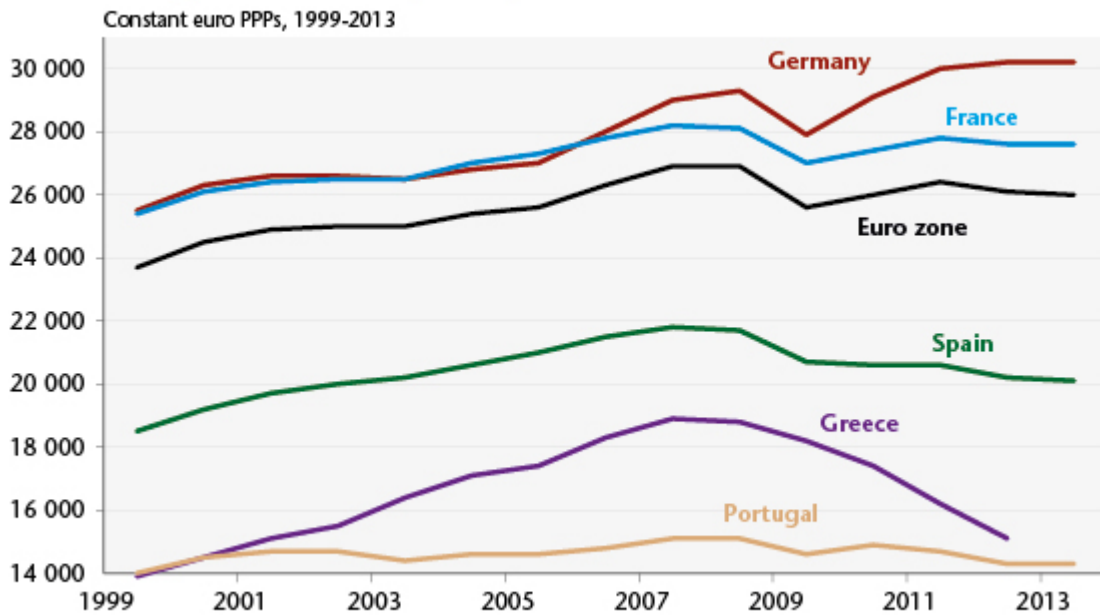
The Greek crisis, which in 2010 triggered the sovereign debt crisis in the euro zone, has seen prolonged agony punctuated by European psycho dramas that always conclude in extremis by an agreement that is supposed to save Greece and the euro zone. From the beginning, it was clear that a method based on the administration of massive doses of austerity without any real support for the modernization of the Greek economy was doomed to failure [\[1\]](#), for reasons that are now well understood [\[2\]](#) but at the time were almost universally ignored by officialdom, whether from European governments, the European Commission or the IMF, the main guarantor and source of inspiration for the successive adjustment plans.

The results, which up to now have been catastrophic, are well known: despite the lengthy austerity cure, consisting of tax hikes, public spending cuts, lower wages and pensions, etc., the Greek economy, far from recovering, is now in a worse state, as is the sustainability of the country's public finances. Despite the agreement in 2012 of Europe's governments on a partial default, which reduced the debt to private creditors – relief denied by those same governments two years earlier – Greece's public debt now represents a larger percentage of GDP (almost 180%) than at the beginning of the crisis, and new relief – this time probably by rescheduling – seems unavoidable. The third bailout package – roughly 85 billion euros, on the heels of approximately 250 billion over the past five years – will be negotiated over the coming weeks and will be in large part devoted just to meeting debt repayments.

Meanwhile, the average living standard of Greeks has literally collapsed; the difference with the euro zone average, which had tended to decline during the decade before the crisis, has now widened dramatically (Figure 1): the country's GDP per capita is now a little less than half that in Germany. And GDP per capita still only poorly reflects the reality in an economy where inequality has increased and spending on social

protection has been drastically reduced.

**Figure 1. Real GDP per capita in several euro zone countries**

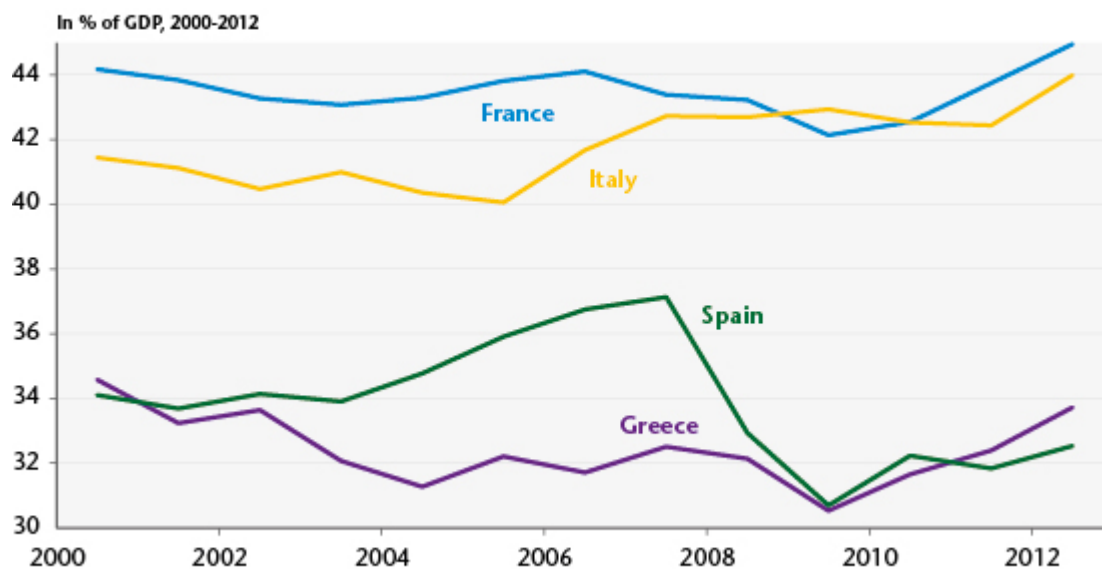


Source : Eurostat.

The new austerity plan is similar to the previous ones: it combines tax hikes – in particular on VAT, with the normal rate of 23% being extended to the Islands and many sectors, including tourism, that were previously subject to the intermediate rate of 13% – with reduced public spending, and will result in budget savings of about 6.5 billion euros over a full year, which will depress domestic demand and exacerbate the current recession.

The previous adjustment plans also featured “structural” reforms, such as lowering the minimum wage and pensions, deregulation of the labour market, etc. But it is clear that the fiscal component of these plans did not have a very visible impact on government revenue: after having declined significantly until 2009, the Greek tax burden – measured by the ratio of total tax revenue to GDP – has definitely increased, but not much more than in France (Figure 2). This does not mean, of course, that an even stronger dose of the same medicine will lead to better healing.

**Figure 2. Level of overall fiscal pressure  
in several euro zone countries**



Source : Eurostat.

### **Does history shed light on the future?**

The ills afflicting the Greek economy are well known: weak industrial and export sectors – apart from tourism, which could undoubtedly do better, but performs honourably – numerous regulated sectors and rentier situations, overstuffed and inefficient administration and tax services, burdensome military expenditure, etc.

None of this is new, and no doubt it was the responsibility of the European authorities to sound the alarm sooner and help Greece to renovate, as was done for the Central and Eastern Europe countries in the early 2000s in the years before they joined the European Union. Will the way it has been decided to do this now, through a forced march with the Greek government under virtual guardianship, be more effective?

If we rely simply on history, the temptation is to say yes. There are many similarities between the situation today and a Greek default back in 1893. At that time Greece was a relatively new state, having won its independence from the Ottoman Empire in 1830 following a long struggle supported by the European powers (England and France), which put the

country under a Bavarian king. Greece was significantly poorer than the countries of Western Europe: despite an effort at modernization undertaken after independence that was led by the Bavarian officials assembled around the Greek King Otto, in 1890 the country's GDP per capita was, according to data assembled by Angus Maddison[\[3\]](#), about 50% of the level of France, and a little less than one-third that of the UK. The analysis of Greece at that time was little better than that today:

“ ... Greece has been characterized throughout the 19<sup>th</sup> century by structurally weak finances, which has led it to default repeatedly on its public debt. According to the *Statesman's Yearbook*, in addition to significant military spending, Greece faces high expenditures on a disproportionately large number of officials for a small undeveloped state. Moreover, since part of Greece's debt is guaranteed by France and Great Britain, Greece could suspend debt service without the creditors having to suffer the consequences. The French and British budgets would be compelled to pay the coupons.

“By 1890, however, the situation had become critical. At the end of 1892, the Greek Government could continue paying interest only by resorting to new borrowing. In 1893, it obtained parliamentary approval for negotiating a rescheduling with its international creditors (British, German, French). Discussions were drawn out until 1898, with no real solution. It was Greece's defeat in the country's war with Turkey that served as a catalyst for resolving the public finances. The foreign powers intervened, including with support for raising the funds claimed by Turkey for the evacuation of Thessaly, and Greece's finances were put under supervision. A private company under international control was commissioned to collect taxes and to settle Greek spending based on a seniority rule designed to ensure the payment of a minimal interest. Fiscal surpluses were then allocated based on 60% to the creditors and 40% for the government.”[\[4\]](#)

Between 1890 and 1900, Greek per capita income rose by 15% and went on to increase by 18% over the next decade; in 1913, it came to 46% of French per capita income and 30% of the British level, which was then at the height of its prosperity. So this was a success.

Of course, the context was very different then, and the conditions that favoured the guardianship and the recovery are not the same as today: there was no real democratic government in Greece; there was a monetary regime (the gold standard) in which suspensions of convertibility – the equivalent of a “temporary Grexit” – were relatively common and clearly perceived by creditors as temporary; and in particular there was a context of strong economic growth throughout Western Europe – what the French called the “Belle Epoque” – thanks to the second industrial revolution. One cannot help thinking, nevertheless, that the conditions dictated to Greece back then inspired the current decisions of Europe’s officials[5].

Will the new plan finally yield the desired results? Perhaps, if other conditions are met: substantial relief of the Greek public debt, as the IMF is now demanding, and financial support for the modernization of the Greek economy. A Marshall Plan for Greece, a “green new deal”? All this can succeed only if the rest of the euro zone is also experiencing sustained growth.

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[1] See Eloi Laurent and Jacques Le Cacheux, “Zone euro: *no future?*”, *Lettre de l’OFCE*, no. 320, 14 June 2010, <http://www.ofce.sciences-po.fr/pdf/lettres/320.pdf> .

[2] See in particular the work of the OFCE on the recessionary effects of austerity policies: <http://www.ofce.sciences-po.fr/pdf/revue/si2014/si2014.pdf> . Recall that the IMF itself has acknowledged that the



adjustment plans imposed on the European economies experiencing public debt crises were excessive and poorly designed, and especially those imposed on Greece. This *mea culpa* has obviously left Europe's main leaders unmoved, and more than ever inclined to persevere in their error: *Errare humanum est, perseverare diabolicum!*

[3] See the data on the Maddison Project site: <http://www.ggdcc.net/maddison/maddison-project/home.htm> .

[4] Excerpt from the article by Marc Flandreau and Jacques Le Cacheux, "La convergence est-elle nécessaire à la création d'une zone monétaire ? Réflexions sur l'étalon-or 1880-1914" [Is convergence necessary for the creation of a monetary zone? Reflections on the gold standard 1880-1914], *Revue de l'OFCE*, no. 58, July 1996, <http://www.ofce.sciences-po.fr/pdf/revue/1-58.pdf> .

[5] An additional clue: the German Finance Minister Wolfgang Schäuble insisted that Greece temporarily suspend its participation in the euro zone; in the 1890s, it had had to suspend the convertibility into gold of its currency and conducted several devaluations.

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## Is Greece in the process of divorce?

By [Jérôme Creel](#)

The ongoing Greek saga is looking more and more like an old American TV series. JR Ewing returns to the family table feeling upset with Sue Ellen for her failure to keep her promise to stop drinking. Given the way things are going, a

divorce seems inevitable, especially if Bobby sides with his brother and refuses to help his sister-in-law any longer.

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

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

Furthermore, how were the other EU countries faring at the same time? No better! The addiction to public debt, if we can indeed speak of addiction, is general. The public debt of the EU and the euro zone rose by 6 GDP points, or by 1400 billion and 800 billion respectively. By comparison, the increase in the Greek debt is a drop in the ocean. Germany's public debt rose by 68 billion euros, Italy's by 227 billion, Spain's and France's by 285 billion respectively, and the United Kingdom's by 277 billion pounds, or 470 billion euros, again according to Eurostat. Relative to their respective GDPs, Spain's debt

increased by almost 30 points, Italy's by more than 15 points, France's by 10 points, and the UK's by nearly 8 points. Only Germany has seen its debt ratio go down, thanks to stronger economic growth.

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

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

In contrast to businesses and households, the state is supposed to have an infinite time horizon, which makes it possible to reset the present value of the debt at the "end of time" to zero. We can then say that the public debt is sustainable if future governments provide adequate public surpluses to pay off that debt. This is possible after periods of high public deficits, provided that these periods are followed by others during which governments accumulate budget surpluses. Given the extension of the maturity of Greek debt and the low level of future interest payments, the budget

surplus required to repay the current debt is low. Paul de Grauwe concludes that Greece is subject to a liquidity crisis rather than a sovereign default crisis. So, again according to Paul de Grauwe, what is needed is to adjust the fiscal austerity plans and forthcoming reforms to the actual level of the public debt, which is substantially lower than the level being used as the basis for negotiations between the Greek state and the “institutions” (ECB, Commission, IMF). In other words, the “institutions” can loosen their grip.

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

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

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## Greece: an agreement, again and again

By [Céline Antonin](#), Raul Sampognaro, [Xavier Timbeau](#), [Sébastien Villemot](#)

*... La même nuit que la nuit d'avant*  
night as the night before

[...The same

*Les mêmes endroits deux fois trop grands*

The same

places, twice too big  
*T'avances comme dans des couloirs* You  
walk through the corridors  
*Tu t'arranges pour éviter les miroirs* You  
try to avoid the mirrors  
*Mais ça continue encore et encore ...* But it  
just goes on and on...]

[Francis Cabrel, \*Encore et encore\*, 1985.](#)

Just hours before an exceptional EU summit on Greece, an agreement could be signed that would lead to a deal on the second bail-out package for Greece, releasing the final tranche of 7.2 billion euros. Greece could then meet its deadlines in late June with the IMF (1.6 billion euros) as well as those in July and August with the ECB (6.6 billion euros) and again with the IMF (0.45 billion euros). At the end of August, Greece's debt to the IMF could rise by almost 1.5 billion euros, as the IMF is contributing 3.5 billion euros to the 7.2 billion euro tranche.

Greece has to repay a total of 8.6 billion euros by September, and nearly 12 billion by the end of the year, which means funding needs that exceed the 7.2 billion euros covered by the negotiations with the Brussels Group (i.e. the ex-Troika). To deal with this, the Hellenic Financial Stability Fund (HFSF) could be used, to the tune of about 10 billion euros, but it will no longer be available for recapitalizing the banks.

If an agreement is reached, it will almost certainly be difficult to stick to it. First, Greece will have to face the current bank run (despite the apparent calm in front of the bank branches, more than 6 billion euros were withdrawn last week according to the *Financial Times*). Moreover, even if an agreement can put off for a time the scenario of a Greek exit from the euro zone, the prospect of exceptional taxes or a tax reform could deter the return of funds to the country's banks. Furthermore, the agreement is likely to include a primary

surplus of 1% of GDP by the end of 2015. But the [information on the execution of the state budget](#) up to May 2015 (published 18 June 2015) showed that revenue continues to be below the initial forecast (- 1 billion euros), reflecting the country's very poor economic situation since the start of 2015. It is true that the lower tax revenues were more than offset by lower spending (down almost 2 billion). But this is cash basis accounting. The [monthly bulletin](#) for April 2015, published on 8 June 2015, shows that the central government payment arrears have increased by 1.1 billion euros since the beginning of 2015. It seems impossible that, even with an excellent tourist season, the Greek government could make up this lag in six months and generate a primary surplus of 1.8 billion euros calculated on an accrual basis.

A new round of fiscal tightening would penalize activity that is already at half-mast, and it could be even more inefficient in that this would create strong incentives to underreport taxes in a context where access to liquidity will be particularly difficult. The Greek government could try to play with tax collection, but introducing a new austerity plan would be suicidal politically and economically. Discussion needs to get started on a third aid package, including in particular negotiations on the reduction of Greece's debt and with the counterparties to this relief.

Any agreement reached in the coming days risks being very fragile. Reviving some growth in Greece would require that financing for the economy is functioning once again, and that some confidence was restored. It would also require addressing Greece's problems in depth and finding an agreement that was sustainable over several years, with short-term steps that need to be adapted to the country's current situation. In our study, "[Greece on the tightrope](#) [in French, or the English-language post describing the study at <http://www.ofce.sciences-po.fr/blog/greece-tightrope/>]," we analysed the macroeconomic conditions for the sustainability

of the Greek debt. More than ever before, Greece is on the tightrope. And the euro zone with it.

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## Save Greece by Democracy!

By [Maxime Parodi](#) @MaximeParodi, Thomas Piketty (Director of research at the EHESS and professor at Paris School of Economics), and [Xavier Timbeau](#) @XTimbeau

The newspapers have been full of the Greek drama since Syriza's election to power on 25 January 2015. Caught in the noose of its loans, Greece's government is defending its position by threatening to leave the euro zone. The situation today is at an impasse, and the country's economy is collapsing. As bank deposits flee and uncertainty mounts about the times ahead and the measures to come, no-one is really able to think about the future.

Europeans, for their part, are wondering what has led to this state of affairs. There has been a diagnosis of Institutional incompleteness, with proposals to reinforce the construction of the euro zone. But what is emerging is not up to the challenges facing Europe.

So let's take the problem by the other end of the stick and give European democracy a chance to evolve. Let's entrust the resolution of the Greek debt crisis to a body of representatives of the euro zone's national parliaments, that is to say, an embryo of a true parliamentary assembly for the euro zone.

Such an Assembly would arbitrate the conflict between the

creditors and the Greek government, shifting the debate and decision-making to the big questions: what responsibility should the younger generation bear for the debt of their elders? What about the creditors' rights? How have other large public debts been resolved historically, and what lessons can we draw for the future?

As any agreement reached would be legitimated by a formal assembly that would also act as its guardian, it would no longer be in danger of being denounced – once again – on the morrow. Since what's at stake is to resolve a debt and to not reach an agreement through force, the first step would be to suspend Greece's debt for the time needed. This step is a matter of common sense and the ordinary practice during the resolution of private debt in nearly all the world's countries.

#### A lasting agreement

This would require leaving the IMF out of the discussion by letting Greece reimburse this institution. It would be necessary at the same time to eliminate the possibility of Athens leaving the euro zone. By accepting the principle of negotiations, Greece and the other European countries would take this option off the agenda and pledge to accept the agreement reached. This embryonic Assembly would periodically review the situation and monitor the contingencies of the Greek economy. This is in effect what is already being done today, but now this would be explained and legitimated.

The technical institutions (the Commission, the European Central Bank) would continue to assess and support the reforms envisaged. They would inform the Assembly and answer to it. The Assembly would be a body set up to arbitrate, whenever necessary, any conflicts. Nor would there be any reason not to involve the European Council and the European Parliament. But clarifying the issue of legitimacy would open the door to a solution that was both more constructive for Greece and the



other heavily indebted countries and fairer to the taxpayers of the euro zone.

We would be experimenting with a scheme for the resolution of sovereign defaults within the euro zone by building a political union – while remembering one thing: that Europe was reconstructed starting back in the 1950s by investing in the future and forgetting the debts of the past, in particular Germany's.

Finally, this Assembly would be competent to establish a common fund for euro zone debt, to undertake its global restructuring and to establish democratic rules governing the choice of a common level of public deficits and investments – which would help to overcome today's Do-It-Yourself approach to our euro zone.

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## **France – the sick man of Europe?**

by [Mathieu Plane](#) – Economist at OFCE (French Economic Observatory – Sciences Po)

The year 2014 was marked for France by the risk of European Commission sanctions for the failure of its budget to comply with Treaties; by the downgrade by Fitch of French government debt (following the one by S&P a year earlier); by the absence of any sign of a in the unemployment rate; by a rising deficit after four years of consecutive decline; and by the distinction of being the only country in Europe to run a significant current account deficit: economically, it seemed

like the country's worst year since the beginning of the crisis, in 2008. France did not of course go through the kind of recession it did in 2009, when the Eurozone experienced a record fall in GDP (-4.5% and -2.9% for the EMU and for France respectively). But for the first time since the subprime bubble burst, in 2014 French GDP grew more slowly (0.4%) than eurozone average (0.8%). The country's weakening position is fuelling the view that France may be the new sick man of Europe, a victim of its leaders' lax fiscal approach and its inability to reform. Is this really the case?

It is worth noting first that the French economic and social model proved its effectiveness during the crisis. Thanks to its system of social safety nets, to a combined (consumers, business, government) debt level that is lower than the Eurozone average, while the household savings rate that is higher, to a low level of inequality, and to a relatively solid banking system, France weathered the crisis better than most of its European partners. Indeed, between early 2008 and late 2013, French GDP grew by 1.1%, while during that same period the Eurozone as a whole contracted by 2.6%; France also avoided the recession in 2012 and 2013 that most Eurozone countries experienced. Looking at Europe for the six years from 2008 to 2013, France's economic performance was relatively close to that of Germany (2.7%), better than that of the UK (-1.3%) and well ahead of Spain (-7.2%) and Italy (-8.9%). Similarly, during this period investment in France contracted less than in the Eurozone as a whole (-7.7% versus -17%), and unemployment increased less (+3 points versus +4.6). Finally, the French economy's ability to stand up better to the crisis was not linked with a greater increase in public debt compared to the Eurozone average (+28 GDP points for both France and the Eurozone) or even the United Kingdom (+43 points).

Nevertheless, [France has seen its position in the Eurozone deteriorate in 2014. This was marked not only by lower growth](#)

[than its partners](#), but also by higher unemployment (the Eurozone rate has gradually fallen), an increase in public debt (which virtually stabilized in the Eurozone), a decline in investment (which improved slightly in the euro zone), an increase in its public deficit (while that of the Eurozone fell) and a substantial current account deficit (the euro zone is running a significant surplus). Why this divergence?

While France does have a problem with competitiveness, note that [almost half of its current account deficit is cyclical](#) due to more dynamic imports than its major trading partners, which generally have worse output gaps. Furthermore, until 2013, the country's fiscal adjustment [was focused more on the tax burden than on public spending](#). Conversely, the focus in 2014 was more on public spending. [Given France's position in the business cycle and its budget decisions](#), the fiscal multiplier in 2014 was higher than in previous years, so that fiscal consolidation imposed a heavy toll in terms of growth. In terms of competitiveness, French industry is caught in the middle of the Eurozone between, on the one hand, peripheral countries of the euro area, including Spain, which have entered into a spiral of wage deflation fuelled by mass unemployment, and the core countries, especially Germany, which are reluctant to give up their excessive trade surpluses through higher domestic demand and more inflation. [Faced with the generalization of wage devaluations in the Eurozone](#), France had no choice but to respond with a policy to improve the competitiveness of its businesses by cutting labour costs. Thus, the CICE tax credit and the Pact of Responsibility represent a total transfer of 41 billion euros to the firm system, mainly financed by households. While the positive impact of these transfers will be felt over the medium-to-long term, [the financing effort together with the country's fiscal consolidation effort had an immediate adverse effect on purchasing power](#), which goes a long way in explaining the poor growth performance of 2014. Finally, 2014 also saw a steep fall in housing investment (-7%), the largest drop since the

real estate crisis of the early 1990s (excluding 2009).

There are several reasons why France's poor performance is not likely to be repeated in 2015: first, in order to halt the decline in construction, [emergency measures were taken in August 2014 to free up housing investment](#), with the first effects to be felt in 2015. Second, the programmes enacted to improve business competitiveness will begin to take full effect from 2015: the CICE tax credit and the Responsibility Pact will slash business costs by 17 billion euros in 2015, up significantly from only 6.5 billion in 2014. Third, the slowdown in the fiscal consolidation programmes of our commercial partners and the introduction of a minimum wage in Germany will both help French exports. In addition, [the lower exchange rate for the euro](#) and falling oil prices are powerful levers for boosting the French economy in 2015, and together could amount to one extra point of growth. Given the ECB's policy on quantitative easing, interest rates should also remain low for at several more quarters. Finally, although timid, the Juncker plan along with marginal changes in Europe's fiscal rules will favour a pickup in investment. These factors will put some wind in the sails of French growth by helping to offset the negative impact of the reduction in public spending for 2015, so that the economy finally reaches a pace that will be sufficient to begin to reverse the unemployment curve and reduce the public deficit.

While France is not the sick man of Europe, [it is nevertheless still very much dependent, like all euro zone countries, on Europe having strong macroeconomic levers](#). Up to now, these have had a negative impact on business, be it through overly restrictive fiscal policies or a monetary policy that has proved insufficiently expansionary in the light of other central banks' action. In an integrated currency zone, deflation cannot be fought on a national basis. The choice of a European policy mix that is more geared towards growth and inflation is a first since the start of the sovereign debt

crisis. Boosted by lower oil prices, let us hope that these levers will prove strong enough to halt the depressive spiral that the Eurozone has been going through since the onset of the crisis. The recovery will be European, before being French, or there won't be one.

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

[Sandrine Levasseur](#)

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

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

ECB.

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

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

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

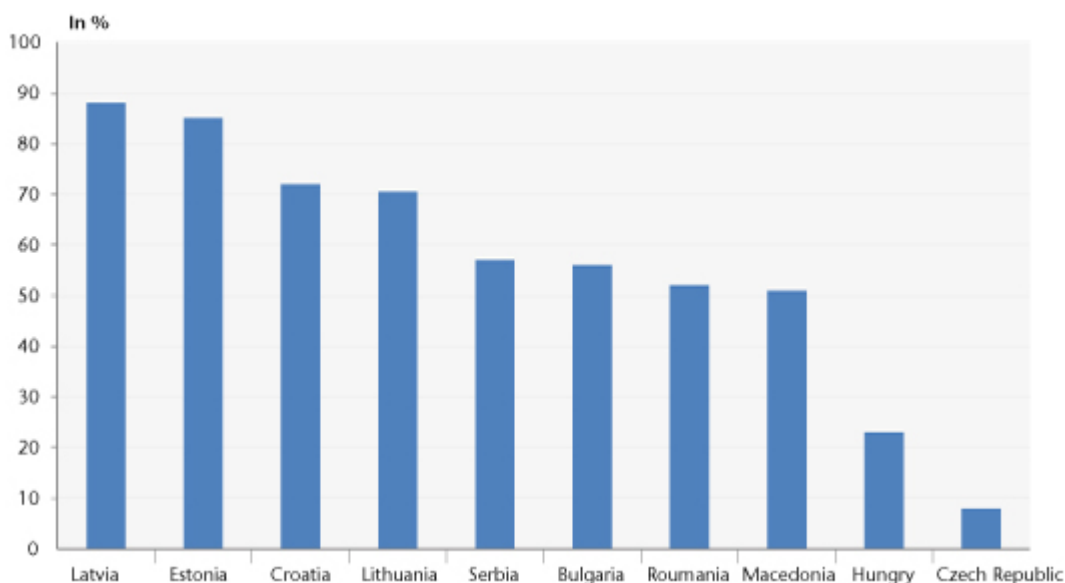
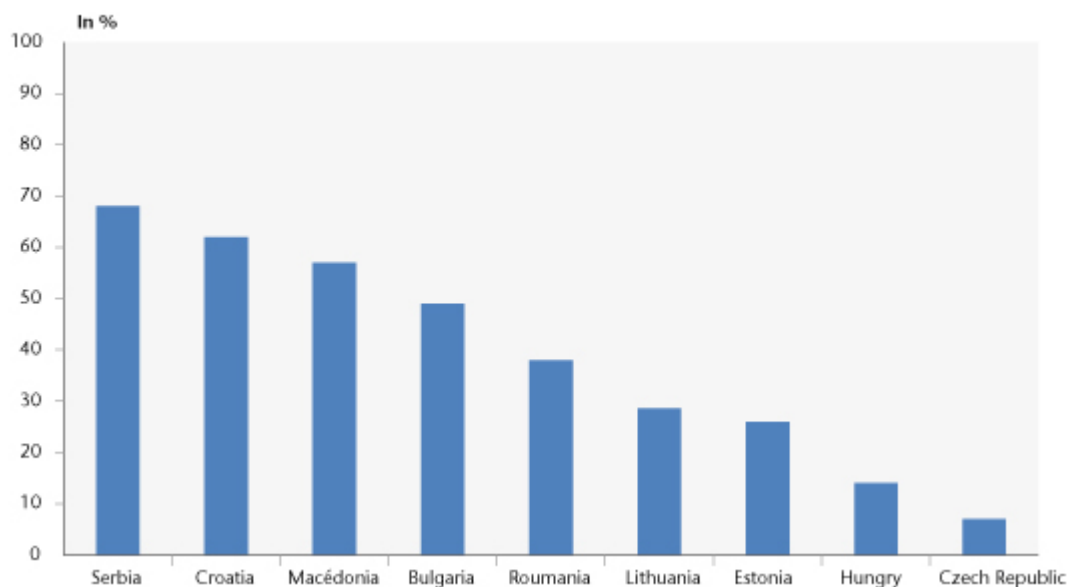


Figure 2. Share of private sector deposits in euros (emerging Europe, 2009)



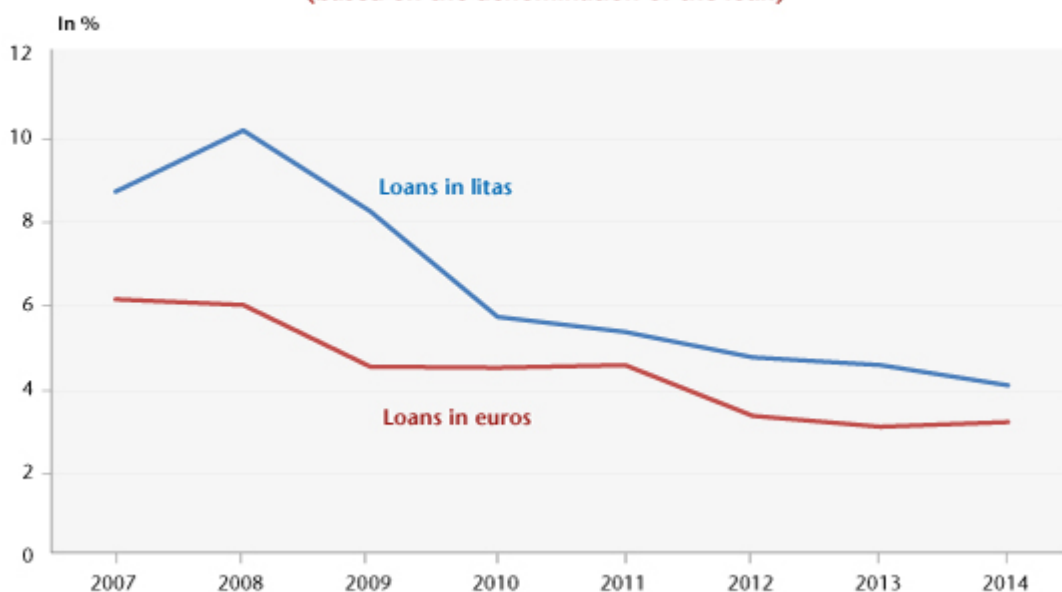
There are a number of reasons why these countries have used the euro in addition to their own currency:

- **The existence of fixed** (or relatively fixed) **exchange rates** against the euro, which protects borrowers against the risk that their euro-denominated debt will grow heavier (since the likelihood of a devaluation / depreciation of the national currency is considered to be low);
- **A lower interest rate on loans denominated in euros** than when the loans are denominated in the national currency;
- **A strong presence of multinational companies (particularly in the banking sector)** that have not only funds in euros but also the “technology” to lend / borrow in euros;
- For loans in euros, **the ex ante existence of bank deposits in euros**, which is itself linked to [multiple factors](#) (e.g. the credibility of the monetary authorities, a strong presence of multinationals, revenue from migration coming from countries in the euro zone) .

These factors have been present to a greater or lesser extent in the different countries. In Lithuania, the existence of a [Currency Board \[2\]](#) vis-à-vis the euro since 2002 has generally

contributed to the economy's "euroization". This system of fixed exchange rates has enjoyed great credibility, prompting the country's businesses and consumers to borrow in euros, particularly since these benefited from very low interest rates (Figure 3). The presence of multinational companies in a number of sectors strengthened the use of the euro as a benchmark currency for different functions (billing, deposits and savings). The importance to Lithuania of banks from the euro zone should nevertheless not be overestimated: [the three largest banks operating in Lithuania are from Sweden and Norway](#). The risk of loans in euros thus involves, beyond the risk associated with the value of the Lithuanian lita, a risk associated with the value of a third currency. ... This risk will obviously not disappear with Lithuania's formal adoption of the euro.

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



### **What changed on 1 January 2015?**

Four changes can be highlighted:

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



transactions; and the lita will disappear after dual circulation for a fortnight.

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

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

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

governor of Germany's central bank now has only [80% of its voting right](#), it still has 100% of its right to speak... Will not voting one month out of five really mean that it loses its power of persuasion?

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

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

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

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

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

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[\[1\]](#) Strictly speaking, euroization refers to the adoption of the euro as legal tender by a country without its being given permission by the issuing institution (i.e. the European Central Bank) or the decision-making authorities (i.e. the heads of State of the European Union member countries). Euroization is then said to be [unilateral](#). It differs from the

phenomenon discussed here, where the euro is used in conjunction with the national currency, but only the national currency constitutes [legal tender](#).

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

[\[3\]](#) See footnote 2.