

Would returning to the drachma be an overwhelming tragedy?

by [Céline Antonin](#)

Following the vote in the Greek parliamentary elections on 17 June 2012, the spectre of the country leaving the euro zone has been brushed aside, at least for a while. However, the idea is not completely buried, and it is still being evoked in Greece and by various political forces around the euro zone. This continues to pose the question of the cost of a total default by Greece for its creditors, foremost among them France. The analysis published in the latest [OFCE Note \(No. 20, 19 June 2012\)](#) shows that, despite the magnitude of the potential losses, several factors could mitigate the consequences for the euro zone countries of a default by the Greek state.

The withdrawal of Greece from the euro zone, which is not covered in the Treaties, would cause a major legal headache, as it would involve managing the country's removal from the Eurosystem [\[1\]](#). In case of a return to a new drachma, which would depreciate sharply against the euro [\[2\]](#), the burden of the public debt still outstanding would be greatly increased, as would private debt, which would still be denominated in euros. Many financial and nonfinancial firms would go to the wall. Legally, Greece could not unilaterally convert its debt into new drachmas. Since the country's public debt is not very sustainable and it is denominated almost exclusively in euros, Greece would certainly default (at least partially) on its public debt, including its foreign debt [\[3\]](#). Given that the main holders of Greek debt are euro zone countries, what would be the magnitude of the shock in the case of a Greek default?

While more detail about this can be found in the [OFCE Note \(No. 20, 19 June 2012\)](#), the focus here is on providing a breakdown of the exposure of the euro zone countries (in particular France) to Greek public and private debt. Exposure to Greek public debt involves three main channels:

- 1) The two aid packages of May 2010 and March 2012;
- 2) Participation in the Eurosystem;
- 3) The exposure of the commercial banks.

An analysis of these channels shows that the main source of exposure of the euro zone countries to losses is the two support plans. The maximum exposure of the euro zone countries through this channel is 160 billion euros (46 billion euros for Germany and 35 billion euros for France). Euro zone countries are also exposed to Greek government debt through their participation in the Eurosystem: indeed, the Eurosystem's balance sheet swelled dramatically to support the vulnerable countries in the euro zone, notably Greece. However, given the Eurosystem's capacity to absorb losses (over 3,000 billion euros), we believe that the potential losses for the countries of the euro zone are not likely to be realized if Greece were to default unilaterally on its public debt. Finally, the euro zone's banking system is exposed to 4.5 billion euros in Greek sovereign risk and up to 45 billion euros from the Greek private sector [\[4\]](#).

The cumulative exposure of the euro zone to Greek debt, excluding the Eurosystem, amounts to a maximum of 199 billion euros (2.3% of the euro zone's GDP, cf. Table), including 52 billion euros for Germany (2% of GDP) and 65 billion euros for France (3.3% of GDP). If we include exposure to the Eurosystem, the cumulative exposure of the euro zone to Greek debt comes to 342 billion euros (4% of euro zone GDP), including 92 billion for Germany (3.6% of GDP) and 95 billion (4.8%) for France. France is the most heavily exposed

euro zone country, due to the exposure of its banks to Greek private debt through subsidiaries in Greece. If we consider only Greek government debt, however, it is Germany that appears to be the country most exposed to a Greek default.

Summary of the exposure of different countries to Greek debt

In billion euros

	1) Support plans		2) Eurosystem		3) Commercial banks		Total	Total excl. Eurosystem
	1st plan	2e plan	SMP	TARGET2	Public debt	Private debt		
Germany	14.7	31.4	12.5	27.3	1.3	5.1	92.3	52.5
Austria	1.5	3.2	1.3	2.8	NC*	NC*	8.8	4.7
Belgium	1.9	4.0	1.6	3.5	0.1	0.0	11.1	6.0
Cyprus	0.1	0.2	0.1	0.2	NC	NC	0.6	0.3
Spain	6.5	13.8	5.5	12.0	0.1	0.5	38.4	20.9
Estonia	0.0	0.3	0.1	0.3	NC	NC	0.7	0.3
Finland	1.0	2.1	0.8	1.8	NC	NC	5.7	3.1
France	11.1	23.6	9.4	20.5	1.3	29.1	95.0	65.1
Ireland	0.9	0.0	0.7	1.6	NC	NC	3.2	0.9
Italy	9.7	20.7	8.3	18.0	0.2	1.1	58.0	31.7
Luxembourg	0.1	0.3	0.1	0.3	NC	NC	0.8	0.4
Malta	0.1	0.1	0.0	0.1	NC	NC	0.3	0.2
Netherlands	3.1	6.6	2.6	5.7	NC	NC	18.0	9.7
Portugal	1.4	0.0	1.2	2.5	NC	NC	5.1	1.4
Slovakia	0.5	1.1	0.5	1.0	NC	NC	3.1	1.6
Slovenia	0.3	0.6	0.2	0.5	NC	NC	1,6	0.9
Total EZ	52.9	107.7	45.0	98.0	2.9	35.8	342.3	199.3

[NC => NA]

NA: Not available, as the BIS gives only the exposures of Germany, Belgium, France, Italy and Spain. The totals are thus calculated without taking into account the second tier banks, except for Germany, Belgium, France, Italy and Spain and the Euro Zone Total.

Sources: "The Economic Adjustment Programme for Greece – First review summer 2010", ECB, EFSE, BIS *Quarterly Review* (June 2012), Bank of Greece, author's calculations.

These amounts constitute an upper bound: they represent the maximum potential losses in the worst case scenario, namely the complete default of Greece on its public and private debt. Furthermore, it is impossible to predict with certainty all the chain reactions associated with a Greek exit from the euro zone: everything depends on whether the exit is coordinated or not, whether a debt rescheduling plan is implemented, the magnitude of the depreciation of the drachma against the euro, and so on.

The "reassuring" element in this analysis is the magnitude of the potential losses (Table): the shock of a Greek exit would be absorbable, even if it would generate a shock on each member country and widen its deficit, undermining the members' efforts to restore balanced budgets. However, this analysis also points out how intertwined the economies of the euro zone are, even if only through the monetary union, not to mention the mechanisms of the solidarity budget. A Greek exit from the euro zone could therefore open a Pandora's Box – and if other countries were tempted to imitate the Greek example, it is the euro zone as a whole that could go under.

[1] The Eurosystem is the European institution that groups the European Central Bank and the central banks of the countries in the euro zone.

[2] On this point, see [A. Delatte, What risks face the Greeks if they return to the drachma?, OFCE blog, 11 June 2012.](#)

[3] The foreign debt designates all the [debt](#) that is owed by all a country's public and private debtors to foreign lenders.

[4] This refers to a textbook case, where the drachma's depreciation would be so great that the currency would no longer be worth anything.

Will Germany be caught up in the recession of its European

partners?

[Christophe Blot](#) and Sabine Le Bayon

Can Germany avoid the recession that is hitting a growing number of countries in the euro zone? While Germany's economic situation is undoubtedly much more favourable than that of most of its partners, the fact remains that the weight of exports in its GDP (50%, vs 27% for France) is causing a great deal of uncertainty about the country's future growth.

Thus, in the last quarter of 2011, the downturn in the German economy (-0.2%) due to the state of consumption and exports has upset hopes that the country would be spared the crisis and that it could in turn spur growth in the euro zone based on the strength of its domestic demand and wage increases. Exports of goods fell 1.2% in value in late 2011 over the previous quarter, with a contribution of -1.5 points for the euro zone and -0.4 points for the rest of the European Union. Admittedly, the beginning of 2012 saw renewed growth, with GDP rising by 0.5% ([versus 0% in the euro zone](#)). Once again this was driven by exports, in particular to countries outside the euro zone. The prospects of a recession across the Rhine in 2012 thus appear to be receding, but there is still great uncertainty about how foreign trade will be affected in the coming months and about the extent of the slowdown "imported" into Germany. The question is whether the improvement in the first quarter of 2012 is temporary. The decline in manufacturing orders from euro zone firms to Germany (-7.5% in the first quarter of 2012, after -4.8% in the last quarter of 2011) could spell the end of German's persistent growth, especially if the recession in the euro zone continues or worsens.

With GDP per capita above the pre-crisis level, Germany has been an exception in a euro zone that is still profoundly marked by the crisis. The country's public deficit is under

control, and it already meets the 3% threshold set by the Stability and Growth Pact. Germany is still running a foreign trade [1] surplus, which came to 156 billion euros (6.1% of GDP) in 2011, whereas at this same time France ran a deficit of 70 billion euros (3.5% of GDP). Despite Germany's favourable foreign trade performance, the crisis has left scars, which today are being aggravated by the energy bill. For instance, before the crisis the trade surplus was 197 billion euros, with over 58% from trade with partners in the euro zone. With the crisis, activity slowed sharply in the euro zone – the zone's GDP in the first quarter of 2012 was still 1.4% lower than the level in the first quarter of 2008 – which is automatically reflected in demand addressed to Germany. Thus, exports of goods to the euro zone are still below their level of early 2008 (down 2.9% for Germany and 6.3% for France, see Table 1). Germany's trade surpluses vis-à-vis Italy and Spain – two countries that were hit hard by the crisis – have fallen significantly, mainly due to lower demand from the two countries. German exports to these two countries have decreased by 27% and 4% respectively since 2007.

Nevertheless, although Germany is more exposed to foreign trade shocks than France, it is less exposed to the euro zone. The share of euro zone countries in German exports fell from 44.8% in 2003 to 39.7% in 2011 (Table 2a). In France, despite a fall on the same order of magnitude, 47.5% of exports are still directed towards the euro zone. When the European Union as a whole is considered, however, the gap disappears, as the EU represents 59.2% of German exports compared with 59.8% of French exports. The lower level of dependence on the euro zone has been offset by increasing exports to the new member states of the European Union (the NEM), with which German trade reached 11.4% in 2011. Moreover, Germany has maintained its lead over France on the emerging markets: in 2011 Asia represented 15.8% of German exports and China 6.1%, against 11.5% and 3.2% in the French case. By managing to diversify

the geographical composition of its exports to areas experiencing vigorous growth, Germany has been able to dampen the shock of the slowdown in the euro zone. This can be seen in recent trade trends: while Germany's exports (like France's) have surpassed their pre-crisis level, this was due to exports to countries outside the euro zone, where Germany has benefited more than France (Table 1). Germany has in fact succeeded in significantly reducing its deficit with Asia, which has helped to offset the poor results with the euro zone and with Central and Eastern Europe. Finally, Germany has advantages in terms of [non-price competitiveness](#) [2], which reflects the dynamism of trade in automobiles and electrical, electronic and computer equipment. The surpluses in these two sectors regained their pre-crisis level in 2011 (respectively, 103 and 110 billion euros in 2011), whereas the balances in these two sectors have continued to deteriorate in France.

Even if orders from countries outside the euro zone remain buoyant (up 3.6% in early 2012), the weight of the euro zone is still too strong for exports to emerging markets to offset the decline in orders placed by the euro zone to Germany. This will inevitably affect the country's growth. GDP should therefore rise less rapidly in 2012 than in 2011 (0.9% according to the OFCE [3], following 3.1%). Germany might thus avoid a recession, unless the euro zone as a whole experiences even sharper fiscal contraction. Indeed, the slowdown in growth means that the euro zone member states will not be able to [meet their budget commitments in 2012 and 2013](#), which could lead them to decide on further restrictive measures, which would in turn reduce growth throughout the zone, and therefore demand addressed to the zone's partners. In this case Germany would not avoid a recession.

Finally, the role of foreign trade is not limited to growth and employment. It could also have an impact on negotiations between France and Germany about the governance of the euro zone. The relative growth of the two countries will in

practice affect the balance of power between them. The expected slowdown in growth in Germany clearly reflects its conflicting interests between, on the one hand, maintaining its market opportunities and, on the other, its fears vis-à-vis the functioning of the euro zone and the cost to public finances of broader support for the countries in greatest difficulty. While up to now the latter consideration has dominated the German position, this could change once its commercial interests come under threat, especially at a time when the German Chancellor is negotiating with the Parliamentary opposition about the ratification of the fiscal pact – an opposition that could demand measures to support growth in Europe, as has the new French president.

Table 1. German and French exports since the crisis, in value

2008 Q1 = 100

		2009 - Q2	2012 - Q1
Totale	Germany	76,5	108,4
	France	77,6	101,6
Euro zone	Germany	76,4	97,1
	France	75,4	93,7
Other EU countries	Germany	71,2	103,3
	France	71,4	89,4
Rest of the world	Germany	79,8	123,0
	France	83,1	117,5

Sources : Customs, Destatis.

Table 2a. The main partners of Germany and France

%

	2003		2011	
	Germany	France	Germany	France
European Union	65,0	67,0	59,2	59,8
Euro zone	44,8	52,2	39,7	47,5
- <i>France/Germany</i>	10,4	15,8	9,6	16,3
- <i>Italy</i>	7,3	9,2	5,9	8,0
- <i>Spain</i>	4,9	10,0	3,3	7,2
- <i>Netherlands</i>	6,4	3,8	6,5	4,2
- <i>Belgium/Luxembourg</i>	5,8	8,2	5,0	7,5
- <i>Austria</i>	5,4	1,0	5,4	0,9
United Kingdom	8,4	9,5	6,2	6,5
NEM*	9,2	3,7	11,4	4,8
United States	9,3	6,7	6,9	5,5
Asia	11,4	7,3	15,8	11,5
- <i>China</i>	2,7	1,4	6,1	3,2
- <i>Japan</i>	1,8	1,6	1,4	1,5

Note : The NEM include Bulgaria, the Czech Republic, Latvia, Lithuania, Hungary, Poland, Romania, Slovenia, Slovakia and Estonia.

Sources : Customs, Destatis.

Table 2b. The main suppliers of Germany and France

%

	2003		2011	
	Germany	France	Germany	France
European Union	61,4	65,2	55,7	58,9
Euro zone	42,4	53,6	37,7	48,2
- <i>France/Germany</i>	9,3	18,9	7,6	17,3
- <i>Italy</i>	6,5	9,4	5,3	7,4
- <i>Spain</i>	3,0	7,6	2,8	6,1
- <i>Netherlands</i>	7,9	4,7	8,4	4,4
- <i>Belgium/Luxembourg</i>	5,1	7,4	4,5	8,2
- <i>Austria</i>	4,1	1,0	4,1	0,9
United Kingdom	6,4	6,7	4,8	4,4
NEM*	9,3	3,2	10,7	4,0
United States	7,8	6,5	5,6	5,7
Asia	15,5	12,5	20,4	15,7
- <i>China</i>	4,1	4,1	9,7	8,2
- <i>Japan</i>	3,8	3,2	2,8	1,9

Note : The NEM include Bulgaria, the Czech Republic, Latvia, Lithuania, Hungary, Poland, Romania, Slovenia, Slovakia and Estonia.

Sources : Customs, Destatis.

[1] Measured by the gap between the export and import of goods.

[2] See also J.-C. Bricongne, L. Fontagné and G. Gaulier (2011): “Une analyse détaillée de la concurrence commerciale entre la France et l’Allemagne” [A detailed analysis of commercial competition between France and Germany], Presentation at the Fourgeaud seminar [in French].

[3] This figure corresponds to the update of our forecast of April 2012, which takes into account the publication of the growth figures for Q1 2012.

Less austerity = more growth and less unemployment

[Eric Heyer](#) and [Xavier Timbeau](#)

The European Commission has just released its [spring forecast](#), which anticipates a recession in 2012 for the euro zone (“mild” in the words of the Commission, but still -0.3%), which is in line with [the OFCE’s economic analysis of March 2012](#).

The brutal fiscal austerity measures launched in 2010, which were intensified in 2011 and tightened even further in 2012 virtually throughout the euro zone (with the notable exception of Germany, Table 1 and 1a), are hitting activity in the zone hard. In 2012, the negative impact on the euro zone resulting from the combination of raising taxes and reducing the share

of GDP that goes to expenditure will represent more than 1.5 GDP points. In a deteriorating fiscal situation (many euro zone countries had deficits of over 4% in 2011) and in order to continue to borrow at a reasonable cost, a strategy of forced deficit reduction has become the norm.

Table 1. The euro zone in 4 macroeconomic aggregates from 2009 to 2012

	2009	2010	2011	2012
GDP growth (%/yr)	-4,4	1,8	1,5	-0,4
Public deficit (% GDP)	-5,5	-5,5	-3,6	-2,9
Jobless rate (% active pop)	9,6	10,1	10,2	10,9
Fiscal impulse (% GDP)	1,7	-0,3	-1,1	-1,5

Sources : National accounts, OFCE calculations and forecasts.

This strategy is based on declarations that the 3% ceiling will be reached by 2013 or 2014, with balanced budgets to follow by 2016 or 2017 in most countries. However, these goals seem to be overly ambitious, as no country is going to meet its targets for 2013. The reason is that the economic slowdown is undermining the intake of the tax revenue needed to balance budgets. An overly optimistic view of the impact of fiscal restraint on activity (the so-called fiscal multiplier) has been leading to unrealistic goals, which means that GDP growth forecasts must ultimately be systematically revised downward. The European Commission is thus revising its spring forecast for the euro zone in 2012 downward by 0.7 point compared to its autumn 2011 forecast. Yet there is now a broad consensus on the fact that fiscal multipliers are high in the short term, and even more so that full employment is still out of reach (here too, [many authors](#) agree with the [analyses made by the OFCE](#)). By underestimating the difficulty of reaching inaccessible targets, the euro zone members are locked in a spiral where jitters in the financial markets are driving ever greater austerity.

Unemployment is still rising in the euro zone and has hardly stopped increasing since 2009. The cumulative impact on economic activity is now undermining the legitimacy of the

European project itself, and the drastic remedy is threatening the euro zone with collapse.

What would happen if the euro zone were to change course in 2012?

Assume that the negative fiscal impulse in the euro zone is on the order of -0.5 percent of GDP (instead of the expected total of -1.8 GDP points). This reduced fiscal effort could be repeated until the public deficit or debt reaches a fixed target. Because the effort would be more measured than in current plans, the burden of the adjustment would be spread out more fairly over the taxpayers in each country, while avoiding the burden of drastic cuts in public budgets.

Table 2 summarizes the results of this simulation. Less austerity leads to more growth in all the countries (Table 2a), and all the more so as the fiscal consolidation announced for 2012 intensifies. Our simulation also takes into account the impact of the activity in one country on other countries through trade. Thus, Germany, which has an unchanged fiscal impulse in our scenario, would experience an 0.8 point increase in growth in 2012.

Table 2. Fiscal impulse of -0.5 GDP point in the euro zone in 2012

	GDP (%/yr)		Public deficit (% GDP)		Jobless rate (% active pop.)	
	2011	2012	2011	2012	2011	2012
2012, under current plans	1,5	-0,4	-3,6	-2,9	10,2	10,9
2012, if 0.5% GDP impulse		1,7		-3,1		9,7

Note: The impulse is the change in the structural deficit. The structural deficit is the public deficit excluding the impact of the economic cycle. A negative impulse reflects a restrictive fiscal policy. Here the public («administrations publiques», or "APU") deficit includes the central state, regional government and social security agencies.

Sources: National accounts, OFCE calculations and forecasts.

In the "less austerity" scenario, unemployment would decline instead of continuing to increase. In all the countries except Greece, the public deficit would be lower in 2012 than in 2011. Admittedly, this reduction would be less than in the initial scenario in certain countries, in particular those that have announced strong negative impulses (Spain, Italy, Ireland, Portugal and ... Greece), which are the ones most

mistrusted by the financial markets. In contrast, in some countries, such as Germany and the Netherlands, the government deficit would shrink more than in the initial scenario, with the indirect positive effect of stronger growth outweighing the direct effect of less fiscal consolidation. For the euro zone as a whole, the public deficit would be 3.1 percentage points of GDP, against 2.9 points in the initial scenario. It is a small difference compared to more favorable growth (2.1%), along with lower unemployment (-1.2 points, Table 2) instead of an increase as in the initial scenario.

The key to the “less austerity” scenario is to enable the countries in greatest difficulty, those most obliged to implement the austerity measures that are plunging their economies into the vicious spiral, to reduce their deficits more slowly. The euro zone is split into two camps. On the one hand, there are those who are demanding strong, even brutal austerity to give credibility to the sustainability of public finances, and which have ignored or deliberately underestimated the consequences for growth; on the other are those who, like us, are recommending less austerity to sustain more growth and a return to full employment. The first have failed: the sustainability of public finances has not been secured, and recession and the default of one or more countries are threatening. The second strategy is the only way to restore social and economic – and even fiscal – stability, as it combines a sustainable public purse with a better balance between fiscal restraint and employment and growth, as we proposed in a [letter to the new President of the French Republic](#).

Table 1a. Details on the 4 macroeconomic aggregates for the euro zone from 2009 to 2012

	GDP growth (%/yr)				Public deficit (% GDP)				Jobless rate (% active pop.)				Fiscal impulse (% GDP)			
	2009	2010	2011	2012	2009	2010	2011	2012	2009	2010	2011	2012	2009	2010	2011	2012
DEU	-5,1	3,6	3,1	0,3	-3,2	-4,3	-1,0	-1,1	7,8	7,1	6,0	5,5	0,7	1,2	-0,9	-0,3
FRA	-2,6	1,4	1,7	0,2	-7,5	-7,1	-5,2	-4,4	9,2	9,4	9,3	9,8	2,5	-0,7	-1,7	-1,7
ITA	-5,5	1,8	0,5	-1,7	-5,4	-4,6	-3,8	-2,8	7,8	8,4	8,4	9,4	0,8	-0,4	-1,0	-2,9
ESP	-3,7	-0,1	0,7	-1,1	-11,2	-9,3	-8,5	-6,5	18,0	20,1	21,7	23,5	4,1	-1,9	-1,2	-3,4
NLD	-3,5	1,6	1,3	-1,1	-5,6	-5,1	-5,0	-4,5	3,7	4,5	4,5	5,4	3,8	-1,5	-0,2	-1,9
BEL	-2,7	2,3	1,9	0,1	-5,8	-4,1	-4,0	-3,4	7,9	8,3	7,2	7,6	1,8	-0,3	-0,1	-1,4
PRT	-2,9	1,4	-1,5	-2,9	-10,1	-9,8	-4,0	-4,5	10,7	12,1	12,9	13,4	4,9	-0,6	-5,5	-3,0
IRL	-7,0	-0,4	0,7	-0,3	-14,4	-32,0	-10,1	-8,7	11,9	13,7	14,5	14,9	3,7	-4,1	-2,5	-3,0
GRC	-2,3	-4,4	-6,2	-5,3	-15,8	-10,6	-9,3	-7,3	9,5	12,5	17,2	19,5	3,4	-7,9	-5,6	-5,3
FIN	-8,4	3,7	2,8	0,7	-2,5	-2,5	-1,2	-0,9	8,8	8,4	7,8	7,5	0,4	-1,5	-1,1	-1,1
AUT	-3,6	2,5	3,0	0,4	-4,1	-4,4	-3,4	-3,0	4,8	4,4	4,2	4,5	0,4	0,6	-0,5	-1,2

Note: DEU Germany; FRA France; ITA Italy; ESP Spain; NLD Netherlands; BEL Belgium; PRT Portugal; IRL Ireland; GRC Greece; FIN Finland; AUT Austria.

Sources: National accounts, OFCE calculations and forecasts.

Table 2b. Fiscal impulse of -0.5 GDP point in the euro zone countries in 2012

	DEU	FRA	ITA	ESP	NLD	BEL	PRT	IRL	GRC	FIN	AUT
GDP growth rate (%/yr)	1,1	2,2	1,4	2,6	2,1	1,8	0,7	2,8	0,2	1,9	1,8
Difference with Table 1a	0,8	2,0	3,1	3,7	3,2	1,7	3,6	3,1	5,5	1,2	1,4
Of which: - direct impact	0,0	1,2	2,4	2,9	2,5	0,9	2,5	2,5	4,8	0,6	0,7
- impact <i>via</i> trade	0,8	0,8	0,7	0,8	0,7	0,8	1,1	0,6	0,7	0,6	0,7
Public deficit (% GDP)	-0,7	-4,6	-3,7	-7,5	-4,3	-3,4	-5,2	-9,7	-9,4	-0,9	-3,0
Difference with Table 1a	0,4	-0,2	-0,9	-1,0	0,2	0,0	-0,7	-1,0	-2,1	0,0	0,0
Jobless rate (% active pop.)	5,1	8,8	7,9	21,6	3,8	6,7	11,6	13,3	16,8	6,9	3,8
Difference with Table 1a	-0,4	-1,0	-1,5	-1,9	-1,6	-0,9	-1,8	-1,5	-2,7	-0,6	-0,7

Sources: National accounts, OFCE calculations and forecasts.

A letter to President François Hollande

by Jérôme Creel, Xavier Timbeau and Philippe Weil [\[1\]](#)

Dear Mr. President,

France and the European Union are at a crucial economic juncture. Unemployment is high, the output loss to the financial crisis since 2008 has not been recovered and you have promised, in this dismal context, to eliminate French public deficits by 2017.

Your predecessor had committed to achieving the same objective a tad faster, by 2016, and a distinctive feature of your campaign has been your insistence that the major burden of the coming fiscal retrenchment be borne by the richest of taxpayers. These differences matter politically (you did win this election) but they are secondary from a macroeconomic viewpoint unless the long-run future of France and Europe depends on short-run macroeconomic outcomes.

In the *standard macroeconomic framework*, which has guided policy in “normal” and happier times, fiscal multipliers are positive in the short run but are zero in the long run where productivity and innovation are assumed to reign supreme. In such a world, giving your government an extra year to reduce public deficits spreads the pain over time but makes no difference in the long run. When all is said and done, austerity is the only way to reduce the debt to GDP ratio durably – and it hurts badly:

- The fantasy that short-run multipliers might be negative has been dispelled: a fiscal contraction depresses economic activity unless you are a small open economy acting alone under flexible exchange rates and your own national central bank runs an accommodative monetary policy – hardly a description of today’s France. Since France 2012 is not Sweden 1992, the prospect of a rosier fiscal future is not enough to outweigh the immediate recessionary effects of a fiscal contraction.
- To add insult to injury, if the financial crisis has lowered economic activity permanently (as previous banking or financial crises did, according to the IMF), public finances are now in structural deficit. To insure

long-term debt sustainability, there is no way to escape fiscal restriction.

- On top of this, the consensus now recognizes that short-run fiscal multipliers are low in expansions and high in recessions. As a result, accumulating public debt in good times and refraining from running deficits in order to control debt in bad times is very costly: it amounts to squandering precious fiscal ammunition when there is no enemy and to scrimping on it in the heat of combat.

It increasingly looks like, that we are living, since the financial crisis, in a *“new normal” macroeconomic environment* in which fiscal multipliers are still positive in the short run but non-zero in the long run because of **two conflicting effects**:

- A primal fear of French and European policy makers – fed by the outstanding historical work of Carmen Reinhart and Kenneth Rogoff and the difficulties encountered by Italy, Spain or Greece to roll over their public debt – is that bad things might happen when the debt to GDP ratio steps over 90%. For instance, the sudden realization by investors that, past that level, there is no easy way to bring debt back to “normal” levels without inflation or outright default might lead to a rapid rise in sovereign interest rates. These high rates precipitate an increase in the debt to GDP ratio by raising the cost of servicing the debt and impose intensified deficit reduction efforts that further shrink GDP. Thus, crossing the 90% threshold might lead to a one-way descent into the abyss. This implies that fiscal contraction, although recessionary in the short run, is beneficial in the long run. Fiscal pain now is thus an evil necessary for long-run prosperity and debt sustainability. According to this narrative, we may survive – but only if we stop dancing right away.
- An opposite danger is that fiscal contraction now – in a

context of public finances damaged (except for Greece) not by fiscal laxity but by the slowdown in economic activity engendered by the financial crisis since 2008 – might cause a social, political and economic breakdown or durably destroy productive capacity. Fiscal contraction is thus recessionary both in the short run and in the long run. Short-run fiscal expansion is then a necessary condition for long-run prosperity and debt sustainability. In this narrative, we may survive – but only if we keep dancing!

The advisability of your proposal to reduce the public deficits to zero by 2017 depends, Mr. President, on which of these two dangers is the most intense or the most difficult to thwart. Should you be more concerned that loose fiscal policy may hurt long-run growth by increasing the cost of debt service, or should you fear instead first and foremost that strict fiscal policy may harm output durably by leading to social unrest or by reducing productive capacity?

To answer these portentous questions, whose answer is not a matter of ideology or of economic paradigm, we urge you to look at the evidence:

- The sovereign rating of countries with large deficits and debts, like the US and the UK, has been downgraded without any adverse effect on interest rate. This suggests that markets understand, seemingly better than policymakers, that the key problem with EU public finances nowadays is not deficits and debt per se but the governance of the euro zone and its fiscal and monetary policy mix. With a lender of last resort – the euro zone has none –, managing a national debt crisis would be easy and straightforward. The counter-argument that it would lead the ECB to monetize public debts, in sharp contrast with the statutes of this institution and its duty to reach price stability, is invalid: the ex-ante ability to monetize debt would reduce risk premia

by eliminating self-fulfilling runs on national debts.

- Ugo Panizza and Andrea Presbitero have shown that there is no convincing historical evidence that debt reduction leads to higher economic growth. Hence the statement that public debt reduction is a prerequisite to economic growth is at worst an assumption, at best a correlation, but in any case not a causal relation supported by data.
- Twenty years of Japanese stagnation remind us that deflation is a deadly and durable trap. Under-activity pushes prices down slowly but surely. Paul Krugman and Richard Koo have shown how real expected interest rates feed a spiralling of deleveraging when deflation locks into price expectations. If deleveraging extends to the banking sector, it adds a credit squeeze to the contraction.
- One of the pernicious drawbacks of fiscal austerity is the destruction of human capital by long unemployment spells. Young cohorts entering now on the job market will undergo a problematic start and may never recover. The longer unemployment remains over its natural rate, the larger the frustration stemming from a bleak future will grow.
- Beyond human capital, firms are the place where all sorts of capital are accumulated, ranging from social capital to immaterial assets such as R&D. Philippe Aghion and others have argued that this channel links short-term macroeconomic volatility to long-term growth potential. Moreover, in a competitive world, underinvestment in private R&D impairs competitiveness. Hence, austerity, by making output more volatile, has a negative long-term impact.
- What is true for private immaterial assets is even truer for public assets, that is to say assets that generate flows of public goods that individual incentives fail to produce. Typically, so-called golden rules neglect such assets which are by their very nature hard to measure. As a result, the pursuit of quick deficit reduction is

usually carried out at the expense of investment in assets which have a high social profitability and are essential to ensure a smooth transition to a low carbon economy.

Drawing on these facts, please let us suggest you a four-pronged strategy:

1. You should argue that fiscal austerity is bad for both short-term *and* long-term growth and remind Mrs. Merkel that, as a result, it should be handled with the utmost care.
2. Slowing down the pace at which austerity is imposed on EU countries is vital – both to reduce unemployment in the short-run and to maintain the long-run prosperity without which the reduction of debt-to-GDP ratios will be impossible.
3. You should acknowledge that the fears of your predecessor were well-founded: in the absence of a lender of last resort or without debt mutualization, slowing down austerity does expose sovereign debt to the risk of rising interest rates by provoking the self-fulfilling anxiety of creditors. But the experience of the US shows that the best way to deal with this danger is to have a full-fledged central bank that can act as a lender of last resort. The Maastricht Treaty should be amended fast in that dimension. Endowing the ECB with growth as a second mandate is not essential.
4. Mrs. Merkel is right that allowing the ECB to bail out States is a sure recipe for moral hazard. You should therefore agree, as a complement of the modification of ECB statutes, with her insistence that a Fiscal Compact governs Europe but you should strive for a Smart Fiscal Compact. This Smart Fiscal Compact should aim at enforcing the sustainability of public finances in a world where the long run is not given but depends on the short-run fiscal stance. It should draw its strength

from legitimate European political institutions endowed with the power to control and enforce the commitment of each country to fiscal discipline. This task will require pragmatism and evidence-based economic policy – rather than budgetary numerology and simple-minded rules.

Failing to reduce deficits in Europe may end in a debacle. However, reducing them cold turkey is a sure recipe for disaster. Believing that old tricks like deregulating job markets will bring back economic growth lost in the recession is delusional, as the ILO warned in its last report. The possibility of brutal switches in economic or social trends rules out half-measures. The creeping build-up of long-term disequilibria requires prompt and decisive action in the short run. What is true for France is even truer for our main neighbors: the whole EU needs room for maneuver, and it needs it fast for the sake of its future.

Yours faithfully.

[\[1\]](#) Jérôme Creel is deputy director of the Research Department, Xavier Timbeau is director of the Analysis and Forecasting Department, and Philippe Weil is president of OFCE.

Italy: Mario Monti's challenge

By [Céline Antonin](#)

From his arrival in power on 12 November 2011, Mario Monti has

explicitly set out his aims, which are structured around three points: fiscal discipline, growth and equity. Will he meet the challenge?

Mario Monti succeeded Silvio Berlusconi at a time when investors' lack of confidence in Italy was growing continuously, as was seen in the widening gap with German bond rates and the sharp increase in CDS prices.

Ici graph

To meet his first objective of fiscal discipline, in December 2011 one of the government's first measures was to adopt an austerity plan, which came to 63 billion euros over three years. This plan, the third in a single year, has the evocative name of *Salva Italia* (Save Italy) and aims to achieve a near balance of the public books by 2013 (see [Italy: Mario Monti's wager](#) in French).

The second objective, to restore growth and enhance the country's competitiveness, is addressed in the *Cresci Italia* plan ("Grow Italy") adopted in stormy conditions by the Council of Ministers on 20 January 2012. This plan calls for further reforms, including to simplify administrative procedures (tendering procedures, business creation, digital switchover, etc.) and to liberalize the regulated professions, energy, transportation, and insurance, and in particular to enhance labor market flexibility. The ease with which the austerity measures contained in this second plan were adopted was matched by their poor reception, in particular with regard to discussion of the amendments to Article 18 of the Labour Code, which provides protection against dismissal for employees and workers in firms with more than fifteen employees.

Finally, with respect to equity, progress is still slow, especially in the fight against tax evasion and against the underground economy.

Italians know that these measures will be painful: the financial daily *Il Sole 24 Ore* announced that the annual increase in taxes for an average family living in Lombardy will come to 1,500 euros per year, and almost 2,000 euros for a family from Lazio. Yet up to now the people of Italy have displayed great awareness of the national interest, accepting the cure of fiscal consolidation in a spirit of resignation. As for the financial markets, they initially relaxed the pressure on the country, with the gap in long-term government rates with Germany falling from 530 to 280 basis points from early January to mid-March 2012. Mario Monti's actions are not the only explanation: the ECB's purchase of bonds in late 2011 and its two 3-year refinancing operations (LTRO) of the banking system for a total of 1,000 billion euros, which greatly benefited Italy's banks, definitely helped to ease the pressure on rates. Moreover, the success of the plan for the exchange of Greek debt with private creditors also contributed to easing rates.

The situation is still fragile and volatile: the weakness Spain showed regarding fiscal discipline was enough to trigger a renewed loss of confidence in Italy, as the interest rate differential with Germany on long-term bonds began to rise again, reaching 400 basis points in early May 2012, as did CDS premiums (graph).

So what are the prospects for the next two years? After a recession that began in 2011, with two quarters of negative growth, Italy is expected to experience a difficult year in 2012, with GDP falling sharply by 1.7% as a result of the three austerity plans approved in 2011. Their impact will continue to be felt in 2013, with a further contraction in GDP of -0.9% [\[1\]](#). In the absence of additional austerity measures, this will reduce the country's deficit, but less than expected, due to the [multiplier effect](#): the deficit will fall to 2.8% of GDP in 2012, and to 1.7% in 2013, i.e. a pace of deficit reduction that falls short of its commitment to

balance the public finances by 2013.

[1] The IMF forecast is more pessimistic for 2012, with growth of -1.9%, and more optimistic for 2013, at -0.3 %.

Plea for a growth pact: the sound and fury hiding a persistent disagreement

By [Jean-Luc Gaffard](#) and [Francesco Saraceno](#)

The emphasis on the need to complement fiscal restraint by measures to boost growth, which is rising in part due to the electoral debate in France, is good news, not least because it represents a belated recognition that austerity is imposing an excessively high price on the countries of southern Europe.

Nevertheless, there is nothing new about invoking growth, and this may remain without consequence. In 1997, as a result of a French government intervention, the Stability Pact became the Stability and Growth Pact, but this had no significant impact on the nature of strategy, which remained fully oriented towards the implementation of strict monetary and fiscal rules and a constant search for more flexible markets.

Last week, [Mario Draghi](#), along with [Manuel Barroso and Mario Monti](#), were worried not only about the recession taking place

in Spain, Portugal, the Netherlands and Great Britain but also about the need to respond formally to a request that may come from a new French government. They too are arguing for a negotiated Growth Pact, while taking care to note that it must consist of a common commitment to carry out structural reforms wherever they have not yet been made. This position echoes the February [letter](#) of the eleven Prime Ministers to the European authorities. In other words, nothing is to change in the doctrine that determines the choice of Europe's economic policy: growth can be achieved only through structural reform, in particular of the labour markets.

There are two grounds for criticizing this position. [It is far from sure](#) that structural reform is effective, unless, that is, it is wielded in a non-cooperative spirit to improve the competitiveness of the country that undertakes the reform at the expense of its trading partners, as Germany was able to do with the Hartz reforms. Secondly, widespread reform, including where this is justified in terms of long-term growth, would initially have a recessionary impact on demand [\[1\]](#), and hence on activity. Reform cannot therefore deal with what is actually the immediate top-priority requirement, namely stemming the spreading recession.

The real challenge facing Europeans is to reconcile the short term and the long term. The solution proposed so far, general fiscal austerity aimed at [restoring the confidence of private actors](#), which would be complemented by structural reforms intended to increase the potential growth rate, just doesn't work. This can be seen by developments in Greece, as well as in Portugal and Ireland, which are model students of Europe's bailout plans, and also in Britain, Italy and Spain. The fiscal multipliers remain firmly Keynesian (see [Christina Romer](#), and [Creel, Heyer and Plane](#)), and any "non-Keynesian" effects on expectations are limited or nonexistent.

Growth can neither be decreed nor established instantly, unlike the deflationary austerity spiral in which more and

more European countries are currently trapped.

Growth is likely to materialize only if fiscal consolidation is neither immediate nor drastic – in fact, only if the consolidation required of countries in difficulty is spread over time (beyond the year 2013, which in any case will be impossible to achieve) and if the countries that are able to carry out a more expansionary fiscal policy actually do this in such a way that at the European level the overall impact is neutral or, even better, expansionary. This strategy would not necessarily be punished by the markets, which have shown recently that they are sensitive to the requirement for growth. Otherwise, steps should be taken by the ECB to deal with the constraints imposed by the markets. This short-term support must be accompanied by substantial medium-term investment made through European industrial programs financed by the issuance of Eurobonds – which would mean, finally, a European budget on a scale large enough to handle the tasks facing the Union. This method of coordinating short- and medium-term choices would be an important step towards the establishment of the kind of federal structure that alone will allow the resolution of the “European question”.

[\[1\]](#) R.M. Solow, Introduction to Solow, R.M. Ed. (2004), *Structural Reforms and Macroeconomic Policy*, London: Macmillan).

The financial markets: Sword of Damocles of the presidential election

By [Céline Antonin](#)

Although some of the candidates may deny it, the financial risk linked to the fiscal crisis in the euro zone is the guest of honour at the presidential campaign. As proof that this is a sensitive issue, the launch in mid-April of a new financial product on French debt crystallized concerns. It must be said that this took place in a very particular context: the Greek default showed that the bankruptcy of a euro zone country had become possible. Despite the budgetary firewalls in place since May 2010 (including the European Financial Stability Fund), some of France's neighbours are facing a lack of confidence from the financial markets, which is undermining their ability to meet their commitments and ensure the fiscal sustainability of their government debt, the most worrying example to date being Spain. What tools are available to speculators to attack a country like France, and what should be feared in the aftermath of the presidential election?

The tool used most frequently for speculation on a country's public debt is the Credit Default Swap, or CDS. This contract provides insurance against a credit event, and in particular against a State's default (see the "Technical functioning of CDS" annex for more detail). Only institutional investors, mainly banks, insurance companies and hedge funds, have direct access to the CDS market on sovereign States [\[1\]](#).

Credit default swaps are used not only for coverage, but also as an excellent means of speculation. One criticism made of the CDS is that the buyer of the protection has no obligation to hold any credit exposure to the reference entity, i.e. one

can buy CDS without holding the underlying asset (“naked” purchase/sale). In June 2011, the CDS market represented an outstanding notional amount of 32,400 billion dollars. Given the magnitude of this figure, the European Union finally adopted a Regulation establishing a framework for short-selling: it prohibits in particular the naked CDS on the sovereign debt of European States, but this will take effect only on 1 November 2012.

The FOAT: new instrument for speculation on French debt?

This new financial instrument, introduced by Eurex on April 16 [2], is a futures contract, that is to say an agreement between two parties to buy or sell a specific asset at a future date at a price fixed in advance. The specific asset in this case is the French Treasury OAT bond, with a long residual maturity (between 8.5 and 10.5 years) and a coupon of 6%, and it has a face value of 100,000 euros. Should we worry about the launch of this new contract on the eve of the presidential election? Not when you consider that the launch of the FOAT addresses the gap in yields between German and French bonds that has arisen since the recent deterioration of France’s sovereign rating: previously, as German and French bond yields were closely correlated, the FOAT on German bonds allowed coverage of both German and French bond risks. After the gap in yields between the two countries widened, Eurex decided to create a specific futures contract for French bonds. Italy witnessed this same phenomenon: in September 2009, Eurex also launched three futures contracts on Italian government bonds [3]. In addition, Eurex is a private market under German law, and is much more transparent than the OTC market on which CDS are traded. Note that the FOAT launch was not very successful: on the day it was launched, only 2,581 futures contracts were traded on French bonds, against 1,242,000 on German bonds and 13,671 on Italian bonds [4].

Even if, as with the CDS, the primary function of the FOAT is to hedge against risk, it can also become an instrument for

speculation, including via short selling. While speculation on French debt was previously limited to large investors, with an average notional amount of 15 billion euros per CDS [\[5\]](#), the notional amount of the new FOAT contract is 100,000 euros, which will attract more investors into the market for French debt. If speculators bet on a decline in the sustainability of France's public finances, then the price of futures contracts on the OAT bonds will fall, which will amplify market movements and result in higher interest rates on OAT contracts.

The not so rosy future?

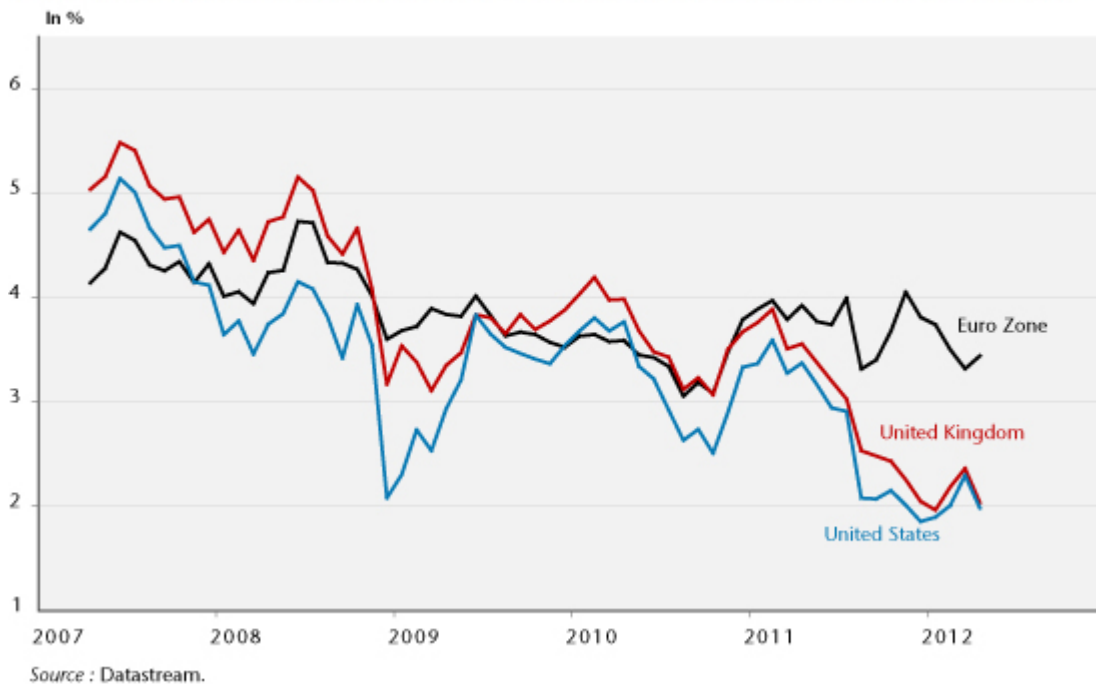
It is difficult to predict how the financial markets will behave in the wake of the French presidential election. Studying what has happened in other euro zone countries is not very informative, due to each one's specific situation. The country most "comparable" to France would undoubtedly be Italy. However, the appointment of Mario Monti in November 2011 took place in an unusual context, where the formation of a technocratic government was specifically intended to restore market confidence through a strenuous effort to reduce the deficit, with Italy also benefitting from the ECB's accommodative policy.

The [French budgetary configuration is different](#), as the financial imperative appears only in the background. The candidates of the two major parties both advocate the need to restore a balanced budget. Their timetables are different (2016 for Nicolas Sarkozy's UMP, 2017 for François Hollande's PS), as are the means for achieving this: for Sarkozy, the focus will be more on restraint in public spending (0.4% growth per year between 2013 and 2016, against 1.1% for the PS), while Hollande emphasizes growth in revenue, with an increase in the tax burden of 1.8% between 2012 and 2017 (against 1% for the UMP).

But this is not the heart of the matter. What is striking,

beyond the need to reduce public deficits in the euro zone countries, is the fact that our destinies are inextricably linked. As is shown by the graph on changes in bond yields in the euro zone (Figure 2), when the euro zone is weakened, all the countries suffer an impact on their risk premium relative to the United States and the United Kingdom, although to varying degrees. It is therefore unrealistic to think about France's budget strategy and growth strategy outside of a European framework. What will prevent the financial markets from speculating on a country's debt is building a Europe that is fiscally strong, has strict rules, and is supported by active monetary policy. This construction is taking place, but it is far from complete: the EFSF does not have sufficient firepower to help countries in difficulty; the growth strategy at the European level agreed at the summit of 2 March 2012 needs to be more comprehensive; and the ECB needs to pursue an active policy, like the Fed, which specifically requires a revision of its statutes. As was pointed out by Standard and Poor's when it announced the downgrade of the French sovereign rating last December, [what will be watched closely by the financial markets is the fiscal consistency of the euro zone.](#) On 6 May 2012, what attitude will the next President then take vis-à-vis the construction of the budget and how able will he be to assert his position in the euro zone – this will determine the future attitude of the financial markets, not only vis-à-vis France, but also vis-à-vis every euro zone country.

Figure 1. Average yields on 10-year bonds in the euro zone, the United States and the United Kingdom



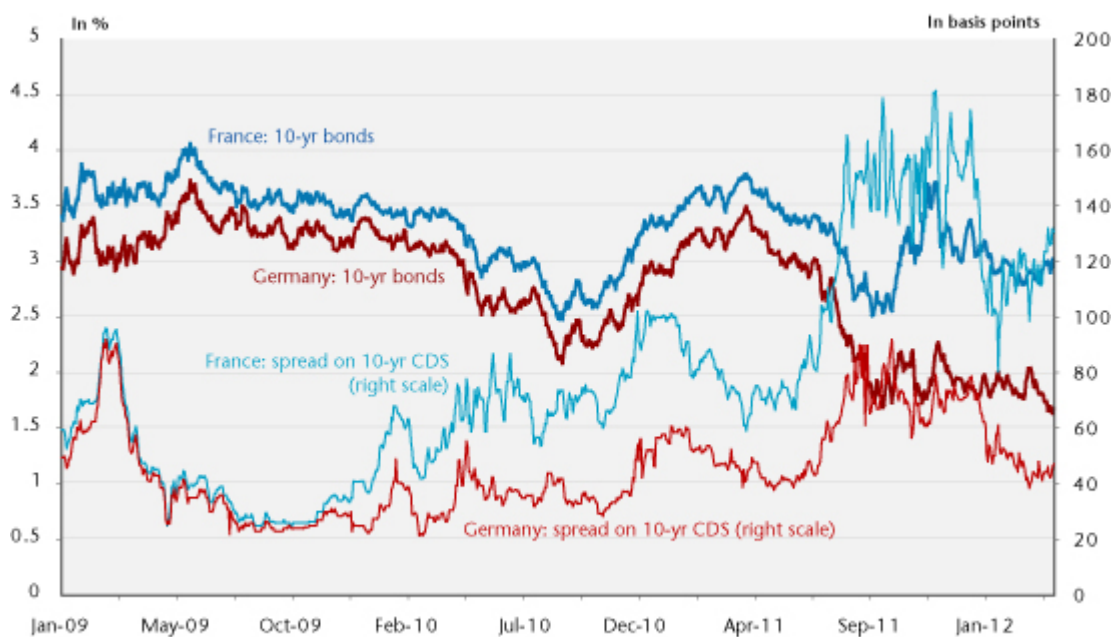
Annex: Technical functioning of Credit Default Swaps

The contract buyer acquires the right to sell a benchmark bond at its face value (called the “principal”) in case of a credit event. The buyer of the CDS pays the seller the agreed amounts at regular intervals, until maturity of the CDS or the occurrence of the credit event. The swap is then unwound, either by delivery of the underlying instrument, or in cash. If the contract terms provide for physical settlement, the buyer of the CDS delivers the bonds to the seller in exchange for their nominal value. If the CDS is settled in cash, the CDS seller pays the buyer the difference between the nominal amount of the buyer’s bonds and the listed value of the bonds after the credit event (recovery value), in the knowledge that in this case the buyer of the CDS retains its defaulted bonds. In most cases, the recovery value is determined by a formal auction process organized by the ISDA ([International Swaps and Derivatives Association](#)). The annual premium that the bank will pay to the insurance company for the right to coverage is called the CDS spread and constitutes the value listed on the market: the higher the risk of default, the more the CDS spread increases (Figure 1). In reality, as the banks are both the buyers and sellers of protection, the spread is usually

presented as a range: a bank can offer a range from 90 to 100 basis points on the risk of a French default. It is thus ready to buy protection against the risk of default by paying 90 basis points on the principal but it demands 100 to provide that protection.

To illustrate this, consider the following example. On 7 May 2012, a bank (buyer) signs a CDS on a principal of 10 million euros for five years with an insurance company (seller). The bank agrees to pay 90 basis points (spread) to protect against a default by the French State. If France does not default, the bank will receive nothing at maturity, but will pay 90,000 euros annually every 7 May for the years 2012-2017. Suppose that the credit event occurs on 1 October 2015. If the contract specifies delivery of the underlying asset, the buyer has the right to deliver its French bonds with a par value of 10 million euros and in exchange will receive 10 million euros in cash. If a cash settlement is expected, and if the French bonds are now listed only at 40 euros, then the insurance company will pay the bank 10 million minus 4 million = 6 million euros.

Annex Figure. France/Germany: premiums on 10-year CDS and 10-year bond yields



Source : Datastream.

[\[1\]](#) Individuals can play on the markets for corporate CDS via trackers (collective investment in transferable securities that replicates the performance of a market index).

[\[2\]](#) The Eurex was created in 1997 by the merger of the German futures market, Deutsche Termin-Börse (DTB), and the futures market in Zurich, the Swiss Options and Financial Futures Exchange (SOFFEX), to compete with the LIFFE. It belongs to Deutsche Börse and dominates the market for long-term financial futures.

[\[3\]](#) In September 2009 for bonds with long residual maturities (8.5 to 11 years), October 2010 for bonds with short residual maturities (2 to 3.25 years) and July 2011 for bonds with average residual maturities (4.5 to 6 years).

[\[4\]](#) Note that this comparison is biased due to the fact that there are 4 types of futures contracts on German debt, 3 on Italian debt and only 1 on French debt.

[\[5\]](#) Weekly data provided by the [DTCC](#) for the week of 9 to 13 April 2012 on CDS on French sovereign debt: the outstanding notional amount came to 1,435 billion dollars, with 6822 contracts traded.

Europe's banks: leaving the

zone of turbulence?

By [Vincent Touzé](#)

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

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

reduction in exposure was most pronounced in Greece (-55% since Q1 2007) and lowest in Portugal (-15%). Divestments of the debt of Spain (-29%), Italy (-33%) and Ireland (39%) have been comparable and are at an intermediate level compared to the previous two.

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

This financial crisis is also hitting the life insurance companies, right in the midst of a period of reform in prudential regulations. The banking sector has just managed to come up to Basel II standards and will steadily have (until 2019) to adopt Basel III (2), while the insurance industry is changing rapidly towards Solvency II (3). These two regulatory

reforms are leading to an increasing need for capital just as the financial crisis is undermining balance sheets and putting greater pressure on capital ratios. While equity capital can be used to withstand a financial crisis, at the same time regulations can compel recapitalizations in very difficult refinancing conditions. This is an undesirable pro-cyclical result of the prudential regulations.

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

crisis.

After the second aid package to Greece on 21 July 2011, and with ongoing pressure on the other sovereign debts, worry seized the stock markets, and European bank stocks fell sharply from August to December 2011 (Figure 2). These stock market changes were in complete contradiction with the positive results of the stress tests. There are three possible ways to interpret the reaction of the financial markets:

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

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

the stock price of banks that are particularly exposed to PIIGS, as evidenced by the strong correlation between CDS on private banks and on sovereign debt in the euro zone (8).

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

to be subtracted from that amount. Given the inability of Greece to resume growth, the sustainability of its remaining debt is not guaranteed, and the risk of contagion persists. In any event, the public debt of the Southern euro zone countries and Ireland are now considered risky assets, which is a factor that is weakening the European banking sector. In this respect, since late March the recent rise in interest rates on Italian and Spanish public debt has provoked a decline in the stock prices of European banks (Figure 2).

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

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

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

ECB to identify and implement the “right” policy mix and the appropriate structural measures.

2) The Greek State is insolvent; this failure in public finances must not be allowed to spread to other economies, since the banking crisis is also a test of the strength of financial solidarity in the euro zone, and it remains to be seen whether the Germans are more inclined to support Spain or Italy in case of a risk of default than they were with Greece.

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

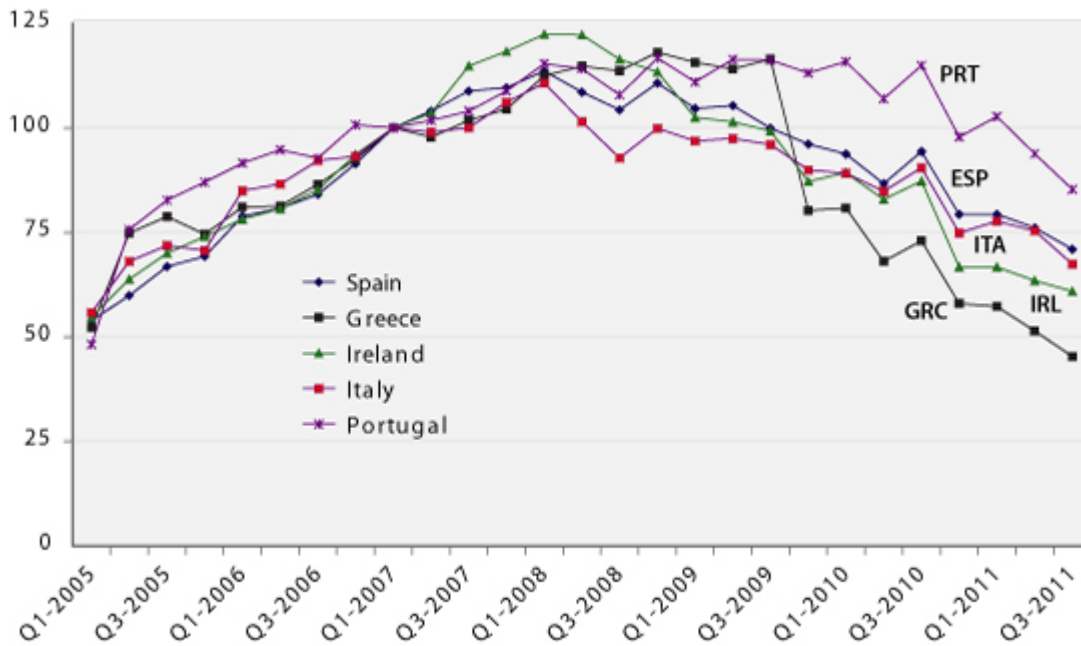
4) The maneuvering room of governments as first responders in a crisis has become very limited due to their massive debt. If there is a new major shock, the ECB could have no other choice but to be the lender of last resort.

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

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

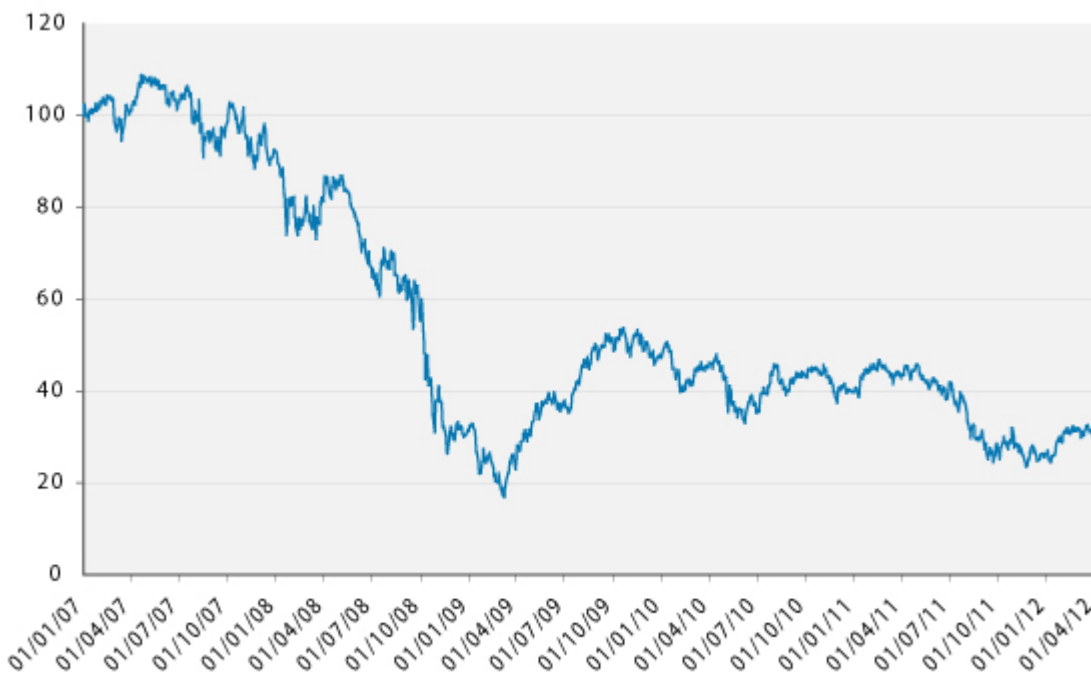
Sources : Banque des règlements internationaux – Consolidated banking statistics / ultimate risk basis – and author's calculations.

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



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

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



Sources : Datastream (FTSE World Europe Banks).

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

[2] http://www.bis.org/speeches/sp100921_fr.pdf

[3]

http://ec.europa.eu/internal_market/insurance/solvency/background_fr.htm.

[4] *European Banking Authority*, 2011, http://stress-test.eba.europa.eu/pdf/EBA_ST_2011_Summary_Report_v6.pdf.

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

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

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

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

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

[10]

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

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

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

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

[13]

http://www.isda.org/dc/docs/EMEA_Determinations_Committee_Decision_0103201202.pdf.

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

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

[16]

http://www.ecb.int/press/pr/date/2011/html/pr111208_1.en.html.

[17] "Les entreprises après la crise", Colloquium Banque de France, 28 June 2011, http://www.banque-france.fr/fileadmin/user_upload/banque_de_france/publications/Bulletin-de%20la-Banque-de-France/Bulletin-de-la-Banque-de-France-etude-185-2.pdf

Towards a major tax reform?

By [Guillaume Allègre](#) and [Mathieu Plane](#) (eds.)

Taxation is more at the heart of the current election campaign and public debate than ever before. The economic and financial crisis, coupled with the goal of rapidly reducing the deficit, is inevitably shaking up the electoral discourse and forcing us to confront the complexity of our tax system. How do taxes interact with each other? What are the effects? How are they measured? What kind of consensual basis and constraints does taxation require? How should the tax burden be distributed among the economic actors? How should social welfare be financed? Should we advocate a “tax revolution” or incremental reform? The contributions to [a special “Tax Reform” issue of the Revue de l’OFCE – Débats et Politiques](#) aim to clarify and enrich this discussion.

The first section of the special issue deals with the requirements and principles of a tax system. In an introductory article, [Jacques Le Cacheux](#) considers the main principles that should underpin any necessary tax reform from the viewpoint of economic theory. In a historical analysis, [Nicolas Delalande](#) emphasizes the role of political resources, institutional constraints and social compromises in drawing up tax policy. [Mathieu Plane](#) considers past trends in taxation from a budgetary framework and analyzes the constraints on public finances today. In response to the problem of imported carbon emissions, [Eloi Laurent and Jacques Le Cacheux](#) propose the implementation of a carbon-added tax.

The second section deals with the issue of how the tax burden

is distributed among households. [Camille Landais, Thomas Piketty and Emmanuel Saez](#) respond to the important article by [Henri Sterdyniak](#) in which he recommends a “tax revolution”. [Clément Schaff and Mahdi Ben Jelloul](#) propose a complete overhaul of family policy. [Guillaume Allègre](#) attempts to shed light on the debate over France’s “family quotient” policy. Finally, [Guillaume Allègre, Mathieu Plane and Xavier Timbeau](#) propose a reform of taxation on wealth.

The third section concerns the financing of social protection. In a sweeping review of the literature, [Mireille Elbaum](#) examines changes in the financing of social protection since the early 1980s, and considers the alternatives that have been proposed and their limits. [Eric Heyer, Mathieu Plane and Xavier Timbeau](#) analyze the impact of the implementation of the “quasi-social VAT” approved by the French Parliament. [Frédéric Gannon and Vincent Touzé](#) present an estimate of the marginal tax rate implicit in the country’s pension system.

The new European treaty, the euro and sovereignty

By [Christophe Blot](#)

On 2 March 2012, 25 countries in the Economic and Monetary Union (EMU) adopted a new treaty providing for greater fiscal discipline. The treaty became an object of dispute almost before the ink was dry [1], as Francois Hollande announced that, if elected, he would seek to renegotiate it in order to emphasize the need to address growth. There is no doubt that a turnabout like this on a treaty that was so fiercely negotiated would be frowned upon by a number of our European

partners. The merit of strengthening fiscal discipline in a time of crisis is, nevertheless, an issue worth posing.

So how should we look at this new treaty? Jérôme Creel, Paul Hubert and Francesco Saraceno have already demonstrated [the potential recessionary impact of the rules it introduces](#). In addition to these macroeconomic effects, the treaty also fails to deal with an essential question that should be at the heart of the European project: sovereignty.

In 1998, one year before the launch of the euro, Charles Goodhart [2] published an article in which he raised a peculiar feature of the Economic and Monetary Union (EMU) with respect to monetary theory and history. Goodhart recalled that a currency is almost always inextricably bound up with the expression of political and fiscal sovereignty. However, in the context of the EMU, this link is broken, as the euro and monetary policy are controlled by a supranational institution even though they are not part of any expression of European sovereignty, as fiscal policy decisions in particular remain decentralized and regulated by the Stability and Growth Pact. Goodhart concluded that the creation of the euro portends tensions that will need careful attention.

The current crisis in the euro zone shows that this warning was well founded. The warning makes it possible above all to consider the crisis from a different perspective – a political one. The issue of the sustainability of the debt and compliance with rules in effect masks the euro's underlying problem, its "original sin": the single currency is doomed if it is not based on fiscal and political sovereignty. If there are any exceptions to this, they consist of micro-states that have abandoned their monetary sovereignty to neighbours that are far more powerful economically and politically. The euro zone is not the Vatican.

The renegotiation of the treaty or the opening of new negotiations with a view to the ratification of a European

Constitution is not only urgent but vital to the survival of the European project. Beyond the overarching objectives of growth, employment, financial stability and sustainable development, which, it must be kept in mind, are at the heart of European construction, as is evidenced by their inclusion in Article 3 of the [Treaty on the European Union](#), any new negotiations should now address the question of Europe's political and fiscal sovereignty, and therefore, by corollary, the issue of the transfer of national sovereignty.

It should be noted that this approach to the implementation of European sovereignty is not inconsistent with the existence of rules. In the United States, most states have had balanced budget rules since the mid-nineteenth century, prior to which a number of them had defaulted (see C.R. Henning and M. Kessler [3]). However, these rules were adopted at the initiative of the states and are not included in the US Constitution. There are, however, ongoing efforts to include a requirement in the Constitution for a balanced budget at the federal level. [For the moment, these have not been successful, and they are being challenged](#) on the grounds that this would risk undermining the stabilizing power of the federal budget. In the United States, before the crisis the resources of the federal state accounted for 19% of GDP, compared with an EU budget that does not exceed 1% of GDP and which must always be balanced, and therefore cannot be used for of macroeconomic adjustments. In the US, the stabilization of shocks is thus handled through an unrestricted federal budget, which offsets the poor responsiveness of local fiscal policies that are constrained by the requirement for balance. While the euro zone must surely find its own way, the fact remains that the euro should not be an instrument in the hands of the European Central Bank alone: it must become a symbol of the political and fiscal sovereignty of all the euro zone's citizens.

[1] It will only take effect, however, after a ratification

process in the 25 countries. This could be a long and uncertain process, as Ireland has announced that it will hold a referendum.

[2] See “The two concepts of money: implications for the analysis of optimal currency areas”, *Journal of European Political Economy* vol.14 (1998) pages 407-432.

[3] “[Fiscal federalism: US history for architects of Europe’s fiscal union](#)”, (2012) Peterson Institute for International Economics.