Competitiveness: danger zone!

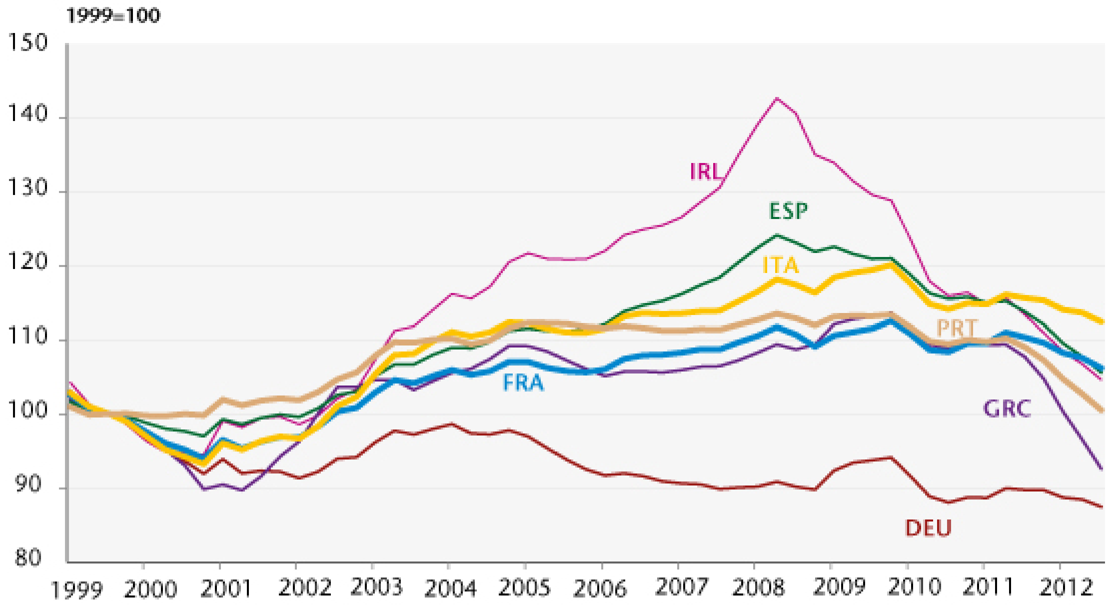
By Céline Antonin, Christophe Blot, Sabine Le Bayon and Catherine Mathieu

The crisis affecting the euro zone is the result of macroeconomic and financial imbalances that developed during the 2000s. The European economies that have provoked doubt about the sustainability of their public finances (Spain, Portugal, Greece and Italy [1]) are those that ran up the highest current account deficits before the crisis and that saw sharp deteriorations in competitiveness between 2000 and 2007. Over that same period Germany gained competitiveness and built up growing surpluses, to such an extent that it has become a model to be emulated across the euro zone, and especially in the countries of southern Europe. Unit labor costs actually fell in Germany starting in 2003, at a time when moderate wage agreements were being agreed between trade unions and employers and the coalition government led by Gerhard Schröder was implementing a comprehensive programme of structural reform. This programme was designed to make the labour market [2] more flexible and reform the financing of social protection but also to restore competitiveness. The concept of competitiveness is nevertheless complex and reflects a number of factors (integration into the international division of production processes, development of a manufacturing network that boosts network effects and innovation, etc.), which also play an important role.

In addition, as is highlighted in a recent analysis by Eric Heyer, Germany's structural reforms were accompanied by a broadly expansionary fiscal policy. Today, the incentive to improve competitiveness, strengthened by the implementation of improved monitoring of macroeconomic imbalances (see here), is part of a context marked by continued fiscal adjustment and high levels of unemployment. In these conditions, the implementation of structural reforms coupled with a hunt for gains in competitiveness could plunge the entire euro zone into a deflationary situation. In fact, Spain and Greece have already been experiencing deflation, and it is threatening other southern Europe countries, as we show in our latest forecast. This is mainly the result of the deep recession hitting these countries. But the process is also being directly fueled by reductions in public sector wages, as well as in the minimum wage (in the case of Greece). Moreover, some countries have cut unemployment benefits (Greece, Spain, Portugal) and simplified redundancy procedures (Italy, Greece, Portugal). Reducing job protection and simplifying dismissal procedures increases the likelihood of being unemployed. In a context of under-employment and sluggish demand, the result is further downward pressure on wages, thereby increasing the deflationary risks. Furthermore, there has also been an emphasis on decentralizing the wage bargaining process so that they are more in tune with business realities. This is leading to a loss of bargaining power on the part of trade unions and employees, which in turn is likely to strengthen downward pressure on real wages.

The euro zone countries are pursuing a non-cooperative strategy that is generating gains in market share mainly at the expense of other European trading partners. Thus since 2008 or 2009 Greece, Spain, Portugal and Ireland have improved their competitiveness relative to the other industrialized countries (see graph). The continuation of this strategy of reducing labor costs could plunge the euro zone into a deflationary spiral, as the countries losing market share seek in turn to regain competitiveness by reducing their own labour costs. Indeed, this non-cooperative strategy, initiated by Germany in the 2000s, has already contributed to the crisis in the euro zone (see the box on p.52 of the ILO report published in 2012). It is of course futile to hope that the continuation of this strategy will provide a solution to the current crisis. On the contrary, new problems will arise, since deflation [3] will make the process of reducing both public and private debt more expensive, since debt expressed in real terms will rise as prices fall: this will keep the euro zone in a state of recession.

Figure 1. Competitiveness measured by unit labour costs (total economy)



Note: A fall in the indicator expresses an improvement in competitiveness.
Source: European Commission.

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[1] The Irish case is somewhat distinct, as the current account deficit seen in 2007 was due not to trade, but a shortfall in income.

[2] These reforms are examined in detail in a report by the Conseil d'analyse économique (no. 102). They are summarized in a special study La quête de la compétitivité ouvre la voie de la déflation ("The quest for competitiveness opens the door to deflation").

[3] For a more comprehensive view of the dynamics of debt-driven deflation, see here.

Monetary policy and property booms: dealing with the heterogeneity of the euro zone

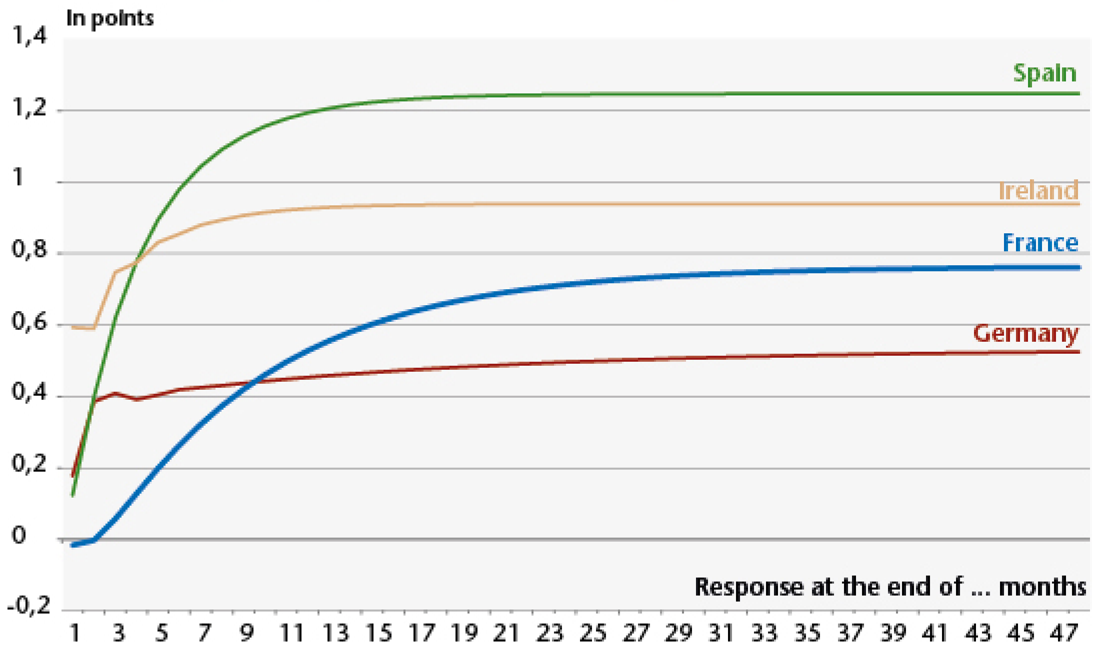
By [Christophe Blot] and Fabien Labondance

The transmission of monetary policy to economic activity and inflation takes place through various channels whose role and importance depend largely on the structural characteristics of an economy. The dynamics of credit and property prices are at the heart of this process. There are multiple sources of heterogeneity between the countries of the euro zone, which raises questions about the effectiveness of monetary policy but also about the means to be used to reduce this heterogeneity.

The possible sources of heterogeneity between countries include the degree of concentration of the banking systems (*i.e.* more or fewer banks, and therefore more or less competition), the financing arrangements (*i.e.* fixed or variable rates), the maturity of household loans, their levels of debt, the proportion of households renting, and the costs of transactions on the housing market. The share of floating rate loans perfectly reflects these heterogeneities, as it is 91% in Spain, 67% in Ireland and 15% in Germany. In these conditions, the common monetary policy of the European Central Bank (ECB) has asymmetric effects on the euro zone countries, as is evidenced by the divergences in property prices in these countries. These asymmetries will then affect GDP growth, a phenomenon that has been observed both “before” and “after” the crisis. These issues are the subject of an article that we published in the OFCE's [Ville et Logement] (Housing and the City) issue. We evaluated heterogeneity in the transmission of monetary policy to property prices in the euro zone by explicitly distinguishing two steps in the transmission channel, with each step potentially reflecting different sources of heterogeneity. The first describes the impact of the interest rates controlled by the ECB on the rates charged for property loans by the banks in each euro zone country. The second step involves the differentiated impact of these bank rates on property prices.

Our results confirm the existence of divergences in the transmission of monetary policy in the euro zone. Thus, for a constant interest rate set by the ECB at 2%, as was the case between 2003 and 2005, the estimates made during the period preceding the crisis suggest that the long-term equilibrium rate applied respectively by Spanish banks and Irish banks would be 3.2% and 3.3%. In comparison, the equivalent rate in Germany would be 4.3%. Moreover, the higher rates in Spain and Ireland amplify this gap in nominal rates. We then show that the impact on bank rates of changes in the ECB's key rate is, before the crisis, stronger in Spain and Ireland than it is in Germany (figure), which is related to differences in the share of loans made at floating rates in these countries. It should be noted that the transmission of monetary policy was severely disrupted during the crisis. The banks did not necessarily adjust supply and demand for credit by changing rates, but by tightening the conditions for granting loans. [1] Furthermore, estimates of the relationship between the rates charged by banks and property prices suggest a high degree of heterogeneity within the euro zone. These various findings thus help to explain, at least partially, the divergences seen in property prices within the euro zone. The period during which the rate set by the ECB was low helped fuel the housing boom in Spain and Ireland. The tightening of monetary policy that took place after 2005 would also explain the more rapid adjustment in property prices observed in these two countries. Our estimates also suggest that property prices in these two countries are very sensitive to changes in economic and population growth. Property cycles cannot therefore be reduced to the effect of monetary policy.

Figure. Impact on bank rates of a 1 point hike in ECB rates



Source : Authors' calculations.

To the extent that the recent crisis has its roots in the macroeconomic imbalances that developed in the euro zone, it is essential for the proper functioning of the European Union to reduce the sources of heterogeneity between the Member states. However, this is not necessarily the responsibility of monetary policy. First, it is not certain that the instrument of monetary policy, short-term interest rates, is the right tool to curb the development of financial bubbles. And second, the ECB conducts monetary policy for the euro zone as a whole by setting a single interest rate, which does not permit it to take into account the heterogeneities that characterize the Union. What is needed is to encourage the convergence of the banking and financial systems. In this respect, although the proposed banking union still raises many problems (see Maylis Avaro and Henri Sterdyniak), it may reduce heterogeneity. Another effective way to reduce asymmetry in the transmission of monetary policy is through the implementation of a centralized supervisory policy that the ECB could oversee. This would make it possible to strengthen the resilience of the financial system by adopting a means of regulating banking credit that could take into account the situation in each country in order to avoid the development of the bubbles that pose a threat to the countries and the stability of the monetary union (see CAE report no. 96 for more details).

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[1] Kremp and Sevestre (2012) emphasize that the reduction in borrowing volumes is not due simply to the rationing of the supply of credit but that the recessionary context has also led to a reduction in demand.

What factors have put the brakes on growth since 2010?

By Eric Heyer and Hervé Péléraux

At the end of 2012, five years after the start of the crisis, France’s GDP has still not returned to its earlier level (Figure 1). At the same time, the labour force in France has grown steadily and technical progress has constantly raised workers’ productivity. We are therefore more numerous and more productive than 5 years ago when output was lower: the explosion in unemployment is a symptom of this mismatch. Why had the shoots of recovery seen in 2009 been choked off by mid-2010?

The main factor stifling the recovery has been the austerity measures that were enacted in France and Europe in 2010 and then intensified in 2011 and 2012 (Table 1). The impact of austerity has been all the more marked as it has been generalized throughout the euro zone. The effects of domestic cutbacks have combined with the effects of undercutting demand from other European partners. Given that 60% of France's exports are to the European Union, any external stimulus had virtually vanished by mid-2012, less due to the slowdown in global growth, which is still almost 3%, than to the consequence of the poor performance of the euro zone, which is on the brink of recession.

It is austerity that is at the root of the lack of growth: after shaving -0.7 GDP point off growth in 2010, its effects increased in 2011 and 2012 (respectively -1.5 and -2.1 points) because of the stepped-up measures and the existence of high fiscal multipliers. Indeed, in a period of low economic activity simultaneously tightening fiscal policy in all the European countries while there is very little manoeuvring room for monetary policy (real interest rates close to zero) has led to raising the value of the multiplier. There is now a broad consensus that the short-term fiscal multipliers are high, especially as full employment is still out of reach (see Heyer (2012) for a review of the literature on multipliers). The theoretical debate about the value of the multiplier and the role of agents' expectations must give way to empirical observation: the multipliers are positive and greater than 1.

In addition to the fiscal drag, there is the effect of tight monetary conditions: the easing of monetary policy – seen in particular in the lower key interest rates – is far from enough to offset the negative effect on the economy of tighter borrowing conditions and the widening of the spread between private investment and risk-free public investment.

All things considered, including taking into account the impact of the resurgence in oil prices after the onset of the recession, the spontaneous growth of the French economy would have averaged 2.6% over the past three years. The realization of this potential would have led to a further reduction in excess production capacity and would ultimately have cut short the downturn in the economy that actually took place.

In the Netherlands, change is for now!

By Christophe Blot

While France has just reaffirmed that it will meet its commitment to reduce its budget deficit to below 3% by 2014 (see Eric Heyer), the Netherlands has announced that it is abandoning this goal on the grounds that additional austerity measures could jeopardize growth. The country plunged into recession in 2012 (-1%), and GDP will fall again in 2013 (see the analysis of the CPB, the Netherlands Bureau for Economic Policy Analysis). In these circumstances, the social situation has deteriorated rapidly, with a 2 percentage point rise in unemployment in five quarters. In the first quarter of 2013, 7.8% of the workforce was out of work. Beyond the implications for the Netherlands itself, could this rejection of austerity (finally) signal a shift in Europe's strategy of fiscal consolidation?

Up to now, the coalition government elected in September 2012 and led by the Liberal Mark Rutte had followed the general strategy of consolidation, with expectations of rapidly bringing the deficit below 3%. However, the austerity measures already being implemented together with an adjustment in the housing market and the general decline in activity throughout the euro zone led the Netherlands into a new recession in 2012 and put off the prospects of meeting the budget target in 2013. In view of the European Commission's projections for growth and for the budget deficit in 2013, it does however seem that the Dutch government would have been able to achieve a deficit of 3% in 2014, but like France, at the cost of taking additional measures.

The budget deficit is expected by the Commission to come to 3.6% in 2013. The CPB expects an even slightly lower deficit (3.3%), using growth forecasts similar to those of the Commission. In these conditions, the fiscal effort required to reach the 3% target in 2014 would amount to between 3.5 and 7 billion euros. In comparison, for France this would require the approval of additional austerity measures for 2014 amounting to 1.4 GDP points, *i.e.* just under 30 billion euros (see France: holding to the required course).

However, under pressure from the social partners, the Dutch government ultimately abandoned the plan announced on March 1 that provided for savings of 4.3 billion euros, which mainly consisted of a wage freeze in the public sector, a freeze in the income tax scale and the stabilization of public spending in real terms. Putting austerity on hold like this should give a small boost to the economy without calling into question fiscal sustainability, as the improved prospects for growth should reduce the cyclical component of the budget deficit.

While the 3% target will of course not be met, it is not at all clear that the markets will make much out of this infringement of the rules. In fact, the difference in interest rates vis-à-vis the German rate has stabilized since it was announced that the plan had been abandoned, whereas the difference had tended to increase in the previous weeks (see figure).

While this decision should not upset the economic and financial stability of the Netherlands or the euro zone, it does nevertheless send a strong anti-austerity signal from a country that had hitherto favored fiscal consolidation. It is therefore one more voice that is challenging the effectiveness of this strategy and emphasizing the economic and social risks associated with it (see here for an overview of the case against austerity and the 2013 iAGS report for more specific points concerning an alternative strategy for Europe). It is also a decision that should give France inspiration. Credibility is not necessarily gained by sacrificing one objective (growth and employment) for another (the budget deficit). It is still necessary to await the response of the European Commission in that the Netherlands, like most countries in the euro zone, is subject to an excessive deficit procedure. If the decision of the Netherlands is not challenged, then this will represent a significant shift in European macroeconomic strategy.

The chalice of austerity, right to the dregs

Céline Antonin, Christophe Blot and Danielle Schweisguth

This text summarizes the OFCE's April 2013 forecasts

The macroeconomic and social situation in the euro zone continues to cause concern. The year 2012 was marked by a further decline in GDP (-0.5%) and a continuing rise in the unemployment rate, which reached 11.8% in December. While this new recession is not comparable in magnitude to that of 2009, it is comparable in duration, as GDP fell for the fifth consecutive time in the last quarter of 2012. Above all, for some countries (Spain, Greece and Portugal), this prolonged recession marks the beginning of deflation that could quickly spread to other countries in the euro zone (see The onset of deflation). Finally, this performance has demonstrated the failure of the macroeconomic strategy implemented in the euro zone since 2011. The strengthening of fiscal consolidation in 2012 did not restore market confidence, and interest rates did not fall except from the point when the risk of the euro zone's collapse was mitigated by the ratification of the Treaty of stability, coordination and governance (TSCG) and the announcement of the new WTO operation allowing the ECB to intervene in the sovereign debt markets. Despite this, the fiscal dogma has not been called into question, meaning that in 2013, and if necessary in 2014, the euro zone countries will continue their forced march to reduce their budget deficits and reach the symbolic threshold of 3% as fast as possible. The incessant media refrain that France will keep its commitment is the perfect reflection of this strategy, and of its absurdity (see France: holding the required course). So until the chalice has been drunk to the dregs, the euro zone countries seem condemned to a strategy that results in recession, unemployment, social despair and the risk of political turmoil. This represents a greater threat to the sustainability of the euro zone than the lack of fiscal credibility of one or another Member State. In 2013 and 2014, the fiscal stimulus in the euro zone will again be negative (-1.1% and -0.6%, respectively), bringing the cumulative tightening to 4.7 GDP points since 2011. As and to the extent that countries reduce their budget deficits to less than 3%, they can slow the pace of consolidation (Table). While in the next two years Germany, which has already balanced the public books, will cease its consolidation efforts, France will have to stay the course in the hope of reaching 3% in 2014. For Spain, Portugal and Greece, the effort will be less than that what has already been done, but it will continue to be a significant burden on activity and employment, especially as the recessive impact of past measures continue to be felt.

In this context, the continuation of a recession is inevitable. GDP will fall by 0.4% in 2013. Unemployment is expected to break new records. A return to growth is not expected until 2014, but even then, in the absence of any relaxation of the fiscal dogma, hopes may again be disappointed since the anticipated growth of 0.9% will be insufficient to trigger any significant decline in unemployment. In addition, the return to growth will come too late to be able to erase the exorbitant social costs of this strategy, while alternatives to it are discussed inadequately and belatedly.

Table. Public balance and fiscal impulse in the euro zone countries

In GDP points

	Public deficit			Fiscal impulse	
	2012	2013 (p)	2014 (p)	2013 (p)	2014 (p)
Germany	0,2	-0,4	-0,1	0,1	0,0
Austria	-3,0	-2,5	-1,8	-0,6	-0,3
Belgium	-3,0	-2,8	-1,9	-0,5	-1,0
Spain	-10,2	-6,5	-5,8	-2,0	-1,1
Finland	-1,6	-1,5	-0,9	-0,8	-0,7
France	-4,8	-3,9	-3,0	-1,8	-1,4
Greece	-6,6	-5,4	-4,5	-3,8	-2,0
Ireland	-8,2	-8,4	-6,6	-1,9	-1,8
Italy	-3,0	-3,9	-3,4	-1,4	-0,7
Netherlands	-4,1	-3,4	-3,0	-1,7	-0,7
Portugal	-5,0	-4,4	-3,0	-2,1	-1,9
Euro zone 11*	-3,2	-2,6	-1,8	-1,1	-0,6

* Excluding Cyprus, Luxembourg, Malta, Slovakia and Estonia.

Sources : Eurostat, European Commission, OFCE calculations and forecast March 2013.

France: the rise in cyclical unemployment continues

By Bruno Ducoudré

The Great Recession, which began in 2008, has resulted in a continuous and inexorable rise in unemployment in France, by 3.1 percentage points between the low point reached in the first quarter of 2008 (7.1% in mainland France) and the peak in the fourth quarter of 2012. The unemployment rate is now close to the record levels reached in the late 1990s. This rise can be broken down into a change in the rate of cyclical unemployment due to the lack of economic growth, and a change in the rate of structural unemployment. The latter gives information on the extent of the output gap, which is crucial for measuring the structural deficit. Consequently, any choice about the fiscal policy to be adopted to re-balance the public finances needs an analysis of the nature of the additional unemployment generated by the crisis. In other words, has the crisis mainly resulted in cyclical unemployment or structural unemployment?

A study of the Non-Accelerating Inflation Rate of Unemployment (NAIRU)[1] offers one way of analysing whether the unemployment is structural or cyclical. Based on an estimate of the wage-price spiral, we propose in the OFCE's 2013-2014 forecasts for the French economy taking a look at the level of the equilibrium rate of unemployment (ERU) using a recursive estimate of the NAIRU since 1995 in order to identify the share of cyclical unemployment.

Table. Estimates of the equilibrium rate of unemployment

In %

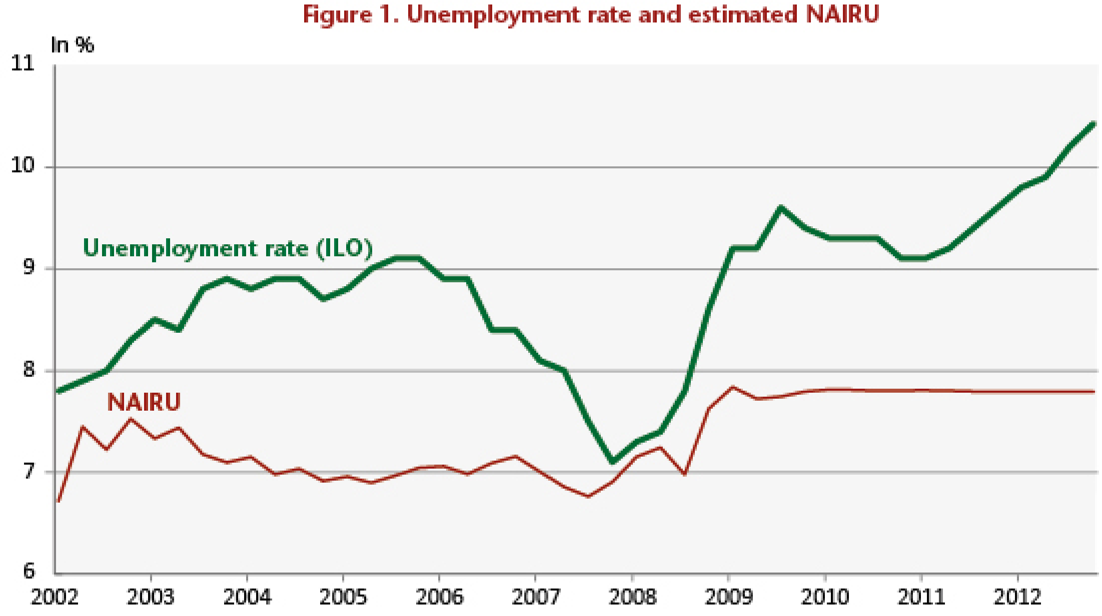
Périod	2000-2012	2000-2007	2008-2012
NAIRU	7,2	6,8	7,7

Note : Hypotheses on exogenous factors: values observed on average over the periods 2000-2007 and 2008-2012. The productivity trend equals 1.1.
Source : OFCE calculations.

First, our estimate of the ERU takes good account of the lack of real inflationary pressures since 1995. Indeed, the actual unemployment rate is consistently higher than the ERU over this period (Figure 1). However, between 1995 and 2012 underlying inflation varies between 0 and 2%. It reaches 2% in 2002 and 2008, times when the actual unemployment rate is closer to the ERU, although this does not reflect the real inflationary pressures. In 2012, the increase in the unemployment rate led to a wider gap with the equilibrium rate of unemployment and was accompanied by a slowdown in underlying inflation, which fell below 1% by the end of the year.

Second, the NAIRU is estimated at 7.2% on average over the years 2000-2012, with an average inflation rate of 1.9% over the period. Inflation rose to an average 7.7% over the period 2008-2012 (Table 1) and to 7.8% in 2012 (Figure 1).

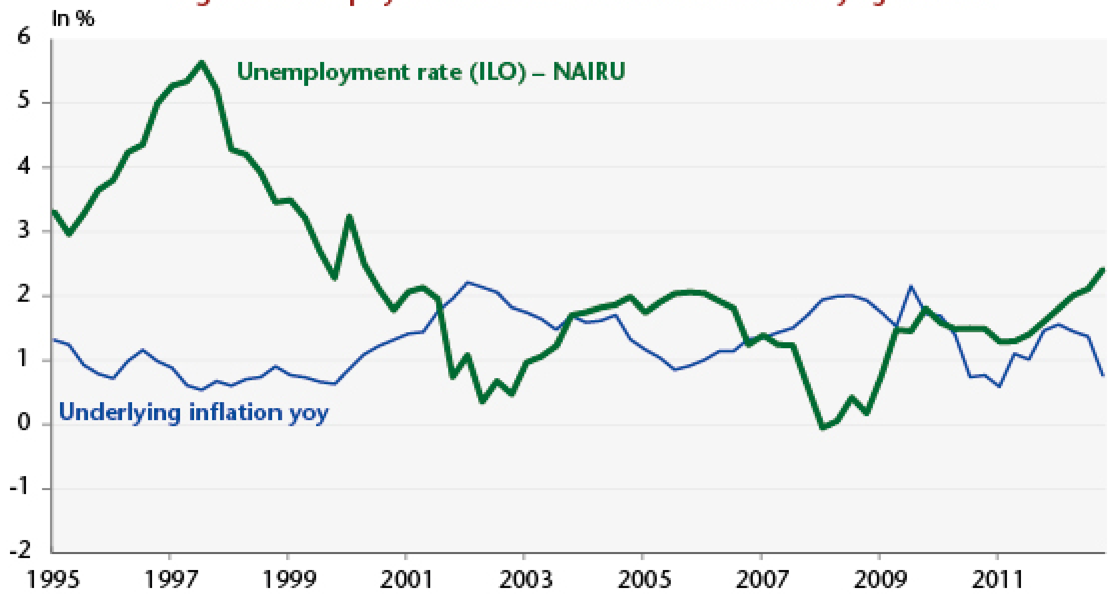
Figure 1. Unemployment rate and estimated NAIRU



Sources : INSEE, OFCE calculations.

Third, these estimates also indicate that the NAIRU has increased by 0.9 percentage points since the onset of the crisis. This explains at most 30% of the rise in the unemployment rate since 2008, with the remainder coming from an increase in cyclical unemployment. The cyclical component of unemployment would therefore represent 2.1 percentage points of unemployment in 2012. This change in the gap between the actual unemployment rate and the equilibrium rate of unemployment is also consistent with underlying inflation, which has been declining since 2009. Given our forecast of unemployment, this gap will increase by 1.5 percentage points, to a level of 3.6% in 2014 on an annual average.

Figure 2. Unemployment rate-NAIRU difference and underlying inflation



Sources : INSEE, OFCE calculations.

Estimates of the equilibrium rate of unemployment thus indicate that the gap with the actual unemployment rate has widened during the crisis. The share of cyclical unemployment has increased, with the rise in cyclical unemployment accounting for about 70% of the rise in the unemployment rate since 2008. This confirms our diagnosis of a high **output gap** for the French economy in 2012, a gap that will continue to widen in 2014 under the combined impact of fiscal austerity and a high fiscal multiplier.

This text draws on the analysis of the economic situation and the forecast for 2013-2014, which is available [in French] on the OFCE site.

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[1] The NAIRU is the rate of unemployment at which the inflation rate remains stable. Above it, inflation slows,

which eventually makes possible an increase in employment and a reduction in unemployment. Below it, the dynamic is reversed, leading to higher inflation, a fall in employment and a return of unemployment to its equilibrium level.

Cyprus: Aphrodite to the rescue?

By Céline Antonin and Sandrine Levasseur

For two weeks Cyprus sent tremors through the European Union. If the banking crisis that the island is going through has attracted much attention, it is essentially for two reasons. First, because the dithering over the rescue plan led to a crisis of confidence in deposit insurance, and second, because it was the first time that the European Union had allowed a bank to fail without coming to its aid. While the method of resolving the Cyprus crisis seems to represent an institutional advance [1], insofar as investors have been forced to face up to their responsibilities and citizens no longer have to pay for the mistakes of the banks, the impact of the purge of the island's real economy will nevertheless be massive. With its heavy dependence on the banking and financial sector, Cyprus is likely to face a severe recession and will have to reinvent a growth model in the years to come. In this respect, the exploitation of natural gas resources seems an interesting prospect that should not be ruled out in the medium / long term.

To grasp what is at stake in Cyprus today, let us briefly recall the facts. On 25 June 2012, Cyprus requested financial assistance from the EU and the IMF, essentially in order to bail out its two main banks (Laiki Bank and Bank of Cyprus), whose losses are estimated at 4.5 billion euros due to their high exposure to Greece. Cypriot banks were hit both by the depreciation of the Greek assets they held on their balance sheets and by the partial write-down of Greek debt under the second bail-out plan (PSI Plan of March 2012 [2]). Cyprus estimated that it needed 17 billion euros in total over four years to prop up its economy and its banks, about one year of the island's GDP (17.9 billion euros in 2012). But its backers were not ready to give it this much: the national debt, which had already reached 71.1% of GDP in 2011, would become unsustainable. The IMF and the euro zone thus came to an agreement on a smaller loan, with a maximum amount of 10 billion euros (9 billion financed by the euro zone and 1 billion by the IMF) to recapitalize the Cypriot banks and finance the island's budget for three years. Cyprus was in turn ordered to find the remaining 7 billion through various reforms: privatizations, an increase in corporate tax from 10 to 12.5%, and a windfall tax on bank deposits.

Initially [3], Nicosia decided to introduce a one-off tax of 6.75% on deposits of between 20,000 and 100,000 euros and 9.9% on those above 100,000 euros, and a withholding tax on interest on these deposits. Given the magnitude of the resulting protest, the government revised its approach, and the taxation of deposits gave way to a bankruptcy and restructuring. The solution adopted concerned the country's two main banks, Laïki Bank and Bank of Cyprus. Laïki was closed and split into two: first, a "good bank" that will take over the insured deposits (less than 100,000 euros) and the loans from the ECB to Laïki [4], but which will also take over its assets and ultimately be absorbed by Bank of Cyprus; and second, a "bad bank" that will accommodate the stocks, bonds, unsecured deposits (above 100,000 euros), and which will be used to pay off Laïki's debts [4], according to the order of priority associated with bank liquidations (depositors being paid first). In addition to absorbing the “good bank” hived off of Laïki, Bank of Cyprus will freeze its unsecured deposits, some of which will be converted into shares to be used in its recapitalization. To prevent a flight of deposits, temporary [5] capital controls were put in place.

This plan introduces a paradigm shift in the method of resolving banking crises in the European Union. At the beginning of the euro zone crisis, in particular in the emblematic case of Ireland, the European Union considered that creditors had to be spared in the event of losses, under the logic of “too big to fail”, and it called on the European taxpayer. But in 2012, even before the declaration of Jeroen Dijsselbloem, Europe’s doctrine had already begun to bend [6]. Hence, on 6 June 2012, the European Commission proposed a Directive on the reorganization and resolution of failing credit institutions, which provided for calling on shareholders and bondholders to contribute. [7] However, the rules on creditors are to apply only from 2018, after approval of the text by the Council and the European Parliament. This type of approach is now being tested experimentally in the Cyprus crisis.

Heavy consequences for the real economy

The situation of the country before 2008

In the period preceding the global economic crisis, the Cypriot economy was thriving, and indeed in 2007 even in danger of overheating. Over the period 2000-2006, its GDP grew on average by 3.6% per year, with growth of 5.1% in 2007. The unemployment rate was low (4.2% in 2007), with even some labour shortage as a result of the emigration of Cypriot nationals to other EU countries. The influx of foreign workers into Cyprus helped to hold down wages. Consumer spending and, to an even greater extent, business investment, which were largely financed through credit, were particularly dynamic starting in 2004, with growth rates that in 2007 reached, respectively, 10.2% and 13.4%. Inflation was moderate, and in this generally positive context, Cyprus qualified to adopt the euro on 1 January 2008.

In this pre-crisis period, the Cypriot economy – a small, very open economy – relied in the main on two sectors: tourism and financial services.

The two key sectors of the Cypriot economy

Revenue from tourism (Table 1) has provided a relatively stable financial windfall for the Cypriot economy. This (non-cyclical) flow brings in approximately 2 billion euros annually. [8] As a share of GDP, however, the weight of tourism has decreased by half since 2000, to a level of less than 11% in 2012. Likewise, the share of tourism in the export of services fell sharply during the last decade: in 2012, it accounted for 27% (against 45% in 2000). Over the last 15 years, the number of tourists has fluctuated somewhat between 2.1 million (in 2009) and 2.7 million (2000), compared with about 850,000 people who are residents of the island.

Financial services constitute the other pillar of the Cypriot economy (Table 2). Two figures give a clear idea of its significance: bank assets accounted for more than 7.2 times GDP in 2012 (with a maximum of 8.3 achieved in 2009), and the stock of FDI in the sector "Finance & Insurance" is estimated at more than 35% of GDP, *i.e.* more than 40% of all FDI inflows.

Table 1. Weight of tourism in Cyprus

	2000	2004	2009	2012
Tourist revenue				
In millions of €	2 040,1	1 678,4	1 493,2	1 926
In % of GDP	20,5	13,3	8,9	10,8
By tourist (in €)	759	715	697	781
In % of services exports	44,8	32,6	25,0	26,8
Tourists (1000s of people)	2 686	2 349	2 141	2 465

Source: Central Bank of Cyprus and National statistical office. Author's calculations.

Table 2. Weight of the banking sector in Cyprus

	2007	2008	2009	2010	2011	2012
Banking assets						
In billions of €	92,9	118,1	139,4	135,0	131,6	128,1
Relative to GDP	5,8	6,9	8,3	7,8	7,3	7,2
Stock of FDI in the Finance and Insurance sector						
In billions of €						6,4
In % of GDP						35,6
In % of total FDI						41,6

Source: Central Bank of Cyprus and National statistical office. Author's calculations.

As major sources of wealth for the Cypriot economy, these two sectors have played an important role by, at least until 2007, compensating (partially) the considerable deficit in the balance of payments, which has risen continuously since the early 1990s and fluctuated at around 30% of GDP since 2000 (Table 3). The “fuel” bill has been an increasing burden on imports into Cyprus, mainly due to higher oil prices: the energy bill has tripled over the last decade, rising from 461 million euros in 2000 to 1.4 billion in 2011. As a percentage of GDP, the rise in energy costs has also been very visible, as it has shot up from 5% of GDP in 2000 to 8% in 2011.

Reducing the size of the financial sector therefore raises the question of a new growth model for the Cypriot economy, *i.e.* its “industrial conversion”.

Table 3. Extract from the balance of payments of Cyprus

In millions of € (unless stated otherwise)

		2000	2004	2007	2008	2009	2010	2011
Balance of goods								
Exports	Total	1 011	936	1 083	1 190	971	1 137	1 404
	o/w "re-exports"	600	521	578	643	491	570	777
Imports	Total	4 104	4 578	6 353	7 367	5 692	6 517	6 311
	o/w "fuels"	461	503	895	1 247	880	1 157	1 381
Exports - Imports	Total	-3 093	-3 641	-5 271	-6 176	-4 721	-5 381	-4 907
	Total (% of GDP)	-31 %	-29 %	-33 %	-36 %	-28 %	-31 %	-27 %
Balance of services								
Exports	Total	4 552	5 147	6 579	6 538	5 779	6 049	6 262
Imports	Total	1754,40	2 201	2 841	2 937	2 416	2 467	2 676
Exports - Imports	Total	2 797	2 946	3 739	3 601	3 363	3 583	3 586
	Total (% of GDP)	28 %	23 %	24 %	21 %	20 %	21 %	20 %
Balance of goods and services								
Exports - Imports	Total	-295	-696	-1 532	-2 575	-1 358	-1 798	-1 321
	Total excl. "fuels"	165	-192	-637	-1 328	-479	-641	60
	Total (% of GDP)	-3 %	-6 %	-10 %	-15 %	-8 %	-10 %	-7 %
	Total excl. "fuels" (% of GDP)	2 %	-2 %	-4 %	-8 %	-3 %	-4 %	0 %

Source: Office statistique national, Eurostat et banque centrale de Chypre. Calculs des auteurs.

The temptation to exit the euro

The plan decided by the Troika undermines the island's growth model by penalizing the country's hyper-financialization, and condemns it to years of recession. To avoid a long convalescence, the idea of leaving the euro zone has taken root, as it did in Greece. However, leaving the euro zone is far from a panacea. Regaining monetary sovereignty undeniably offers certain advantages, as is described by C. Antonin and C. Blot in their note, Comparative study of Ireland and Iceland: first, an internal devaluation (through lower wages) would not be as effective as an external devaluation (through exchange rates); second, fiscal consolidation is less costly when it is accompanied by a favourable exchange rate policy. Nevertheless, given the structure of the Cypriot economy, we do not think that leaving the euro is desirable.

In fact, upon leaving the euro, the Central Bank of Cyprus would issue a new currency. Assuming it remains convertible, this currency would depreciate vis-à-vis the euro. By way of comparison, between July 2007 and December 2008 the Icelandic krona lost 50% of its value vis-à-vis the euro. Such a depreciation would have two consequences:

– One, an improvement in competitiveness (the real exchange rate has appreciated by 10% since 2000), which would boost exports and help reduce the deficit in the balance of trade in goods and services (Table 1). Since the accession of Cyprus to the European Union in 2004, this balance has deteriorated as a result of several factors: first, the slowing of inflation from 2004 related to pegging the exchange rate to the euro, which encouraged the growth of real wages at a higher rate than productivity gains; and second, the boom in bank lending, with the substantial decline in risk premiums on loans as a result of accession to the EU [9]. Consumption was boosted, the competitiveness of the Cypriot economy deteriorated, and imports increased. Would exiting the euro reverse this trend? This is the argument of Paul Krugman, who supports Cyprus leaving the euro zone by evoking a tourist boom and the development of new export-oriented industries. However, according to our calculations, a 50% depreciation in the real exchange rate would result in an increase in the value of exports of 500 million euros, including 150 million from additional tourism revenue. [10] As for imports, they are weakly substitutable, as they are composed of energy and capital and consumer goods. Given the weakness of the country's industries, Cyprus will not be able to undertake a major industrial restructuring in the short or medium term. There are therefore limits to improvements in the trade balance. Furthermore, inflation would increase, including through imported inflation, which would lead to a fall in consumer purchasing power and mitigate any competitiveness gains.

– In addition, the devaluation would substantially increase the burden of the outstanding debt, but also of private debt denominated in foreign currency. Net foreign debt in Cyprus is low, at 41% of GDP in 2012. In contrast, public debt reached

70% of GDP, or 12.8 billion euros. 99.7% of the public debt is denominated in euros or in a currency that is part of the European Exchange Rate Mechanism (and thus pegged to the euro), and 53% of this debt is held by non-residents. In addition, the deficit was 6.3% of GDP. If Cyprus no longer had the euro, it would without doubt default on part of its public debt, which would temporarily deprive the country of access to foreign capital, and thus require the kind of violent fiscal consolidation that Argentina went through in 2001.

The exploitation of natural gas resources

The crisis in Cyprus raises the question of the natural gas discoveries in the south of the island in the early 2000s. According to the US Geological Survey, the Levant Basin located between Cyprus and Israel could contain 3,400 billion cu.m of gas resources. By way of comparison, the entire EU has 2,400 billion cu.m (mainly in the North Sea).

Cyprus thus has *a priori* a major natural gas bonanza, even if all of the deposits are not located in its Exclusive Economic Zone (EEZ). At present, only one out of the twelve parcels of land belonging to the Cypriot EEZ has been subject to exploratory drilling, and in December 2011 a deposit of 224 billion cu.m of natural gas was discovered. According to the Government of Cyprus, the value of this field, called Aphrodite, is estimated at 100 billion euros[11]. The exploration of the other eleven parcels belonging to the Cypriot EEZ could prove successful (or even very successful) in terms of natural gas resources. As the licenses for the exploration of these eleven parcels are in the process of being awarded by the Cypriot authorities, the EU could have used the (sad) occasion of the rescue package to secure a portion of the aid granted to Cyprus on its gas potential. Why did the EU not seize on such an occasion?

For the EU, the discovery of the natural gas reserves is good news, in the sense that the exploitation of these deposits will help it to achieve the energy diversification that it values so highly. However, several problems have arisen, problems that darken the prospects for exploiting the gas fields in the very near future. First of all, the discovery of gas reserves in the Levant basin has revived tensions with Turkey, which occupies the northern part of the island of Cyprus and which believes it has rights to the exploitation of the fields. The growing number of Turkish military manoeuvres reflects an effort to impose its presence in the areas being surveyed and could lead to an escalation of violence in the region, especially since the Greek-Cypriot authorities (the southern part) have been working with Israel to defend the gas fields. [12] Second, even assuming that the Greek-Turkish dispute is resolved, the exploitation of the gas will require heavy investment in infrastructure, in particular the construction of an LNG tanker whose cost is estimated at 10 billion euros. Finally, there will be no immediate return on the investment, as it will take at least eight years to put in place the necessary infrastructure. In these conditions, it is understandable why the EU did not take the opportunity to secure some of the aid to Cyprus against these gas resources: exploitation is still too uncertain and, in any case, the horizon is too distant (given the immediacy required for a response to the crisis).

Furthermore, the EU would likely wind up in an awkward situation vis-à-vis several countries. If the EU supports Cyprus in the gas dispute, this comes down to supporting Israel, at the very time that the EU is holding negotiations on Turkey's membership and is trying to build good relations in the region, including with the regimes that have emerged from the "Arab Spring". In addition, two pipeline projects are already in competition: the South Stream project, linking Russia to Western Europe by 2015, and Nabucco, connecting Iran, via Turkey, to Western Europe by 2017. A new gas pipeline connecting the Cypriot fields to the European continent would further reduce Russia's bargaining power, by shifting the centre of gravity of natural gas southwards. This would promote greater dispersion and intensify geopolitical divisions in Europe, between a Northern Europe (including Germany) supplied by Russia and a Southern Europe dependent on the Middle East and Turkey.

Conclusion

If in the immediacy of the crisis the EU has made the right choice (that of the "bad" and "good" bank), the question is posed in the medium / long term of a new growth model for the Cypriot economy. Given the comparative advantages of Cyprus, the exploitation of natural gas seems to offer the only serious solution for the economy's conversion. However, for this strategy to be achievable, the EU will have to take a clear position in favour of Cyprus in the Greek-Turkish dispute.

Not only would the exploitation of the gas bring Cyprus energy self-sufficiency, it would also constitute a major source of revenue for the island. Energy costs would cease being a burden on the balance of payments (Table 1). This is especially important, because, even though tourism (another pillar of the economy) has provided a stable (non-cyclical) source of income since 2000, it is not immune to geopolitical events in the region or to new competition over tourist destinations, in particular from the "Arab Spring" countries.

Consider this simple calculation. Suppose Cyprus manages to maintain its tourism revenues at the level of 2 billion euros (an assumption that, despite the caveats outlined above, is nevertheless realistic); in the absence of industrial restructuring, if the share of the banking sector in the economy is halved (as desired by the Troika and common sense), then Cypriot GDP would return to its 2003 level, or slightly less than 12 billion euros. And GDP per capita would fall by about a third….

Industrial reconversion is thus important for the Cypriot economy, just as for other economies in crisis…. except that Cyprus has Aphrodite.

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[1] See Henri Sterdyniak and Anne-Laure Delatte, ”Cyprus: a well-conceived plan, a country in ruins…”., OFCE blog, March 2013.

[2] See Céline Antonin, Would returning to the drachma be an overwhelming tragedy?, *OFCE Note* no. 20, 19 June 2012.

[3] For more on the dithering on the rescue plan, see Jérôme Creel, “The Cypri-hot case!”, OFCE blog, March 2013.

[4] These loans, granted via Emergency Liquidity Assistance (ELA), amount to 9 billion euros.

[5] Article 63 of the Treaty of the European Union prohibits restrictions on the movement of capital, but Article 64b authorizes Member states to take control measures for reasons of public order or public safety.

[6] “*If the bank can't recapitalize itself, then we'll talk to the shareholders and the bondholders. We'll ask them to contribute in recapitalizing the bank. And if necessary the uninsured deposit holders*”, statement by Jeroen Dijsselbloem, 25 March 2013, to the *Financial Times*.

[7] http://www.revue-banque.fr/risques-reglementations/breve/les-creanciers-des-banques-mis-contribution

[8] The tourist revenue of Cyprus depends in the main on tourists from Britain (43% in 2011), Russia (14%), Germany and Greece (6.5 % each).

[9] On the factors worsening the current accounts, see Natixis, Retour sur la crise chypriote, novembre 2012.

[10] Estimation made using the elasticities calculated by the IMF.

[11] Not far from Aphrodite, 700 billion cu.m of deposits were discovered in the Israeli EEZ, proof that the region is rich in natural gas.

[12] The tensions between Cyprus (southern part) and Israel were resolved (peacefully) by the signing of a treaty in December 2010 defining their respective exclusive economic zones (EEZ). The two entities also plan to cooperate in the construction of common infrastructures to exploit the gas. See the analysis of Angélique Palle on the geopolitical consequences of the discovery of these natural gas resources in the Levant basin.

And what if the austerity budget has succeeded better in France than elsewhere? [1]

By Mathieu Plane

Faced with a rapid and explosive deterioration in their public accounts, the industrialized countries, particularly in Europe, have implemented large-scale austerity policies, some as early as 2010, in order to quickly reduce their deficits. In a situation like this, several questions about France's fiscal policy need to be examined:

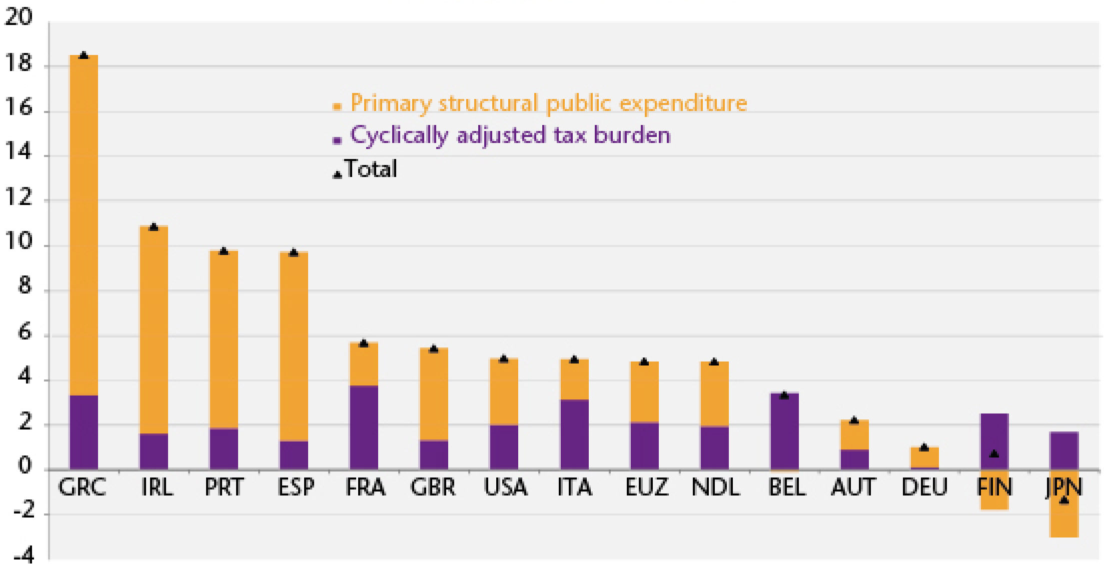
– First, has France made a greater or lesser fiscal effort than other OECD countries to deal with its public accounts?

– Second, is there a singularity in the fiscal austerity policy implemented by France and has it had more or less effect on growth and the level of unemployment?

With the notable exception of Japan, between 2010 and 2013 all the major OECD countries implemented policies to reduce their primary structural deficits [2]. According to the latest OECD figures, these policies represented a fiscal effort of about 5 percentage points of GDP over three years on average in the euro zone, the United States and the United Kingdom. In contrast, the differences within the euro zone itself were very large: they range from only 0.7 percentage points in Finland to more than 18 points in Greece. Among the major industrialized countries of the OECD, France is, after Spain, the country that has made the greatest fiscal effort since 2010 from a structural viewpoint (5.7 percentage points of GDP over three years). In the post-World War 2 era, France has never experienced such a brutal and sustained adjustment in its public accounts. For the record, the budget effort that took place in the previous period of sharp fiscal consolidation from 1994 to 1997 was twice as small (a cumulative negative fiscal impulse of 3.3 GDP points). Between 2010 and 2013, the cyclically adjusted tax burden increased in France by 3.8 GDP points, and the structural effort on public spending represented a gain of 1.9 GDP points over four years (Figure 1). Among the OECD countries, it was France that made the greatest cyclically adjusted increase in the tax burden in the period 2010-2013. Finally, from 2010 to 2013, the structural effort to reduce the public deficit broke down as follows: two-thirds involved an increase in the tax burden and one-third came from public spending. This breakdown is different from that observed on average in the euro zone, where the fiscal effort over the period 2010-13 involved a nearly 60% reduction in public expenditure, rising to over 80% in Spain, Portugal, Greece and Ireland. In contrast, in

Belgium, the entirety of the fiscal effort came from a higher tax burden. And in the case of Finland, primary structural public spending in points of potential GDP rose over the period 2010-2013, which was more than offset by the increase in the tax burden.

Figure 1. Contribution of each component to the change in the primary structural balance from 2010 to 2013, by country

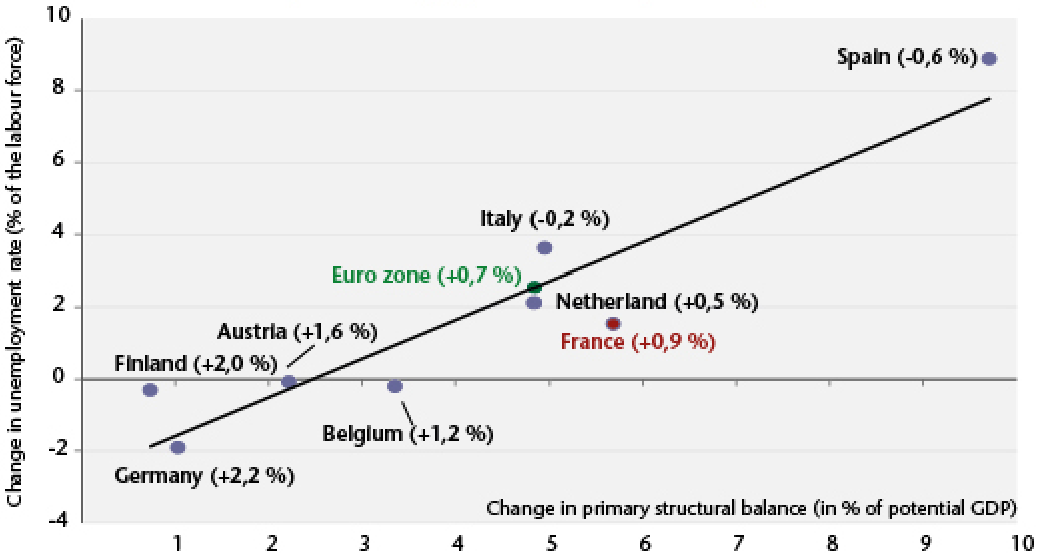


Sources: OECD, OFCE calculations.

While France's substantial budgetary efforts have undeniably had a negative impact on economic activity and employment, it is nevertheless true that the budget decisions of the various governments since 2010 appear to have affected growth and the labour market relatively less than in most other countries in the euro zone. Within the euro zone-11, from 2010 to 2013 only four countries – Germany, Finland, Austria and Belgium – experienced average growth of over 1% per year, with unemployment rates that not only did not increase, but occasionally even fell. However, these are also the four countries that made the smallest reductions in their structural deficits over this period. France, on the other hand, is among the countries that made the greatest structural effort since 2010, and it has simultaneously managed to contain the rise in unemployment to some extent. Indeed, compared with the Netherlands, Italy and the euro zone average, France's fiscal policy was more restrictive by about

1 GDP point from 2010 to 2013, yet the unemployment rate increased by 40% less than in the Netherlands, 60% less than the euro zone average and more than two times less than in Italy. Likewise, growth in France was higher on average over this period: 0.9% per year, against 0.5% in the Netherlands, 0.7% in the euro zone and -0.2% in Italy.

Figure 2. Change between 2010 and 2013 in the primary structural balance and the unemployment rate (and in average growth over the period in %)



Sources: OECD Economic Outlook, November 2012; OFCE calculations.

Why has the French fiscal contraction had less impact on growth and employment than in most other countries? Beyond the economic fundamentals, some evidence suggests that the budget decisions of the successive governments since 2010 may have led to fiscal multipliers that are lower than in the other countries. After Finland and Belgium, France is the country where public spending played the smallest role in reducing the structural deficit. As illustrated by recent studies, in particular the IMF study and the article signed by economists from the central banks in Europe and the U.S., the European Commission, the OECD and the IMF, targeting fiscal adjustment through raising the tax burden rather than cutting public spending has given France smaller short-term fiscal multipliers than those observed in countries that have made the opposite choice (Greece, Portugal, Ireland and Spain). In the case of France, nearly 50% of the fiscal adjustment was achieved by an increase in the direct taxation of household and business income (Table 1). And as has also been the case for the United States, Belgium and Austria, which achieved between 50% and 75% of their fiscal adjustment by increasing direct taxation, it seems that these countries have also done best at maintaining their growth in the face of the budget cuts. Conversely, the ones that have used this lever the least in their fiscal adjustments are the southern European countries and the Netherlands.

Table. Contribution of each component to the change in the primary structural balance between 2010 and 2013, by country

In % of potential GDP

	GRC	IRL	PRT	ESP	FRA	GBR	USA	ITA	EUZ	NLD	BEL	AUT	DEU	FIN	JPN
Primary structural balance (PSB) (= a + b)	**18,5**	**10,9**	**9,8**	**9,7**	**5,7**	**5,4**	**5,0**	**4,9**	**4,8**	**4,8**	**3,4**	**2,2**	**1,0**	**0,7**	**-1,3**
Cyclically adjusted tax burden (a)	3,3	1,6	1,9	1,3	3,8	1,3	2,0	3,1	2,1	2,0	3,4	0,9	0,1	2,5	1,7
o/w increase in direct taxes on household and business income	1,5	3,2	1,9	1,2	2,7	0,0	2,4	1,2		0,8	1,7	1,7	0,1	0,6	0,9
Primary public spending (b)	15,2	9,2	7,9	8,4	1,9	4,1	3,0	1,8	2,7	2,9	-0,1	1,3	0,9	-1,8	-3,0
Contribution of primary public spending to the change in the PSB	82	85	81	87	34	76	59	36	56	60	-2	59	89	-242	225

Sources: OECD Economic Outlook, November 2012; OFCE calculations.

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[1] This post makes use of certain parts of the article published in *Alternatives Economiques*, M. Plane, "L'austérité peut-elle réussir en France ?", Special issue no. 96, 2nd quarter 2013.

[2] The primary structural deficit measures the structural fiscal effort made by general government (*les administrations publiques*). It corresponds to the public balance, excluding interest charges, that would be generated by the government if the GDP of the economy were at its potential level. This measure is used to adjust the public balance for cyclical effects.

The death throes of the "Confederation of Europe"?

By Jacques Le Cacheux

Will the institutions that the European Union has developed – from the Treaty of Maastricht in 1992, which created it and defined the roadmap that led to the launch of the euro in 1999, to the Treaty of Lisbon in 2009, which took up the main articles of the constitutional treaty that the French and Dutch had refused to ratify in referendums in 2005 – be sufficient to resolve the crisis facing the EU today? After five years of economic stagnation and nearly four years of persistent pressure on national debts, it had seemed that fears about the sustainability of the European Monetary Union had been appeased by the determination shown in early autumn 2012 by Mario Draghi, President of the European Central Bank, to ensure the future of Europe's single currency at any cost. But the results of the recent general elections in Italy have once again unsettled the European sovereign debt markets and revived speculation, while the euro zone has plunged back into a recession even as the wounds of the previous one lay still unhealed.

How much longer will we be content with mere expedients? Would it not be better to make a real institutional revolution, like the one undertaken between 1788 and 1790 by the framers of the Constitution of the United States of America, as they faced an acute crisis in the public debt of the Confederation and the confederated states? In his Nobel Lecture, which the OFCE has just published in French, Thomas Sargent invites us to consider this through an economic and financial reading of this critical episode in the institutional history of the

United States, and through a parallel with the current situation of the euro zone that some may find audacious, but which is certainly enlightening.

There are of course many differences between the situation of the former British colonies ten years after independence and the Member States of the European Monetary Union. But how is it possible not to see certain similarities, such as the inability to find a collective solution to the national public debt crises or the inanity of the agreement in February 2012 on the future EU budget? *Mutatis mutandis*, it is a question of fiscal federalism, as well as political, in one case as in the other.

What monetary policy for the ECB in 2013?

By Paul Hubert

After the monthly meeting of the Board of Governors of the European Central Bank on 7 February 2013, the ECB decided to hold its key interest rate at 0.75%. The analysis of the economic situation by Mario Draghi made during the press conference afterwards pointed to contrasting developments justifying the status quo. In a recent study, we showed that the inflation forecasts of the ECB can shed new light on future trends in interest rates.

The status quo can be explained by a number of mutually offsetting factors. The banks have started to repay some of the cash obtained through the LTRO facility (140 billion euros out of 489 billion), which reflects an improvement in their financial position, while at the same time lending to non-financial firms is continuing to contract (-1.3% in December 2012) and consumer loans are still at very low levels.

From a macroeconomic viewpoint, the situation in the euro zone is not giving clear signals about future monetary policy: after shrinking by 0.2% in the second quarter of 2012, real GDP in the euro zone fell another 0.1% in the third quarter, while inflation, as measured on an annual basis, decreased from 2.6% in August 2012 to 2% in January 2013 and is expected to drop below the 2% mark in the coming months based on the figures for GDP growth and for current and anticipated oil prices.

Furthermore, the inflation expectations of private agents, as measured by the *Survey of Professional Forecasters*, remain firmly anchored around the ECB's inflation target. In the fourth quarter of 2012, expectations were for 1.9% inflation for the years 2013 and 2014. Given that the target of "below but close to 2%" has now been reached, and with a euro zone in recession and unemployment at record levels, the ECB could give a boost to real activity. However, it anticipates that economic activity should gradually pick up in the second half of 2013, partly due to the accommodative monetary policy being followed today.

Given expectations, and in light of the historically low levels of key interest rates and the lag in the transmission of monetary policy to the real economy [1], a future rate cut seems very unlikely. One final element is sending out mixed messages: the recent rise of the euro – though it is still far from record levels – could nip in the bud the weak economic recovery that is underway, and could in the eyes of some justify support for export sectors [2].

In a recent OFCE working paper (No. 2013-04), we discuss how the ECB could use its inflation forecasts to improve the implementation of its monetary policy. We propose a new element to shed light on future developments in interest rates, based on the macroeconomic projections published quarterly by the ECB. In this study on the effects of the publication of the ECB’s inflation forecasts on the inflation expectations of private agents, we show that a 1 percentage point reduction in the ECB’s inflation projections is associated with a key interest rate cut by the ECB of 1.2 percentage points in the next two quarters. We conclude that the ECB’s inflation forecasts are a tool that helps to better understand current monetary policy decisions and to anticipate future decisions.

The latest inflation projections, published in December 2012, were 1.6% and 1.4% for the years 2013 and 2014, respectively.

The publication on March 7th of new projections could provide a further indication of the direction monetary policy is likely to take in 2013.

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[1] On average, a change in the key rates is estimated to have an impact on inflation after 12 months and on GDP after 18 months.

[2] Remember, however, that about 64% of trade in the euro zone is conducted with euro zone partners, and thus is independent of fluctuations in exchange rates.