

# Argentina's experience of debt crisis

By [Augusto Hasman](#) and [Maurizio Iacopetta](#)

There is still a lot of uncertainty around the possible paths that Greece can follow in the near future. One possible path, which may be still averted by the current negotiation, is that Greece will default on the upcoming debt obligations (see graphics [here](#) for a detailed list of the upcoming Greek debt deadlines), thus spiraling into a currency and credit crisis and possibly resulting in a “Grexit”[\[1\]](#).

The Greek debt crisis shares some similarity with the Latin American debt crisis of the 1990s and early 2000s. In both Greece and Latin America, debts are mostly bond debts or debts to international institutions. Similarly to Greece, many Latin American countries had become more and more open in the decades before the crisis. The series of financial crises started with Mexico's December 1994 collapse. It was followed by Argentina's \$95 billion default (the largest in history at that time, although later on Argentina resumed some of the payments), Brazil's financial crisis (1998-2002) and Uruguay's default (2002).

Argentina is viewed as benchmark for getting insights on the possible macroeconomic consequences of a Grexit, partly because it abandoned the peg with the dollar as a result of its mounting fiscal crisis. Nevertheless, some have pointed out at marked differences between the two economies, in terms of industry structure as well as trade composition (see [here](#) for instance).

Here, we review the different steps followed by Argentina during the crisis and propose some statistics related to developments of key economic indicators in Argentina before

and after the crisis. For comparison purposes, we also provide key figures of the Greek's economy.

### **Argentina and Greece at time of considerable stress**

Greece entered the European and Monetary Union in 2001, meaning an irrevocably fixed exchange rate regime and the adoption of the Euro as legal tender. By *early 2010*, Greece risked defaulting on its public debt and had to call for a financial rescue to international institutions. On the other hand, at time of the crisis, Argentina had its currency, the peso, 'immutably' fixed to the US dollar on a one-to-one basis. As today's Greek situation, when Argentina defaulted in late 2001, the country's economy and government were both experiencing considerable stress. 2001 was the third consecutive year of serious recession for Argentina, foreign direct investment had virtually stopped, and inflation, interest rates and the budget deficit all were soaring. The IMF had provided loans to keep the peso stable, on the condition that the government would adopt fiscal and monetary discipline. Argentina's economic problems became a serious crisis in December 2001, when the IMF denounced the government's inability to put its financial house in order and suspended its loans. This development was followed almost immediately by a banking crisis and violent public protests that produced a rapid succession of six presidents in two weeks. Figure (1) depicts the behavior of Argentinian key economic indicators before and after the 2001 devaluation. Figure (2) shows the Greek's indicators since 1998 [\[2\]](#). A quick inspection of the two figures reveals that:

-The magnitude of the decline of Greece's GDP during the crisis, counting from its highest point in 2008 is roughly the same as that observed in Argentina during a recessionary period before the devaluation: 25%.

- The rise in the unemployment rate has been much more severe in Greece than in Argentina. In Argentina, unemployment, rose

from 12.4% in 1998 to 18.3% in 2001 whereas in Greece it went up from less than 10% in 2008 to over 25% to this day. Both in Argentina and in Greece the inflation had been relatively low before the debt crisis; in fact in Greece it has even been negative in recent years.

## The recovery

What is somewhat surprising is what happened in Argentina after the crisis.

First, after a short period of turbulence, the Gross Domestic Product, in constant dollars, began to rise at an astonishing pace of almost 10 percent per year, until the 2007-08 financial crisis. Second, the unemployment rate declined from 18 percent to about 7 percent. Third, the poverty rate went down even below the level observed in the heyday of the pegged exchange rate. But financial indices deteriorated. First the difficulties in accessing external credits and the loss of credibility of the government pushed up the bond spreads from 4000 basis points before the crisis to ten times as much after the crisis. Second, the inflation rate seems to have stabilized at a double digit figure. According to some scholars (see for instance [Alberto Cavallo](#) "Online and official price indexes: Measuring Argentina's inflation" Journal of Monetary Economics, 2012) there has been a systematic attempt by government authorities to greatly underestimate or underreport the inflation rate. Therefore, the GDP gain may not be as high as the one showed in Figure 1. Although the Argentinian economy has gone into a sustained period of growth, it would be unwarranted to make an automatic link between the renaissance of the Argentinian economy and the dramatic conclusion of the crisis with the abandonment of the peg and the debt default.

Some have pointed out that the recovery period coincided with a boom in the price of primary commodities (soybeans), which notoriously account for an important part of Argentinian

exports. Clearly the increase in commodity prices has been a windfall for Argentinian agricultural producers with possible trickling effects on the rest of the economy. Yet, the magnitude of the windfall itself can hardly account for the large GDP gains. In fact, soybean was sold in Iowa at an average price of \$4.57 per bushel in the year 2000 and at \$5.88 in the year 2005. Only since 2010 prices have gone up substantially more, but at that point, the Argentinian economy had already gone through almost a decade of economic boom. Furthermore, the high price of soybeans in the second half of the 1990s (it was \$7.32 in 1997) does not seem to have been helpful to avoid the economic depression. The route to recovery in Argentina has been characterized by setbacks, but also by a number of inventiveness that may have played a role in defraying the shock of the crisis.

### **Bank runs**

At the end of November 2001, rising worries about a peso devaluation and a deposit freeze, increased overnight interest rates sharply. Additionally, spreads between US Treasury bonds and Argentine government bonds increased by 5,000 basis points. In order to stop the effects of a bank run, the Minister of Economy Domingo Cavallo announced a freeze on bank deposits. As in Greece, this measure considerably reduced the capacity of depositors to withdraw and manage their bank deposits. The deposit freeze had even accentuated the feeling among the population that a crisis was going to explode, and a series of demonstrations surged along the country. Subsequently, the IMF announced a cut of its support to Argentina, as it had failed to meet the conditions tied to the rescue program and Argentina lost its last source of funding. With a total amount of almost USD 22bn in 2000 and 2001, Argentina was the largest debtor the IMF had at the time. In the protests and raiding that followed, 24 people died. President De La Rúa and his cabinet resigned soon after these events.

## Claims after the currency devaluation

The government decided to 'pesofy' the loans at a rate of A\$1 (Argentinean peso) for each dollar (USD) owned by banks and A\$1.4 for each dollar deposited in a bank. Alternatively, people could get a government bond (Boden 2012), that paid A\$775.12 for a nominal of USD\$100, when the official dollar was 4.35A\$/USD. A less attractive bond was issued the following year: it paid A\$930 for a nominal of USD\$100 but could only be converted at 8.95A\$/USD.

## Massive use of money-bonds

In 2001, different Argentinean provinces started to print their own quasi-currencies, several emergency bonds (technically called Treasury Bills for Debt Settlement) issued between 2001 and 2002. They were created as a way of alleviating the enormous financial and economic crisis that occurred in Argentina in 2001. These bonds were considered a "necessary evil" that initially allowed to cover the absence of money circulation. While at first the issuing of these quasi-currencies was controversial, it later gained acceptance partly because of the size of the issue and partly because of the magnitude of the crisis. These bonds circulated in parallel to the Argentinean peso. They could be used to pay some taxes, shopping and even salaries. As the pesos, they were denominated in different values 1, 2, 5, 10, 20, 50 and 100 to facilitate transactions (nominally equivalent to a Convertible Peso). The most popular bond was the Patacon that was issued in Buenos Aires. This bond had an interest rate of 7% and there were two series (Series A maturing in 2003, while the B in 2006). It is estimated that the total issue amount for the Patacons only reached 2.705 millions. Once the economic recovery of Argentina started in late 2003, the government honored 100% the principal of these outstanding bonds, and even the interests were eventually paid. Up to 13 quasi-currencies were issued by different provinces during that period.

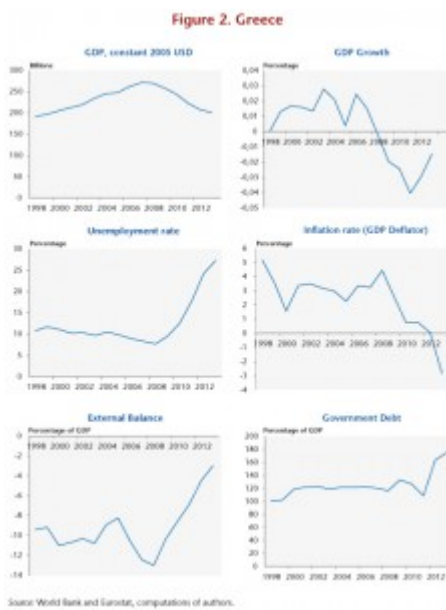
## Credit

Figure (1) shows that in Argentina the “Sovereign Bond Interest Rate Spreads, basis points over US Treasuries” has been growing for the last 18 years showing the difficulties Argentina has had in accessing to international credit market. The difficult access to foreign funding has pushed the Argentinean government to get financed internally through the central bank, retirement funds and the tax agency. The high inflation that resulted from this policy (close to 26%, unofficial measures) has made the use of local credit extremely expensive for companies and households. However, as Argentina started posting large surpluses on the fiscal and current accounts after the default and large devaluation of the peso, access to foreign finance became less urgent. Argentina took a hardline approach against creditors. By 2010, 92% of the Argentine defaulted debt had been restructured. However, ongoing litigation by holdout creditors could lead to a new Argentine default in the near future.

In conclusion, the Argentina exit from the debt crisis through a default did not have long lasting dramatic consequences on real activities as many had anticipated. The crisis meant a transfer of wealth from depositors to debt holders and promoted exports. After an abrupt decline, GDP quickly started its ascent and the country experienced high rates of growth in the 2000s, which reduced significantly unemployment.

Nevertheless the period right after the devaluation was characterized by political instability, large macroeconomic fluctuations and social revolts. The political stability that followed, might have played a role in sustaining growth, but the rate of inflation climbed at double-digit figures and the various price control mechanism introduced by the government have created a lot of frictions in the business sector. Finally, the increasing isolation of the government from the international political arena partly, due to the outstanding litigation with international lenders, could, in the long run,

have negative repercussion on trade.



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[\[1\]](#) “Grexit” is a combination of “Greece” and “exit” and refers to the possibility of Greece leaving the Euro area.

[\[2\]](#) The plots are generated using World Bank data, except for

the level of 2013 Greek debt/GDP ratio, which is taken from Eurostat.

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# The spirit of the letter of the law ... to avoid a “Graccident”

Raul Sampognaro and [Xavier Timbeau](#)

The noose, in the words of Alexis Tsipras, is getting tighter and tighter around the Greek government. The last tranche of the aid program (7.2 billion euros) has still not been released as the Brussels Group (the ex-Troika) has not accepted the conditions on the aid plan. The Greek state is therefore on the brink of default. It might be thought that this is simply one more episode in the drama that Greece has been acting out with its creditors and that, once again, at the last moment the money needed will be found. But if Greece has managed to meet its deadlines up to now, it has been at the price of expedients that it is not at all certain can be used again.

While tax revenues since the start of the year have been almost one billion euros behind the anticipated targets, the expenses for wages and pensions still have to be paid each month. This time the wall is getting closer, and an agreement is needed if the game is to continue. In June, Greece must pay 1.6 billion euros to the IMF in four tranches (5, 12, 16 and 19 June). On 28 May an IMF spokesperson confirmed the existence of a rule that would make it possible to group these payments on the last day of the month (a rule last used by Zambia in the 1980s). Since it would then take six weeks for



the IMF to consider Greece in default, the country could still gain a few days after 30 June before the deadline with the ECB (with 2 tranches for a total 3.5 billion euros by 20 July 2015).

Historically very few countries have failed to honour their payments to the IMF (currently only Somalia, Sudan and Zimbabwe are in arrears to the IMF, for a few hundred million dollars). As the IMF is the last resort in case of a crisis in liquidity or the balance of payments, it has, as such, the status of preferred creditor, so defaulting on its debt may trigger cross defaults on other securities, in particular, in the Greek case, those held by the [European Financial Stability Facility](#) (EFSF). This could make them due immediately. A Greek default with the IMF could well jeopardize Greece's entire public debt and force the ECB to reject Greek bonds as collateral in the Emergency Liquidity Assistance (ELA) operations, the only firewall remaining against the collapse of the Greek banking system.

The legal consequences of such a default are difficult to grasp (which says a lot about the modern financial system). [An article published by the Bank for International Settlements, dated July 2013](#), whose author, Antonio Sainz de Vicuña, was then Director General of ECB Legal Services, is very informative about this issue in the context of the Monetary Union.

In presenting the legal framework, Sainz de Vicuña focuses on Article 123 of the [Treaty on the Functioning of the European Union \(TFEU\)](#), a pillar of the Monetary Union, which prohibits the ECB or the national central banks from financing government<sup>[1]</sup>. In a footnote, the author concedes that there are two exceptions to this rule:

– “Credit institutions controlled by the public sector, which may obtain central bank liquidity on terms identical to private credit institutions.” This exception

appears explicitly in paragraph 2 of Article 123 of the TFEU[2].

– “The financing of state obligations vis-à-vis the IMF.”

This second aspect has attracted our attention because it is little known to the general public, it does not appear explicitly in the Treaty and it could be a solution, at least in the short term, to avoid Greece being put in default by the IMF .

In searching the corpus of European law, this exception is defined more precisely in [Council Regulation no. 3603/93](#), which clarifies the terms of Article 123 of the TFEU, which it is authorized to do under paragraph 2 of Article 125 of the TFEU[3]. More specifically, in Article 7:

*The financing by the European Central Bank or the national central banks of obligations falling upon the public sector vis-à-vis the International Monetary Fund or resulting from the implementation of the medium-term financial assistance facility set up by Regulation (EEC) No 1969/88 (4) shall not be regarded as a credit facility within the meaning of Article 104 of the Treaty[4].*

The justification for this article is that: during quota increases in the IMF, the financing by the central bank was accepted because it had as a counterpart an asset comparable to international reserves. In the spirit of the law, financing Greek borrowing from the IMF by a credit from the central bank (the ECB or the Bank of Greece) should not be permitted. The obligations falling upon the Greek state probably only concern, according to the spirit of the text, the contribution to the IMF quotas. Nevertheless, the spirit of the law is not the law, and the proper interpretation of the phrase “obligations falling upon the public sector vis-à-vis the International Monetary Fund” could open another door for

Greece. Given the consequences of a default with the IMF – in particular the continuity of the ELA – invoking this could be justified as preserving the functioning of the Greek payment system, a role falling within the mission of the ECB.

Beyond the legal possibility of a central bank financing Greece's debt to the IMF, which would certainly be challenged by some governments, this action would open up a political conflict. A MemberState could be accused of violating (the spirit of) the Treaties, even though that is not a reason to exclude it ([according to the ECB's Legal Services](#)). But is this really an obstacle in view of the importance a default on Greece's debt would have for the sustainability of the single currency?

Greece's cash flow problems are not new. Since January, the government has been financing its expenditure through [accounting transactions that allowed it to offset tax losses](#). In particular, on 12 May, the Greek government was able to repay an IMF loan tranche by drawing on an emergency fund that was essentially international reserves. The Eurosystem was able to use this exception to give Greece extra time in order to continue the negotiations and avoid the accident.

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[\[1\]](#) Paragraph 1 of the article stipulates that, “Overdraft facilities or any other type of credit facility with the European Central Bank or with the central banks of the Member States (hereinafter referred to as “national central banks”) in favour of Union institutions, bodies, offices or agencies, central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of Member States shall be prohibited, as shall the purchase directly from them by the European Central Bank or national central banks of debt instruments.”

[\[2\]](#) Which stipulates that, “Paragraph 1 shall not apply to

publicly owned credit institutions which, in the context of the supply of reserves by central banks, shall be given the same treatment by national central banks and the European Central Bank as private credit institutions.”

[3] Which stipulates that, “The Council, on a proposal from the Commission and after consulting the European Parliament, may, as required, specify definitions for the application of the prohibitions referred to in Articles 123 and 124 and in this Article.”

[4] Article 104 became Article 123 in the TFEU.

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## **On the search to “recapture the industrial spirit of capitalism”: From patient shareholders to shared governance**

By [Jean-Luc Gaffard](#) and Maurizio Iacopetta

The government, buoyed by the law to recapture the real economy, [the Florange act](#), which establishes the possibility of double voting for patient shareholders (who have held their shares at least two years), has just taken two significant decisions by temporarily increasing its holdings in the capital of Renault and Air France in order to ensure that in a general shareholders meeting the double voting option is not

rejected by the qualified majority authorized under the law. The objective spelled out by France's Minister of the Economy in [Le Monde](#) is to help "recapture the industrial spirit of capitalism" by favouring long-term commitments in order to promote investment that will foster solid growth.

Under the impulse of the Florange law, that has recently introduced the institute of the double voting for 'patient' shareholders (shareholders who have held their company's shares for at least two years), the government has taken the important decision of increasing temporarily its equity shares into two major French companies: Renault and Air France.

The increased government's stake into the two companies aims at preventing attempts of the shareholders general assembly to block the adoption of the double voting institute, which would require the approval of a qualified majority. The France's Minister of the Economy explained in [Le Monde](#) that the government's action is intended to help "revive the industrial spirit of capitalism" by favouring long-term commitments that promote investments and foster robust growth.

This initiative has led to renewed discussions about the governance of joint-stock companies and corporations (Pollin, 2004, 2006), to consider the problems that afflict them, possible remedies, and what one could expect from the government.

Because corporations have the ability to attract abundant savings and because of their power in choosing where to direct these savings, they are undeniably at the heart of the investment process. They can be governed in various ways, depending on the institutional contexts, which are related in turn to significant differences in productivity and growth (Bloom and Van Reenen, 2010 ; De Nicolo', Laeven and Ueda, 2008 ; La Porta, Lopez-de-Silanes, Shleifer and Vishny, 2000). So the question arises as to which governance model is best able to promote entrepreneurial activity and innovation, and

thus ultimately to ensure growth ([OECD 2012](#)).

There is evidence that the big corporations do not suffer from a lack of long-term financing. The development of the stock and bond markets since the 1980s has allowed corporations to reduce their dependence on bank financing and its cyclical character. Investment problems thus mainly reflect major breakdowns in the governance of companies, whether large, medium or small, as well as in the governance of financial institutions ([Giovannini et al., 2015](#)).

Traditionally, the focus has been on the ways controlling shareholders' choose managers, *i.e.* the conditions under which the capital owners get the yield on their investment that is justified by their special position as residual claimant (Shleifer and Vishny, 1997). But this ignores that other company stakeholders (creditors, employees, suppliers or even customers) also incur risk, and that the long-term performance of the company depends on the conditions in which the shareholders' engagement controls the commitment of the other stakeholders (Mayer, 2013). It is not certain, in this regard, that the distribution of voting rights between different classes of shareholders is decisive.

### *Control and engagement*

The central issue is how capital owners affect management's decision-making. Thus, the goals and values of family businesses reflect the interests and inclinations of the family owners, which can become inconsistent with productive efficiency, especially with the rise of rentier capitalism, when it is no longer the founders who are at the head of the company but their heirs or, more surreptitiously, a self-perpetuating caste (Philippon, 2007). While there is a positive relationship between the wealth of self-made millionaires and GDP and growth, the relationship to GDP turns negative when this concerns the wealth of millionaire heirs (Morck, Stangeland, and Yeung 2000). Faced with this potential

problem, the existence of dispersed ownership would seem to be beneficial in so far as it replaces special interests with what can be likened to a collective interest.

This vision of the corporation nevertheless faces an objection formulated by Berle and Means (1932), who view the separation between ownership and control as a source of inefficiency. It creates problems of agency, meaning that the managers are likely to act in their own interests rather than in those of the shareholders, just like families or owning castes. Empirically, the Tobin's Q (the ratio of capital's market value to its replacement cost) increases, then decreases before increasing again as the power of the managers grows (Morck *et al.*, 1988). It is then possible that shareholders have less incentive to subscribe new shares or keep the ones they hold, resulting in lower share prices and less access by companies to external financing. The provisions that make it possible to protect large enterprises can have the effect of hindering the market entry of new businesses and introducing significant distortions into the investment decision-making of established firms (Iacopetta, Minetti and Peretto, 2015).

Solving these problems requires creating institutional arrangements to ensure that shareholders become active in corporate management.

These arrangements have involved improving the quality of audits, of risk management and of communications between the company and its shareholders. They have led to greater transparency in executive compensation policy and linking pay to performance. This process has spurred the development of "markets for corporate control" and for shareholder activism, and indeed of a particular class of shareholders consisting of investment funds, including pension funds, whose management methods (the delegation of investment decisions to fund managers) emphasizes the immediate performance of their portfolios.

In the light of the financial crisis, these arrangements seem questionable to say the least (Giovannini et al., 2015). Financial institutions, although subject to the “best” governance rules ensuring genuine shareholder control, have been scenes of conflict between shareholders who have benefited from upside positive performance and creditors (and taxpayers) who have had to bear any losses. What was true of the financial institutions also held true for manufacturing companies, which have been arenas of conflict between shareholders and the other stakeholders (creditors, employees, suppliers and customers).

The real problem is that the while arrangements that were designed to solve agency problems have strengthened the control exercised by shareholders over company management, they have also reduced the shareholders’ level of engagement (Mayer, 2013).

Notwithstanding their particular interests, family owners can ensure a stability and long-term engagement vis-à-vis other stakeholders that is not guaranteed by dispersed shareholding. The same is true of managers with delegated authority who have acquired sufficient independence vis-à-vis the shareholders to be open not only to their own interests but also to the interests of the employees (and sub-contractors). After all, the constitution of industrial empires is far from a bad thing so long as they are economically viable and do not violate the rules of competition. But the advantages conferred on managers are being offset by the development of markets for corporate control and shareholder activism, which has led to judging managerial effectiveness on the grounds of current performance. There is indeed a trade-off between the requirements of control and engagement. The problem is perhaps not so much to align the interests of managers with those of shareholders as to make shareholders responsible for what happens in the long run to the companies in which they invest.

*The measure of engagement*



The degree of commitment of financiers, lenders and shareholders is critical since it determines that of the other stakeholders in the company. It is reflected in the attitude chosen in response to fluctuations in performance, and more specifically in the degree of tolerance of poor business results. A low tolerance is a sign of a low degree of engagement, and usually a sign of hostile takeovers and pension fund activism.

It is also necessary to agree on the meaning of poor results. This could be the result of bad management, in which case investors' power to provide financing conditioned on management's ability to make the changes they require does not necessarily indicate a lesser degree of engagement. It may even prevent the financial crises that could result from serious agency problems – at least if consistent performance is the norm. But this is exactly not the case when the relevant industrial activities have a cyclical dimension. Companies can deal with this by offsetting the results of several activities against each other provided that their cycles are different. But the attitude of investment funds is to emphasize the diversification of their portfolio on the valuation of the diversification of their activities by the companies themselves, prompting the latter to refocus on what is sometimes described as their core business. A series of dismantling operations, in particular, in the cases of Alstom, Alcatel and Thomson, constituted one of the reasons for the deindustrialization seen in France (Beffa, 2012).

Nor does the consistency of performance prevail when companies choose to innovate by introducing new products or new production techniques and exploring new markets. Because firms incur the costs long before increased in revenue, these are irrevocable costs, that is to say, whose recovery is contingent on the success of the decision to innovate (“sunk costs”). Any form of governance that would have the effect of favouring immediate results and eliminating tolerance of a

temporarily poor performance would then only hold back innovation by penalizing long-term investment. But this is exactly where the possibility of hostile takeovers and the activism of investment funds are leading.

### *The institutional prescriptions*

The debate has thus been opened on the ins and outs of the conflict between different classes of shareholders established in relation to the volume of securities held and the length they are held (Samama and Bolton, 2012). Many companies have adopted mechanisms that financially reward shareholders' loyalty or that grant them additional voting rights in return for this loyalty. Some countries (France and Italy in particular) have legislated in this regard. It is difficult to assess the results. In theory, the principle of "one share – one vote" does not rule out the existence of several classes of shares involving different voting rights. It does of course reduce the agency problems involving the holders of blocs of shares, but it also reduces the beneficial effects of the stability that these blocs provide (Burkart and Lee, 2008). Moreover, empirical studies reach mixed conclusions, further indicating the complexity of the problem (Adams and Ferreira, 2008).

Nevertheless, numerous empirical studies do confirm that companies that have a more stable ownership structure and meet performance indicators that do not refer merely to financial capital have better outcomes in the long run (Clark et al., 2014). The existence of stable shareholder blocs or of restrictions on voting rights may be mechanisms that are likely to ensure this sustainability and strengthen the degree of commitment made by the capital providers, thereby justifying that other stakeholders – employees, suppliers and customers – do likewise in turn.

The difficulty with mechanisms for restricting voting rights is that they do not allow shareholders to indicate the length

of time that they want to keep their shares and to indicate their level of engagement (Mayer, 2013). In fact, those who intend to hold their shares only briefly (possibly milliseconds in case of high-frequency trading) have the same influence on managers' decisions as those who intend to keep their shares for many years. The first bear the consequences of their votes only momentarily, unlike the latter, but both have the same influence on current decision-making, which may affect the company's performance for a long time to come. Basically, establishing different classes of shares does not necessarily substitute for the constitution of a stable bloc of shareholders that is able to deal with hostile takeovers motivated by the quest for short-term capital gains.

Things may be different when past loyalty is rewarded financially by an increase in the dividends paid, since in this case selling the shares leads to losing the financial advantage acquired. There is therefore an incentive to hold the shares even longer. Nevertheless, the payment of dividends is never equivalent to the retention of profits. The proceeds from new issues are under the control of the shareholders, whereas undistributed profits are still under the control of the managers. The higher the dividends, the more companies are dependent on their ability to draw on the stock market. There is still an issue of too much dependence vis-à-vis impatient shareholders, pulling companies towards short-term investments.

Accordingly, one potential relevant mechanism might be to establish voting rights based not on the time the shares have been held, but on the future period to which the shareholders are committed (Mayer, 2013). Under this proposal, shareholders would be able to register the period for which they intend to hold their shares and to be paid in the form of votes that are set according to the length of time remaining before they are able to dispose of them. At the moment, "loyalty and the double vote of the shares remunerate shareholders for the

period the shares have been held and, consequently, fail to make them more responsible for the future consequences of their decisions. Really, since shareholders who have held their shares a long time are more likely to sell them, this potentially rewards a lack of commitment" (Mayer, 2013, pp. 208-9). It is clear, however, that it would be difficult to implement this institutional arrangement in practice, not least due to its credibility, and it would be preferable to explore other forms of governance that involve other stakeholders in the decision-making process.

### *On the expectations of government*

In light of the analysis above, the question arises of what the government can expect from its decision to impose double voting rights. The answer is that this could be mainly to reduce, even if in a limited way, the public debt, without losing its influence in the companies in which it holds shares. The intention to revive industrial capitalism by this measure, laudable as this may be, is unlikely to have any real impact. This is true in particular because there is nothing to suggest that in the future the State would behave differently from any other shareholder, despite double voting rights, and could impose or contribute to imposing management decisions that are not necessarily in the long-term interest of the companies and their stakeholders.

Also, without wishing to neglect what the existence of several classes of action could mean for making decisions about business strategy, including possibly introducing protection against hostile takeovers, it seems a more fundamental measure would be to revise the business model as a whole.

The degree of engagement of the capital providers commands the commitment of the other stakeholders. Intermediated financing is the primary source of funds for owners who want to keep control of their business. It enables companies to innovate and grow without the need to dilute ownership. But it is

necessary for such financing to exist, i.e. for banks to commit over a long term to these companies. Yet banks too are afflicted with problems of governance, leading to a conflict between the two main types of investors, shareholders and creditors (Giovannini et al., 2015). If institutional progress is to take place, it should therefore concern the financial system and be based on a return of intermediation (Pollin 2006). And if action is to be taken on the conditions of governance of the corporations themselves, this should be based on the proposals by Mayer (2013): perhaps, subject to feasibility, by instituting voting rights in proportion to the time for which shares are held in the future, but especially by establishing “boards of trustees” that set broad guidelines, acting as the guardians of values common to the various stakeholders (shareholders, creditors, employees and even suppliers and customers ) instead of acting merely as representatives of the shareholders. These common values do nothing more than express the recognition of the strategic complementarities that exist between all the actors who are the source of value creation.

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# **The United Kingdom on the eve of elections: The economy, David Cameron's trump card (1/2)**

By [Catherine Mathieu](#)

In the countdown to the general elections on 7 May 2015, there is so much suspense that the bookmakers are putting the Conservative Party as winners and Ed Miliband, the Labour leader, as the next Prime Minister! Not only are the Labour Party and the Conservative Party running neck-and-neck in the polls, but with voting intentions fluctuating between 30 and 35% for many months now, neither party seems poised to secure a sufficient majority to govern alone. David Cameron, current PM and leader of the Tories, has placed the British economy at the heart of the election campaign. And the figures do seem

rather flattering for the outgoing government with regard to growth, employment, unemployment, public deficit reduction, etc., though there are some less visible weaknesses in the UK economy.

### **A flattering macroeconomic result**

With growth of 2.8% in 2014, the UK topped the charts for growth among the G7 countries (just ahead of Canada at 2.5% and the United States at 2.4%). The British economy has been on the road to recovery for two years, as growth picked up from 0.4% yoy in the fourth quarter of 2012 to 3% in the fourth quarter of 2014. This recovery stands in contrast to the situation of the large euro zone economies, where there was a weak recovery in Germany (respectively, 1.5% after 0.4%) and weak growth in France (only 0.4%, against 0.3% in 2012), with Italy still in recession (-0.5% after -2.3%).

At the end of 2014, Britain's GDP was 5% above its pre-crisis level (*i.e.* first quarter 2008), due to a strong recovery in services, which was particularly spectacular in business services (where value added (VA) was 20% above its pre-crisis level, representing 12% of VA), with a good performance in the fields of health care (VA 20% above the level of early 2008; 7% of VA) and in real estate (VA 17% above the pre-crisis level; 11% of added value).

According to the initial estimates released on April 28 by the Office of National Statistics (ONS), GDP nevertheless increased by only 0.3% in the first quarter of 2015, instead of 0.6% as in the previous quarters. While this initial estimate is likely to be revised (upwards or downwards, only half of the data on the quarter is known for this first estimate), this slowdown in growth just a few days before the elections comes at a bad time for the outgoing government...

*A strong decline in the unemployment rate ...*

Another highlight of the macro-economic record as the



elections approach: the unemployment rate has been falling steadily since late 2011, and was only 5.6% (ILO definition) in February 2015, against 8.4% in late 2011. This rate is one of the lowest in the EU, better than in France (10.6%) and Italy (12.6%), though still behind Germany (only 4.8%). While the unemployment rate has not yet reached its pre-crisis level (5.2%), it is now close. The number of jobs has increased by 1.5 million in the UK since 2011, and David Cameron unhesitatingly boasts of the UK's success as "the jobs factory of Europe", creating more jobs on its own than the rest of Europe combined! [\[1\]](#)

Behind this strong increase in employment, however, there are many grey areas... First, the nature of the jobs created: 1/3 of the jobs created during this recovery are individual entrepreneurs, who now represent 15% of total employment. In times of crisis, a rise in the number of the self-employed generally reflects hidden unemployment, although according to a recent study by the Bank of England [\[2\]](#) this increase is part of a trend. The issue of the growth in what are called "zero hour" contracts, which are contracts for jobs with no guaranteed number of hours, has also burst into the discussion. Until 2013, this type of contract was not subject to statistical monitoring, but according to surveys recently released by the ONS, 697,000 households were affected by this type of contract (representing 2.3% of employment) in the fourth quarter of 2014, against 586,000 (1.9% of employment) a year earlier, *i.e.* an increase of 111,000 persons, while total employment increased by 600,000 over the period: zero-hours contracts therefore concern only a relatively small portion of the jobs created.

One corollary of the job creation that has taken place since 2011 is low gains in productivity. The British economy began to create jobs from the beginning of the recovery, while productivity fell sharply during the crisis. Companies have kept more employees on the payroll than they usually do in

times of crisis, but in return wage increases have been curtailed. UK productivity today remains well below its pre-crisis level. Will the British economy keep a growth model based on low productivity and low wages for a long time to come? It is too early to tell, but this is a subject lying in the background of the election campaign.

### *Very low inflation*

Inflation, as measured by the harmonized index of consumer prices (HICP), fell in February 2015 to only 0% yoy against 1.9% at the end of 2012. This slowdown was due to lower energy prices, but since the end of 2012, also to a slowing in core inflation: from 1.9% at end 2012 to 1.2% in February 2015. The question of inflationary risks has been debated within the UK Monetary Policy Committee for many months now: growth and low unemployment are potentially harbingers of short-term inflationary pressure, if one accepts that the economy is once again approaching full employment. In fact, the continuous decline in inflation since 2012, coming amid low wage increases, a more expensive pound and falling energy prices, has put off the prospect of an acceleration in short-term inflation. For the moment, the members of the Bank of England's Monetary Policy Committee are voting unanimously for the status quo.

Long-term interest rates on government debt remain at low levels, which was one of the goals hammered at by the Conservatives during the 2010 electoral campaign. In fact, UK rates are moving in much the same way as US rates, in line with similar growth prospects.

Despite this relatively good record, the British economy is still fragile.

### **The vulnerabilities of the British economy over the medium term**

#### *Household debt continues to be high*

Household debt had reached record levels before the 2007 crisis, and at that time represented 160% of household annual income. Since then, households have begun to deleverage, with indebtedness falling to 136% at end 2014, which is still well above the 100% level of the 1990s. This deleveraging is lessening households' vulnerability to a further economic slowdown or to a fall in the price of assets (especially property), but this also has the effect of reining in private domestic demand, while the household savings rate remains low (about 6%) and growth in nominal and real wages moderate. The rebalancing of domestic demand should continue, especially in terms of business investment.

### *Business investment is catching up*

Business investment was structurally weak in the 2000s in the UK. But the recovery has been underway for 5 years, and the rate of investment volume is now close to its level of the early 2000s. The recovery of investment is obviously good news for the UK's productive capacity. But there is still an external deficit, a sign that the UK is struggling to regain competitiveness, at least with regard to the trade in goods. The stabilization of the trade deficit at around 7 GDP points in 2014, however, was due to the goods deficit being partially offset by a growing surplus in services (5 GDP points at end 2014), a sign that the UK economy still has a high level of specialization in services. Nevertheless, taking into account the balance in income<sup>[3]</sup>, the current account deficit came to 5.5 GDP points, which is high.

### *The deceptive appearance of the public finances*

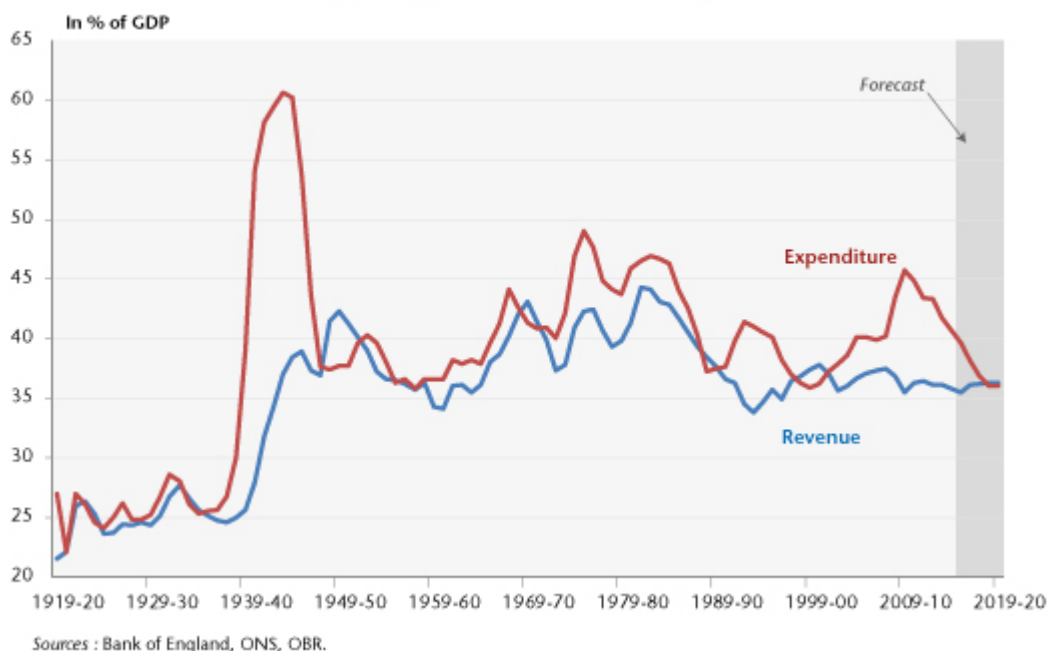
In 2010, the Tory campaign blamed the previous government for letting the deficits mount during the crisis. Their electoral programme included a large-scale fiscal austerity plan, which corresponded to the archetypical IMF plans: 80% spending cuts and 20% revenue increases over a 5-year horizon. In fact, as soon as they came to power, the government increased the VAT

rate, which in 2010-2011 interrupted the recovery; it cut spending, while preserving the public health system (NHS) that the British hold so dear, as well as public pensions, which are low in the UK, but which the government decided to peg to inflation or wages (using whichever is the higher of the two variations, with a guaranteed minimum of 2.5%).

Five years later, David Cameron is highlighting the "success" of his government, which has cut the public deficit in half, from a level of 10% in 2010 to 5.2% in 2014. But with respect to the government's initial ambitions, this is in fact only a partial success: its first budget in June 2010 set out a public deficit of only 2.2% of GDP in 2014. The originally planned decrease in public expenditure relative to GDP was in fact realized, but revenue rose much less than expected (due in part to sluggish household income).

While the austerity programme was generally weaker than what had been announced, in the March 2015 budget the government set out sharp cuts in public spending by 2019, which would bring it down from the current level of 40% of GDP to only 36% of GDP, one of the lowest levels of public spending since World War 2 (graphic). This reduction in public spending would be sufficient in itself to balance the public deficit, without any significant tax hikes: this would represent large-scale budget cuts, whose components are not specified and which it is hard to imagine would not sooner or later affect spending on health care and pensions, which the government has so carefully avoided doing up to now...

Public spending and revenue over the long term



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[1] “We are the jobs factory of Europe; we’re creating more jobs here than the rest of Europe put together” (Speech on 19 January 2015).

[2] “Self-employment: what can we learn from recent developments?”, *Quarterly Bulletin*, 2015Q1.

[3] But the deficit of the balance of direct investment income (2 percentage points of GDP) is probably inflated by the relatively good performance of foreign companies operating in the UK in comparison to British companies operating abroad.

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## Poverty and social exclusion

# in Europe: where are things at?

By [Sandrine Levasseur](#)

In March 2010, the EU set itself the target [for the year 2020](#) of reducing the number of people living below the poverty line or in social exclusion by 20 million compared with 2008, *i.e.* a target of 97.5 million “poor” people in 2020. Unfortunately, due to the crisis, this goal will not be reached. The latest available figures show that in 2013 the EU had 122.6 million people living in poverty or social exclusion. Surprisingly, the EU’s inability to meet the target set by the Europe 2020 initiative is due mainly to the EU-15 countries, the so-called “advanced” countries in terms of their economic development [\[1\]](#). Indeed, if the trends observed over the last ten years continue, the Central and East European countries (CEEC) will continue to experience a decline in the number of people living below the poverty line or in social exclusion. How is it that the countries of the EU-15 are performing so poorly in the fight against poverty and social exclusion? It is important to keep in mind that the East and Central European countries also perform better when we consider other indicators of income inequality within a country (*e.g.* the Gini coefficient, the ratio of the income of the 20% richest over that of the 20% poorest). The EU-15’s performance is troubling not only with regard to relative poverty and social exclusion, but also in terms of all the statistics concerning living conditions and income inequality.

## **Risk of poverty and social exclusion: what exactly are we talking about?**

In order to reduce poverty and social exclusion, the Europe 2020 initiative focuses on three types of groups: people at risk of poverty, people facing severe material deprivation,

and people with a low work intensity[2]. A person belonging to several different groups is counted only once.

According to Europe 2020, people are at risk of poverty when their disposable income falls below 60% of the median income observed at the national level, the median income being the level of income at which half the country's population has a higher income and half a lower one. Since the median income threshold is calculated nationally, this means for example that a Romanian individual at the threshold of the median income has an income well below that of a French person earning the median income: the Romanian median income is in fact one-fifth the French median income in terms of purchasing power parity, that is to say, when we take into account the price differences between the countries[3]. The indicator of the poverty risk used by Europe 2020 is thus a measure of income inequality between individuals *within a country*, not between countries.

Note that disposable income is considered in adult equivalents, *i.e.* incomes were first recorded at the household level and then weights were assigned to each member (1 for the first adult; 0.5 for the second and each person over age 14; and 0.3 for children under age 14). Also note that the disposable incomes in question here are *after* social transfers, *i.e.* after taking account of allowances, benefits and pensions – that is, they are after any action by the country's social system. In addition, the level used to define the threshold for the risk of poverty (*i.e.* 60% of median income) aims to take into account situations other than extreme poverty: the goal is also to take account of people who are having difficulty meeting their basic needs. For example, the poverty threshold of 60% of median income in France was 12,569 euros per year in 2013 (or 1047 euros a month). The concept of material deprivation is used to refine the definition of unmet basic needs.

People experiencing severe material deprivation are those

whose lives are constrained by a lack of resources and who face at least four out of the following nine material deprivations: an inability 1) to pay the rent or utility bills (water, gas, electricity, telephone); 2) to heat the dwelling adequately; 3) to meet unexpected expenses; 4) to eat a daily portion of protein (meat, fish or equivalent); 5) to afford a week's holiday away from home; 6) to own a car; 7) to have a washing machine; 8) to have a color TV; or 9) to have a telephone.

People living in a household with a low work intensity are those aged 0 to 59 who live in a home where the adults (aged 18 to 59) worked less than 20% of their potential capacity in the last year.

According to the latest available statistics (Table 1), 122.6 million people in the EU-28 belonged to at least one of these three groups in 2013, *i.e.* nearly one person out of every four (slightly more than 24%).



**Table 1. People living below the poverty line or in social exclusion**

In 1000s of people and % of the country's total population

	2005 (or 2007*)	2009	2011	2013	Change in the number of poor or socially excluded between 2005 (or 2007*) and 2013	Share in the 2013 population (%)
Belgium	2 338	2 145	2 271	2 286	-52	20,4
Denmark	921	962	1 039	1 059	138	18,8
Germany	15 022	16 217	16 074	16 212	1 190	20,1
Ireland	1 038	1 150	1 319	1 040	2	22,6
Greece	3 131	3 007	3 403	3 904	773	35,5
Spain	10 481	11 232	12 791	12 630	2 149	27,2
France	11 127	11 200	11 840	11 229	102	17,1
Italy	14 621	14 835	17 112	17 326	2 705	28,5
Luxembourg	77	85	84	96	19	17,5
Netherlands	2 705	2 483	2 598	2 648	-57	15,7
Austria	1 416	1 577	1 593	1 572	156	18,5
Portugal	2 745	2 648	2 601	2 877	132	27,6
Finland	887	886	949	854	-33	15,7
Sweden	1 325	1 459	1 538	1 602	277	16,6
United Kingdom	14 530	13 389	14 044	15 586	1 056	24,2
<b>EU-15</b>	<b>82 364</b>	<b>83 275</b>	<b>89 256</b>	<b>90 921</b>	<b>8 557</b>	<b>22,6</b>
Czech Republic	1 988	1 448	1 598	1 508	-480	14,3
Estonia	347	312	307	313	-34	23,8
Latvia	1 027	808	821	702	-325	35,1
Lithuania	1 400	943	1 011	917	-483	31,2
Hungary	3 185	2 924	3 051	3 285	100	33,3
Poland	17 080	10 454	10 196	9 748	-7 332	25,3
Slovenia	362	339	386	410	48	19,9
Slovakia	1 724	1 061	1 112	1 070	-654	19,8
<b>CEEC-8</b>	<b>27 113</b>	<b>18 289</b>	<b>18 482</b>	<b>17 953</b>	<b>-9 160</b>	<b>24,7</b>
Bulgaria*	4 663	3 511	3 693	3 493	-1 170	48,2
Romania*	9 904	9 112	8 630	8 601	-1 303	43,1
<b>CEEC-10</b>	<b>—</b>	<b>30 912</b>	<b>30 805</b>	<b>30 047</b>	<b>-11 633</b>	<b>30,1</b>
Croatia	—	—	1 384	1 271	—	29,9
Cyprus	188	188	207	240	52	28,0
Malta	81	82	90	99	18	23,3
<b>EU-28</b>	<b>—</b>	<b>—</b>	<b>121 742</b>	<b>122 578</b>	<b>≈ -3 000</b>	<b>24,2</b>

Source: Eurostat, author's calculations.

## Contrasting developments between the EU-15 and the CEE countries with regard to poverty and social exclusion

While a little over 30% of the CEE population lives in poverty or social exclusion (versus 22.6% in the EU-15), what is striking is that the number of poor and socially excluded has been decreasing in the CEE countries over the last 10 years while it has been increasing in the EU-15, especially since the onset of the crisis (Table 1).

Over the past decade, the number of people living in poverty or social exclusion fell in almost all the CEE countries (with the exception of Hungary and Slovenia) and rose in almost all the EU-15 countries (with the exception of Belgium, the Netherlands and Finland). During these 10 years, the CEE countries experienced a decline of 11.5 million in the ranks of the poor and socially excluded, while the EU-15 recorded an increase of 8.5 million, *i.e.* an 85% rise since 2009. The crisis has clearly hit the EU-15 hard in terms of poverty and social exclusion. The CEE countries have, all things considered, proved fairly resilient: a number of them are even continuing to see a decrease in the number of poor and socially excluded.

### **What's behind these contrasting trends in poverty and social exclusion?**

The main factor explaining the contrasting trends in poverty between the EU-15 and the CEE countries is that the economic situation has generally developed more favourably in East Europe than in West Europe, including during the crisis period.

Indeed, the average GDP growth rate over the last ten years (2004 to 2013) was 3.2% in the CEEC, compared with 0.8% in the EU-15. The CEE countries, though hit by the crisis, nevertheless recorded average annual growth of 0.7% in 2009-2013 (against 0.1% in the EU-15). Likewise, the unemployment and employment rates during the crisis reflected a more favourable situation on the CEE labour markets than on the EU-15 markets (Table 2).

**Table 2. Employment and unemployment rates in the EU-15 and in the CEE countries**

In %

	Annual average			Change in percentage points between the pre-crisis and crisis periods
	2004-2013	2004-2008	2009-2013	
<b>Employment rate</b>				
EU-15	70,4	71	69,9	-1,1
CEEC-10	64,9	64,2	65,5	1,3
CEEC-8	65,0	64,2	65,8	1,6
<b>Unemployment rate</b>				
EU-15	8,8	7,7	10,0	2,3
CEEC-10	9,6	9,8	9,5	-0,4
CEEC-8	10,4	10,8	10,1	-0,8

Source: Eurostat, author's calculations.

The risk of poverty prior to social transfers continued to fall in the CEE countries, while from 2009 it rose in the EU-15 (Table 3). Consequently, the share of people in the CEE countries living below the poverty line (out of each country's total population) *before transfers* has fallen below the level observed in the EU-15. The crisis has thus had a direct differentiated effect (*i.e.* before redistribution) on income inequality within countries: in Europe's East, income inequality has fallen, while in the West it has risen.

The workings of the social security systems in the EU-15 countries have, however, resulted in reversing (or mitigating) the differences in *post-transfer* poverty rates (Table 3). In 2013, the post-transfer poverty rate was 16.5% in the EU-15, compared with 17.2% in the CEE countries (15.4% excluding Bulgaria and Romania). The Gini coefficient, which is a more common measure of within-country income inequality, also confirms that income inequality is now higher in the EU-15 than in the CEEC[4].

Note that during the crisis the intensity of the redistribution (in % points or rates) was higher in the EU-15 than in the CEEC. However, over time the redistribution rate fell in both the East and the West, starting in 2009. Prior to the crisis, the social security systems in the EU-15 resulted

in a 37.3% reduction in the number of people living in poverty and social exclusion; during the crisis, the rate fell to 36.8%. In the CEE countries, the fall in the redistribution rate was even greater, on the order of 3.7 percentage points. By way of illustration, if the redistribution rate for the pre-crisis period had been maintained during the crisis period, an additional 1.4 million people would have avoided the risk of poverty during the crisis (0.5 million in the EU-15 and 0.9 million in the CEEC).

**Table 3. Percentage of people at risk of poverty\* and redistribution through social transfers**

In %

	Annual average			Change in percentage points between the pre-crisis and crisis periods
	2004-2013	2004-2008	2009-2013	
<b>% of people at risk of poverty**</b>				
<b>Pre-transfer (A):</b>				
CEEC-8	24,6	26,1	23,4	-2,7
CEEC-10	25,7	27,0	24,7	-2,3
EU-15	25,8	25,5	26,1	0,6
<b>Post-transfer (B):</b>				
CEEC-8	15,7	16,0	15,4	-0,6
CEEC-10	17,5	17,8	17,2	-0,6
EU-15	16,3	16,0	16,5	0,5
<b>Redistribution</b>				
<b>In % points: (A)-(B)</b>				
CEEC-8	8,9	10,1	8,0	-2,1
CEEC-10	8,2	9,2	7,5	-1,7
EU-15	9,5	9,5	9,6	0,1
<b>Rate in % [(A)-(B)]/(A)</b>				
CEEC-8	36,2	38,7	34,2	-4,5
CEEC-10	31,9	34,1	30,4	-3,7
EU-15	36,8	37,3	36,8	-0,5

\* Due to the lack of available data "before" and "after" social transfers, people at risk of social exclusion are not taken into account here.

\*\* Number of "poor" people in the country relative to the country's population.

Source: Eurostat, author's calculations.

This brings us to the second explanatory factor. Are the austerity programmes being implemented in many EU countries to comply with the Stability and Growth Pact and / or to satisfy the financial markets responsible for the post-transfer increase in the number of people at risk of poverty that has taken place in the EU-15? And have these programmes acted to

hold back the decline in poverty rates observed in the CEE countries, which otherwise would have been even greater?

The empirical literature on this issue is clear-cut: it shows that income inequality within countries increases during periods of fiscal consolidation<sup>[5]</sup> ([Agnello and Sousa, 2012](#); [Ball et al., 2013](#); [Mulas-Granados, 2003](#); [Woo et al., 2013](#)). Among the tools of fiscal consolidation (*i.e.* cuts in public spending, increases in tax revenues), it is the spending cuts in particular that increase income inequality ([Agnello and Sousa, 2012](#); [Ball et al., 2013](#); [Bastagli et al., 2012](#); [Woo et al., 2013](#)). Austerity programmes implemented after the onset of a banking crisis have a much greater negative effect on income inequality than programmes implemented when not in a banking crisis ([Agnello and Sousa, 2012](#)). Furthermore, small consolidations (*i.e.* involving a cut in the public deficit of less than 1 GDP point) have a bigger negative effect on inequality than large fiscal consolidations ([Agnello and Sousa, 2012](#)).

If the results of this (still sparse) literature are accepted, the timing of the fiscal consolidation implemented in recent years has not been ideal: the programmes have been introduced too early with respect to the occurrence of the crisis. Nor have they been optimal in size: they are insufficient to cut the deficit substantially but very costly in terms of increasing income inequality between individuals. While it is difficult to form a firm and final opinion on the link between fiscal consolidation and income inequality (and poverty) based on the sparse literature, the afore-mentioned studies do have a value: they raise questions about the potentially harmful impacts of the austerity policies that have been implemented in recent years.

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<sup>[1]</sup> The Europe 2020 initiative sets out poverty reduction and social exclusion targets [for each country](#). Here we are

basically interested in the different trends between the two areas: the EU-15 and the CEE countries.

[2] See the article by [Maître, Nolan and Whelan \(2014\) for a critical in-depth analysis](#) of the statistical criteria for poverty and social exclusion.

[3] In current euros, the difference in income would be even greater: in 2013, the French median income was 20,949 euros a year, and Romania's 2071 euros, so Romania's median income per year would thus be one-tenth, not one-fifth, of the French level.

[4] The difference (in favour of the CEE countries) is even more pronounced due to the exclusion of Bulgaria and Romania: the Gini coefficient after transfers is then 0.291 against 0.306 for the EU-15. The Gini coefficient can take a value between 0 and 1. As the coefficient approaches 1, an increasingly small share of the population has a larger and larger share of total income. Ultimately, when the coefficient reaches 1, a single individual has all the income.

[5] Because of the way the poverty line is calculated (*i.e.* 60% of median income), an increase in the share of people living below the poverty line definitely corresponds to an increase in income inequality between individuals.

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**Who has the best playing field for tax competition:**

# the United States or the European Union?

By [Sarah Guillou](#)

Two recent events demonstrate the differences in the American and European views on tax competition. First was the case of Boeing, which the European Union (EU) has brought before the World Trade Organization (WTO). The EU is challenging the tax incentives offered by the State of Washington to the American aircraft maker. Then there is the European Commission's investigation of Luxembourg's tax provisions that benefit Amazon, the Internet retailer. Boeing and Amazon both make massive use of tax competition. While this is widespread and accepted in the United States, it is being increasingly questioned in the EU, and even excluded by law if it is classified as illegal State aid.

In the Boeing affair, in December 2014 the EU filed a request for [consultations](#) with the WTO regarding the tax subsidies paid by the State of Washington for the manufacture of the new Boeing 777X. This aid would amount to 8.7 billion dollars for assembly in the State. This programme was set up in November 2013 by the State of Washington, and the governor has now decided to extend it until 2040! The incentives are conditioned on the use of local products, i.e. the aid is linked "to local content requirements ". However, these requirements are contrary to the WTO Agreement on Subsidies and Countervailing Measures. We are not going to discuss here the EU's complaint, which is awaiting a response from the US, and which is part of an ongoing dispute between Boeing and EADS about their respective public subsidies. This case, however, offers an opportunity to take a look at the intensity of tax competition that exists between the various States in the US.

While the US, like the EU, is concerned with non-discrimination, which is set out in the doctrine of the Commerce Clause of the US Constitution, in practice it has been difficult for case law, which performs an *a posteriori* control, to provide a definition of discrimination that makes it possible to prevent discriminatory regulations. The result has been that the American States are free to offer subsidies and tax breaks to companies, or sometimes specific companies, to attract investment and jobs. Recall that in Europe, controls on State aid are performed *a priori* and that granting subsidies to any specific companies is totally excluded (see [Guillou, 2014, OFCE blog](#)). In the US, Boeing is a major player in this tax competition.

An American research center "[goodjobsfirst](#)", which tracks the aid and subsidies granted to companies by public institutions, showed that a mere 965 companies received 75% of all aid. It is Boeing that receives the most aid. This comes mainly from two States, Washington and South Carolina, with numerous subsidies (130 agreements) from all over the United States. The combination of all the aid brought to light amounts to 13 billion dollars. Boeing comes far ahead of all other companies, as second-place Alcoa receives less than half as much (5.6 billion dollars). Another [study](#) found that 22 States competed to host the production of the new 777X airliner, but Boeing ultimately decided to stay in the Seattle area and entered a 16-year tax agreement with the State of Washington that is estimated to be worth more than 8.7 billion dollars, the largest tax break in the United States. Business lobbying is much more common in the United States than in Europe, which explains much of the competition between States to attract business. While the United States has complained of foreign tax competition (especially vis-à-vis Ireland), it accepts this completely on its own territory. This is not the prevailing position in the EU, of course, as the EU is not fiscally integrated.



Indeed, in Europe, tax harmonization is not yet on the agenda. But tax competition is being increasingly debated. This has not been in vain, as this pushed Ireland to abandon its “double Irish” system that allowed certain companies located in Ireland to be taxed in tax havens. Companies taking part in this tax scheme began the process of withdrawal in January 2015. While differentiated taxation is still accepted in Europe, excessive tax competition has been considered intolerable in the common market. When companies’ tax optimization strategies come together with national strategies to attract jobs and investment, the ingenuity of the tax authorities becomes a threat to the common market. What is most worrying is the legitimization of the avoidance of common tax rules.

European controls on State aid act as a powerful guardian over the use of public resources and on non-discrimination in the European market. These controls could well become an instrument in the fight against tax “loopholes”, vulnerabilities in the tax system that result in significant losses of public resources. The case against Luxembourg concerns its system of “tax rulings”. The tax ruling is a procedure whereby a State negotiates with a company about its future tax status. This procedure, which has been called the “marketing of State sovereignty”, is widespread in Luxembourg and was brought to light by a recent investigative report published in November 2014 (*Le Monde*), which shows that Luxembourg is not the only country to use these “tax rulings”.

Luxembourg attracts a large number of multinational firms that choose the location of their European headquarters based on tax optimization. It is the EU country with the lowest percentage of GDP (the production of residents) out of GNP (domestic production): this figure was only 64% in 2013, against just over 100% for France and Germany. In other words, Luxembourg lost more than one-third of its national income once the payment of income to resident foreign companies was

taken into account (net of income received). This reveals the fiscal opportunism of the numerous multinationals located in Luxembourg, for which the local market is clearly not a target.

In this case, Luxembourg has granted Amazon a valuation of its transfer pricing that the European Commission (EC) considers overestimated, which thus leads to underestimating the tax base (see the recently released [EC decision](#)).

Transfer prices are the prices of the goods and services traded between subsidiaries of the same corporation. These exchanges should theoretically be valued at market prices, that is to say, the price that would be paid by a company that is not a subsidiary of the corporation. The way these prices are decided may change the amount of a subsidiary's purchases and revenues, and thus its profits. The logic of the corporation is to minimize profits where tax rates are high and shift them to where rates are low. It is not so much the price of goods that are manipulated as the price of intangible assets such as patents, copyrights or other intellectual property (trademarks, logos, etc.). Multinationals that hold intangible capital, such as the giants of the Silicon Valley, are the ones that most commonly engage in this type of manipulation.

One way to prevent the manipulation of transfer pricing in Europe would be to make it obligatory to calculate a common consolidated corporate tax base. This is the purpose of the [draft CCCTB directive](#) from 2011, which is still under discussion. Trade-offs between the various European countries would be pointless, as the tax base would be consolidated and then distributed among the member States based on a formula that takes into account fixed assets, labour and sales. The States would retain control of their tax rate on corporations. It is expected that this common base scheme would be optional. It is not certain that this would suffice to get the directive passed, as in fiscal matters this demands a unanimous vote

whereas, for the moment, there is a great deal of disagreement.

On the other side of the Atlantic, the United States has a consolidated tax base system at the national level and a common federal tax rate on corporations. But local taxes, which can vary between 1% and 12%, are generally deductible from the federal tax calculation. The issue of transfer pricing between subsidiaries in different States may therefore also arise. And this is especially so, given that the local tax rate on profits is subtracted from the various tax credits awarded to certain companies.

The outcome of the investigation into Luxembourg and Amazon will be important for the future of the CCCTB Directive, in particular the version that affects only digital businesses. If the day has not yet come when the EU rules that “banking secrecy is a disguised form of subsidy” (G. Zucman, [The hidden wealth of nations](#)), the investigation into Amazon indicates that the EU is beginning to put some limits on tax competition that could soon make American taxpayers jealous.

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## **Flexibility versus the new fiscal effort – the last word has not been spoken**

By Raul Sampognaro

On 13 January, the [Juncker Commission clarified its position on the flexibility](#) that the Member States have in implementing

the Stability and Growth Pact (SGP). The new reading of the SGP should result in reining in the fiscal consolidation required for certain countries[1]. Henceforth, the Commission can apply the “structural reform clause” to a country in the corrective arm of the Pact[2], whereas previously this was only possible for countries in the Pact’s preventive arm[3]. This clause will allow a Member State to deviate temporarily from its prior commitments and postpone them to a time when the fruits of reform would make adjustment easier. In order for the Commission to agree to activate the clause, certain conditions must be met:

– The reform plan submitted by the Member State must be major and detailed, and approved by the Government or the National Parliament; its timetable for implementation must be explicit and credible;

– The plan must have a favourable impact on potential growth and / or the public finances in the medium-term. The quantification of the impact should be carried out transparently and the Member State must submit the relevant documentation to the Commission;

– The Member State must make a structural budget improvement of at least 0.5 GDP point.

In this new context, France has reforms it can point to, such as the regional reform and the law on growth and activity, the so-called Macron law. [According to OECD calculations from October 2014](#), the reforms already underway or being adopted [4] could boost GDP by 1.6 points over the next 5 years while improving the structural budget balance by 0.8 GDP point[5] (the details of the impacts estimated by the OECD are shown in Table 1).

**Table 1. Impact on GDP of the reforms underway or announced**

In points

Reforms	Impact on GDP at 5 years	Impact on GDP at 10 years
<b>Reforms underway</b>	<b>1.2</b>	<b>3.0</b>
Greater competition (administrative simplification shock and first measures on regulated professions)	0.2	0.3
Labour market reform	0.6	1.3
– including CICE tax credit and Responsibility Pact	0.5	1.1
– others (unemployment insurance reform, active policies)	0.1	0.2
Modification of tax system	0.1	0.4
Creation of “metropolises” (Paris and Aix-Marseille)	0.3	1.0
<b>Reforms announced</b>	<b>0.4</b>	<b>0.7</b>
Increase in competition in electricity and gas and reform of the regulated professions (reform a little broader than the Macron law)	0.4	0.7

Source: OCDE (2014), “France. Structural reforms: impact on growth and options for the future”. October 2014.

In March, the Commission will decide whether France’s 2015 Finance Act complies with the rules of the SGP. To benefit from the structural reform clause, France must then meet certain conditions:

1) The outline of the reforms needs to be clarified: [at end December 2014, the Commission felt that there were still many lingering uncertainties](#) concerning the regional reform and the content of the Macron law, uncertainties that will be resolved in the course of the parliamentary process.

2) The Ministry of Finance at Bercy must produce credible assessments of the impact of the Macron law, while the Commission will carry out its own evaluation. The Commission has already noted that the OECD’s calculations will constitute the upper bound of the impact.

The evaluation of the 2015 Finance Act may result in the imposition of financial sanctions on France, unless the government decides to go for a greater fiscal adjustment. [The Commission warned in late November that further steps would be needed to ensure that the 2015 budget complies with the SGP.](#) Indeed, the Commission found that the adjustment was only 0.3 GDP point, while in June 2013 France had committed to an annual structural adjustment of 0.8 point in 2015 to bring its deficit below 3% in 2015 [\[6\]](#).

While the Commission approves the positive effects expected from the reforms, there is a problem with the application of the “structural reform clause”: the structural budgetary adjustment is still below 0.5 GDP point, which prevents the application of the new clause. France therefore still faces the threat of sanctions, despite the new doctrine.

While this analysis of the [document published on January 13](#) shows that the Commission has given the Pact greater flexibility, it also shows that the Commission expects France to make a larger fiscal adjustment. This would be on the order of 4 billion euros (0.2 percent of French GDP) instead of the 8 billion (0.4 percent of GDP) that would have been expected back in October (the impact of a strict reading of the Pact has been analyzed [here](#)).

The Government’s refrain is that it does not wish to go any further with fiscal adjustment, that this is not desirable in the current economic climate: 2015 could be a year for recovery provided that the risk of deflation is taken seriously. There is a lot of support for economic activity, including lower prices for oil and the euro, an expansionary monetary policy and the Juncker plan, even if the latter needed to go much further. However, France’s fiscal policy is continuing to be a drag, and just how much so will remain uncertain until March. From now till then, with the terms of the debate clearly spelled out, everyone will need to take the risk of deflation seriously.

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[\[1\]](#) The Commission permits subtracting investments made under the Juncker Commission Plan from the deficit calculation; it clarifies the applicability of the “structural reform clause” and moderates the speed of convergence towards the medium term objectives (MT0) for countries in the preventive arm of the

Pact based on their position in the business cycle.

[2] *Grosso modo* this means countries with a deficit of more than 3%.

[3] *Grosso modo* this means countries with a deficit of less than 3%.

[4] Which goes beyond the Macron law alone and includes the CICE tax credit and the Responsibility Pact.

[5] The OECD data were used by the Prime Minister in his [October 27 letter to the Commission](#).

[6] In its 2014 autumn forecast, the Commission quantified the adjustment at 0.1 GDP point, but this figure is not directly comparable with the commitment of 0.8 point from June 2013. Once the changes in national accounting standards and the unpredictable changes in certain variables are taken into account, the corrected adjustment is 0.3 GDP point. This figure is the calculation basis for the excessive deficit procedure.

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## **Working in the United States: Longer, harder, and ... on weekends!**

By Elena Stancanelli, Paris School of Economics, CNRS and Research Associate at the OFCE[\[1\]](#)

Americans now work longer hours than Europeans. Daniel

Hamermesh and Elena Stanca show in "[Long Workweeks and Strange Hours](#)" that the lengthening of the workweek in the United States has gone hand in hand with more work at night and on weekends.

The authors' results are based on mining a unique set of data, the American Time Use Survey and a panel of European individuals that accurately measures employee working time (weekly, week-ends, at night) as well as a range of other activities (leisure, child care, domestic work, rest periods, etc.) using daily time diaries [2]. The individuals are interviewed about the entire day (24 hours) using ten-minute slots (144 ten-minute slots are filled in for each individual). These data are collected by the national statistical institutes for representative samples of the population, on an annual basis in the United States but much less frequently in Europe. For example, in France, the *Emploi du temps* (EDT) survey is collected by the INSEE statistics institute once every twelve years. [3]

In the US, over 30% of employees work more than 45 hours per week, a much higher rate than in France, Germany or the Netherlands (Table 1). The number of hours worked per person has fallen significantly in the last two decades in almost all OECD countries. The only exception is the United States, where hours worked fell by only 2% from 1979 to 2012, compared with, for example, an 18% reduction in France (Table 2). It is therefore not very surprising that one in three American workers are working weekends, versus fewer than one in five in France, Germany and the Netherlands (Table 1). Night work, defined as working between 10pm and 6am, is even less widespread in France, as it affects only 7% of workers, compared with over 25% in the United States and 10-15% in Germany and the Netherlands (Table 1). Furthermore, weekend work is usually performed by less-qualified individuals, immigrants and women, that is to say, by those with little bargaining power (Kostiuk, 1990; Shapiro, 1995). This tends to



confirm the arduous nature of weekend work and its compulsory character. In contrast, people who work nights have more varied characteristics. Even so, more educated workers are less likely to work at night, which, again, would suggest its onerous character.

Finally, a simulation shows that, even if we assume that the United States were identical to the European countries in terms of both demographic characteristics and the structure of employment (occupational sectors, type of employment, hours worked) [\[4\]](#), this still fails to explain why Americans work so much and on weekends and at night (Hamermesh and Stanca, 2014). What is the reason for this? The importance of cultural differences between the US and Europe? The existence of institutional differences? A complex interaction between culture and institutions? This is a wide-ranging debate that has barely begun.

In any case, one key result of this study is to highlight the socially undesirable character of work on weekends, due to the damage this can cause to family relations (Jenkins and Osberg, 2005) and to social life (Boulin and Lesnard, 2014). Food for thought for our MPs during the vote on the economic reforms in the Macron bill?

**Table 1. Duration and time of work**

In %

Weekly work hours	États-Unis 2003-11	France 1998-99	Allemagne 2001-02	Pays-Bas 2000, 2005	Roy.-Uni 2000-01
<b>Hours:</b>					
1-19	5,2	5,8	8,5	16,9	13,1
20-34	12,5	16,6	17,4	27,0	15,6
35-44	50,5	74,0	56,4	41,1	39,7
45-54	19,6	2,6	10,6	10,2	18,2
55-64	8,3	0,6	5,1	3,6	8,5
65+	3,9	0,4	2,0	1,2	4,9
Average hours of work per week:	41,0	35,7	36,9	32,8	38,6
<b>Work on weekends:</b>					
Percentage of employees weekends	34,3	21,8	22,3	21,1	27,3
Hours worked on weekends, on average (per day)	5,5	5,3	4,5	5,5	6,2
<b>Work at night (10pm-6am):</b>					
Percentage of employees working nights	26,6	7,3	13,0	10,4	21,6

Source: Daniel Hamermesh and Elena Stancanelli, "Long Workweeks at Strange Hours", NBER Working Paper n° 20 449, September 2014 or Document de Travail de l'OFCE, n° 27.

**Table 2. Hours worked per person employed**

Annual average

	Years		Change
	1979	2012	In %
Australia	1832	1728	-5,7
Canada	1841	1710	-7,1
Denmark	1636	1546	-5,5
Finland	1869	1672	-10,5
France	1804	1479	-18,0
Japan	2126	1745	-17,9
Netherlands	1556	1381	-11,24
Sweden	1530	1621	+5,95
United Kingdom	1813	1654	-8,8
United States	1829	1790	-2,1

Source: OECD Employment Outlook, 2013.

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[\[2\]](#) The authors use the harmonized version of the data made available by a group of researchers from Oxford University (see Gershuny and Fisher, 2014).

[\[3\]](#) These data are based on the average of the 2010 years for the United States and for different years in the early 2000s for the European countries. For France, we decided to use the 1998-1999 EDT data, as the most recent survey, for 2009-10, took place in the midst of the economic crisis, which could have affected the pace of work. In addition, teachers were visibly oversampled there, which would tend to distort international comparisons, as weightings do not perfectly

correct the distortions. It seems very unlikely that the difference between the US and the European countries has narrowed in recent years.

[4] For the United States, the regressions also include fixed effects for the various States, in order to capture institutional differences from one State to another.

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## **The Greek Sisyphus and its public debt: towards an end to the ordeal?**

By [Céline Antonin](#)

After its failure to elect a new President by a qualified majority vote, the Greek Parliament was dissolved, with early elections to be held on 25 January 2015. The radical left party Syriza is leading the opinion polls on the election, ahead of the “New Democracy” party of the outgoing Prime Minister, Anthony Samaras. While Syriza’s economic programme has met with enthusiasm from the population, it has aroused concern from the Troika of creditors (IMF, ECB and EU), particularly on three issues: the country’s potential withdrawal from the euro zone, the implementation of a fiscal stimulus, and a partial sovereign default. This last topic will be the main issue after the elections.

### **The election’s real stakes: restructuring Greece’s public debt**

Fears about Greece’s potential exit from the euro zone (the infamous “Grexit”) need to be nuanced. The situation is

different from what it was at the time of the sovereign debt crisis, when bond rate differentials were fuelling worry about contagion and the breakup of the euro zone. Furthermore, Syriza is not in favour of leaving the euro, and no-one can force the country's hand, given that there is no provision for this in any text. Finally, the consequences of such a decision on the other members could be severe, so that a Greek withdrawal from the euro zone would come only as a last resort.

Syriza is calling for an end to austerity and for a fiscal stimulus of 11 billion euros along with restoring the minimum wage to its previous level, better pensions, rehiring civil servants and increased public spending. Can a compromise be reached with the Troika? Nothing is less sure, and it is virtually certain that Syriza will have to revise its ambitions downwards. The Greek deficit has of course shrunk. The country ran a small primary surplus in 2014 and is expected to continue its fiscal consolidation policy in 2015-2016. But Greece must continue to borrow to finance the interest on the debt, to repay or renew the debt reaching maturity and to repay the loans from the IMF. To do this, Greece must rely largely on external aid. From the second half of 2015, the country will face a financing gap of 12.5 billion euros (19.6 billion euros if it does not get IMF assistance). Moreover, Greece's still fragile banks [\[1\]](#) are very dependent on access to the ECB's Emergency Liquidity Assistance Program (ELA), which allows them to obtain emergency liquidity from the Bank of Greece. If Greece rejects the reforms, a showdown with the Troika is likely. The ECB has already threatened to cut off the country's access to liquidity. In addition, the Troika is the main creditor of Greece, which however has a new bargaining point: to the extent that Greece borrows only what it needs to repay its debt, and not to fund its budget deficit, it could threaten its creditors with a unilateral default on payments, even if this is a dangerous game that could deprive it of access to market financing for many years

to come.

It is precisely this issue of restructuring Greece's debt and a partial default that is being emphasized by Syriza and which will likely be one of the main post-election issues. Alexis Tsipras wants to cancel a portion of the public debt, to put a moratorium on interest payments, and to condition repayments on the country's economic performance. According to forecasts by the EU Commission and the IMF, Greece's public debt ratio is expected to fall from 175% of GDP in 2013 to 128% in 2020. However, the assumptions underlying this scenario are not realistic, *i.e.* nominal growth of more than 3% in 2015, a primary surplus of 4.5% of GDP between 2016 and 2019, etc. Given the size of Greece's public debt in 2013 and its amortization profile (with reimbursements amounting to 13 billion euros in 2019 and up to 18 billion euros in 2039[\[2\]](#)), a new restructuring seems inevitable.

### **A public debt that is essentially held by euro zone countries**

Since the onset of the Greek crisis in autumn 2009, the composition of the country's public debt has changed substantially. While in 2010, the debt was held by financial investors, the picture in early 2015 is very different [\[3\]](#). After two assistance plans (in 2010 and 2012) and a restructuring of the public debt held by the private sector in March 2012 (Private Sector Involvement Plan), 75% of the public debt now consists of loans (**Table 1**). Together the IMF, the ECB, the national central banks and the countries of the Eurozone hold 80% of Greece's public debt.

**Table 1. Breakdown of Greece's public debt, by holder, september 2014**

In billion euros

	September 2014	As % of total debt
<b>Total</b>	<b>321,7</b>	<b>100</b>
<b>Debt securities</b>	<b>79,8</b>	<b>25</b>
Commercial paper (Short-term)	13,4	4
Treasury bills (Long-term)	66,4	21
<i>By ECB and national central banks</i>	25,0	8
<i>By private sector</i>	41,4	13
<b>Loans</b>	<b>241,8</b>	<b>75</b>
IMF	32,1	10
Greek central bank + domestic loans	4,4	1
Euro zone countries	194,8	61
<i>From 1st assistance plan (Greek Loan Facility)</i>	52,9	16
<i>From 2nd assistance plan (EFSF)</i>	141,9	44
Other loans and repos	10,5	3

Sources: Debt Management Agency, IMF, ECFIN, author's calculations.

Conversely, since the March 2012 restructuring plan, Europe's banks have sharply reduced their exposure to Greece's public debt (**Table 2**). Moreover, their capital levels have risen since 2010, especially with the gradual implementation of the Basel 3 reform. The banks thus have a safety margin in the case of a partial default by Greece.

**Table 2. Exposure of banks to Greek debt (public and total)**

In billions of euros

	Total Greek debt (public + private)			Greek public debt		
	Q3 2009	Q1 2012	Q2 2014	Q4 2010	Q1 2012	Q2 2014
<b>Total banks</b>	<b>430,5</b>	<b>105,6</b>	<b>73,8</b>	<b>62,9</b>	<b>9,0</b>	<b>3,5</b>
<b>European banks</b>	<b>389,2</b>	<b>99,1</b>	<b>47,8</b>	<b>60,2</b>	<b>8,3</b>	<b>2,2</b>
<i>France</i>	112,4	54,7	3,0	20,3	2,5	0,1
<i>Germany</i>	61,8	8,3	18,9	20,0	1,0	0,2
<i>United Kingdom</i>	17,9	11,1	18,1	4,6	0,3	0,8
<b>Non-European banks</b>	<b>NA</b>	<b>6,5</b>	<b>26,1</b>	<b>2,6</b>	<b>0,7</b>	<b>1,3</b>
<i>United States</i>	27,8	5,1	24,6	2,0	0,6	1,3

Sources: BIS, ECB, author's calculations.

Since more than half of Greece's public debt is held by members of the euro zone, no renegotiations can take place without their involvement.

### **So what are the possibilities for restructuring the debt?**

The European countries have already made several concessions

to help Greece service its debt:

- The maturity of the loans has been increased and the interest rate on loans granted by the EFSF has been reduced. For the first assistance program (bilateral loans), the initial maturity was 2026 (with a grace period until 2019) and the interest rate was indexed to the 3-month Euribor plus a risk premium of 300 basis points. In 2012, this risk premium was cut to 50 basis points and the maturity was extended by 15 years to 2041;
- Any profits made by the ECB and the national central banks on the bonds they hold were returned to Greece;
- Interest payments on the EFSF loans were deferred by 10 years.

Solutions like some used in the past could be implemented. The debt could be rescheduled. Indeed, the rate charged on the loans in the first assistance package (3-month Euribor + 50 basis points) is generally higher than the financing costs of the European countries, and could be lowered. And the term of the loans in the first and second assistance packages could be extended by another 10 years, until 2051. According to the Bruegel think-tank, these two measures combined [would reduce Greece's total repayments by 31.7 billion euros](#).

These measures nevertheless seem limited for resolving the issue of Greek debt: they only postpone the problem. Other measures are needed to relieve Greece of its public debt burden. As the euro zone countries are the main ones exposed to Greece's debt, they have an interest in finding a compromise: if there is a unilateral default, it is taxpayers throughout Europe who will wind up paying.

As for the IMF, there's no point waiting for debt forgiveness. The institution is indeed the senior creditor in case of a country's default, and lender of last resort. Since its founding, it has never cancelled a debt. It is therefore with



the members of the euro zone, Greece's main creditors, that a partial default needs to be negotiated. On the one hand, Greece can threaten an uncoordinated unilateral default, causing losses for its creditors. But on the other, it has no interest in alienating euro zone members and the ECB, which have been its main supporters during the crisis. A sudden default would deprive it of access to market financing for many years; even if Greece has achieved a primary surplus, the situation is unstable and it still needs external financing, even if only to honour its repayments to the IMF. One solution would be for the euro zone countries to accept a discount on the face value of the government debt they hold, as was done with private investors in March 2012.

In conclusion, Greece is facing a series of challenges. In the short term, the priority is to find sources of financing to get through 2015. To do this, the country will have to deal with the Troika, in particular the ECB, whose action will be crucial. The Bank has warned Greece that if negotiations fail, it could cut off the country's access to liquidity. Furthermore, on 22 January 2015, the ECB must reach its long-awaited decision on quantitative easing; the issue is whether the ECB will accept the redemption of Greek government bonds. In the longer term, the issue of restructuring the debt will inevitably arise, regardless of who wins the polls. However, the restructuring is likely to be easier with public creditors than with the private banks, if, that is, Greece has in turn won the trust of its European partners.

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[1] See the [results of the stress tests published by the ECB on 26 October 2014](#).

[2] See the [Hellenic Republic Public Debt Bulletin, no. 75, September 2014, Table 6](#).

[3] For a comparison with the situation in June 2012, see [Céline Antonin, “Retour à la drachme: un drame insurmontable?”](#), [Return to the drachma: an insurmountable drama?], *Note de l’OFCE* no. 20, June 2012.

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# Rotation of voting on the ECB Governing Council: more than symbolic?

By [Sandrine Levasseur](#)

[Lithuania’s adoption of the euro](#) on 1 January brought the number of euro zone members to nineteen, the threshold at which the voting system in the European Central Bank (ECB) Governing Council has to be changed. While this change took place almost unnoticed in France, things were different in Germany and Ireland, where the introduction of the system of rotation in the voting that decides the euro zone’s monetary policy has raised concern and even opposition. Is this reaction justified? Here we propose some food for thought and reflection.

## 1) How will the system of rotation function?

Until now, at the monthly meetings of the ECB Governing Council that decides monetary policy (policy rates, unconventional policies) in the euro zone, the principle “one country, one vote” applied. In other words, each country had, through the Governor of its central bank, a systematic right to vote. To the votes of the 18 Governors were added the votes

of the six members of the ECB Executive Board, for a total of 24 votes.

From now on, with the entry of a 19th member into the euro zone, the countries are classified into two groups, in accordance with the Treaty[1]. The first group consists of the 5 “largest” countries, as defined by the size of GDP and the financial sector, with respective weights in the criterion of 5/6 and 1/6. The second group consists of the other countries, currently numbering 14 [2]. Each month the group of five “big” countries has 4 votes and the Group of 14 “small” countries 11 votes (Table 1). The voting within the two groups is organized according to a principle of rotation defined by a [precise schedule](#): the Governor of each “big” country will not vote one time out of every five, while the Governor of each “small” country will not vote 3 times out of 14. However, the 6 members of the ECB Executive Board will continue to benefit from a systematic monthly right to vote. So every month, the conduct of the euro zone’s monetary policy will be decided by 21 votes, while under the old principle, that of “one country, one vote”, 25 votes were cast.

All the Governors will continue to take part in the Council’s two monthly meetings, whether or not they take part in the voting.

**Table 1. Rotation group and participation in the ECB's capital**

	GPD* (bn euros)	Bank assets (BA)	Criteria for membership in a vote rotation group (GDP 5/6; AB 1/6)	Rotation group	Share in %	Million euros
<b>Euro zone (19 countries)</b>						
Germany	2 718	7 682	3 545	Group 1 (5 countries/4 votes) The governor of each country votes 80% of the time	18.0	1 948.2
France	2 044	8 229	3 074		14.2	1 534.9
Italy	1 560	4 127	1 988		12.3	1 332.6
Spain	1 023	3 287	1 400		8.8	957.0
Netherlands	602	2 339	892		4.0	433.4
Belgium	380	1 071	496	Group 2 (14 countries/11 votes) The governor of each country votes 78.6% of the time	2.1	228.2
Austria	311	922	413		2.0	212.5
Ireland	164	1 049	312		1.2	125.6
Finland	193	523	248		1.3	136.0
Portugal	164	517	223		1.7	188.7
Greece	182	421	221		2.0	220.1
Luxembourg	45	944	195		0.2	21.9
Slovakia	72	60	70		0.8	83.6
Slovenia	35	49	38		0.3	37.4
Lithuania	34	25	33		0.4	44.7
Cyprus	17	91	29		0.2	16.4
Latvia	23	28	24		0.3	30.5
Estonia	18	19	18		0.2	20.9
Malta	7	55	15		0.1	7.0
	GPD* (bn euros)	Bank assets (BA)	Criteria for membership in a vote rotation group (GDP 5/6; AB 1/6)	Rotation group	Share in %	Million euros
<b>Other EU members</b>						
<b>Potential members of the euro zone:</b>						
Poland	388	361	384	Timetable abandoned	5.1	20.8
Republic Czech	150	192	157	Timetable abandoned	1.6	6.5
Romania	139	89	131	2019	2.6	10.6
Hungary	99	116	102	Timetable abandoned	1.4	5.6
Croatia	43	59	46	Timetable abandoned	0.6	2.5
Bulgaria	40	49	41	Timetable abandoned	0.9	3.5
<b>Countries with opt-out clause:**</b>					0.0	
United Kingdom	1 916	9 146	3 121	Never	13.7	55.5
Sweden	420	1 238	556	Never	2.3	9.2
Danmark	248	1 065	384	Never	1.5	6.0
<b>European Union (28 countries)</b>	<b>13 036</b>	<b>43 753</b>			<b>100</b>	<b>10 825.0</b>

\* At end September 2013.

\*\* Explicit (United Kingdom and Denmark) or implicit (Sweden).

\*\*\* As announced by the national authorities.

\*\*\*\* The contribution to ECB capital is based on the country's GDP and population (1/2; 1/2). The key can be different from the amount actually paid into the ECB capital. The net profits and losses of the ECB are not allocated to countries that are not members of the euro zone.

Source: Eurostat and ECB; author's calculations.

Why change the system of voting rights? The objective is clear and justified: it is to [maintain the decision-making capacity of the Governing Council](#) as the number of countries joining the euro zone increases.

The new system of voting rights [clearly benefits the members of the ECB Executive Board](#), which now have 28.6% of the voting

rights (6/21), while the old system would have given them “only” 24% (6/25). The group of “big” countries has 19% (against 20% in the old system). The group of “small” countries gets 52% (11/21) of the voting rights, whereas it would have had 56% (14/25) if the old voting system had been maintained. The group of “small” countries loses relatively more voting rights than the group of “large” countries, to the advantage of the ECB Executive Board.

## **2) The arguments of German and Irish opponents of the system of rotation**

[The arguments of German opponents of the new system](#), beyond just a loss of prestige, are that the largest economy in the euro zone and also the largest contributor to the ECB’s capital (Table 1) must necessarily take part in the votes deciding the zone’s monetary policy. To ensure that Germany’s interests are not neglected, when Germany doesn’t vote its Governor should have a veto. This veto would also be justified by the principle that you should be responsible only for your own decisions.

In Ireland, [according to the opponents of the new system](#), the myth of equality between the countries of the euro zone is finished: the introduction of a rotation system that favours the big countries is formalizing the lack of equality between the zone’s countries. Ireland has thus been explicitly relegated to being a second tier country. Furthermore, Ireland’s influence in the decision-making process will be reduced even further as the euro zone continues to expand.

The introduction of the rotation system doesn’t seem to have aroused as much resentment from politicians or civil society in other countries in the euro zone.

## **3) Do the German and Irish arguments make sense?**

As is well known, Germany has a culture of stability all its own, in particular due to its history a strong aversion to

inflation. In contrast, the countries of southern European are reputed to have a much less marked aversion to the “inflation tax”. It is this difference in the degree of “acceptable” inflation that has led to modelling the statutes of the ECB more or less on those of the Bundesbank, which was considered the only way of securing Germany’s participation in the euro zone. Today, however, the issue of inflation is no longer posed since the euro zone is entering into deflation, a situation that some think could last for years[3].

Today, it is much more the *methods* the ECB is using to conduct monetary policy that are being questioned in Germany by some of the country’s politicians, economists and citizens. The arguments being made by opponents of the rotation system, based on contributions to the ECB’s capital and more generally being Europe’s leading economic power, echo the policies that have been pursued in recent years by the ECB (e.g. easing eligibility criteria for securities deposited as collateral at the ECB, purchase of securitized assets) but also the future policy of purchasing sovereign bonds. These policies have raised fears in Germany that the ECB balance sheet will contain too much “toxic” debt that sooner or later could be dropped, with the cost of this being borne by the Bank’s principal funder.

Is it really believable that Germany’s interests wouldn’t be taken into account?

There are three arguments for answering “no”. First, even when the German Governor doesn’t vote, Germany will still have a “representative” on the Executive Board (currently Sabine Lautenschläger)[4]. In theory, of course, the members must consider the interests of the euro zone when they vote and not just the interests of their own country, but the reality is more complex[5]. Furthermore, the Governors, even when they do not vote, still have a right to speak, and therefore some power of persuasion. Finally, more generally, the desire for a consensus will make it necessary to take into consideration

the opinion of the Governors who are not voting.

How justifiable are the arguments of the Irish opponents of the rotation system? It is clear that the counter-arguments developed above (concerning the right to speak and the need for a consensus) that apply to the Germans also apply to the Irish.

However, it is true that Ireland, like all the countries in Group 2, will see its voting rights [further diluted as the euro zone expands](#). When the euro zone is comprised of 20 members, the 15 Group 2 countries will have to share 11 votes (Table 2, [source: p. 91](#)). When the euro zone expands again to 21 members, 16 Group 2 countries will still have to share 11 votes ... At 22 members, the creation of a [third group](#) will result in further dilution of the voting rights of groups 2 and 3, but not of group 1, the group of “large” countries, which will still continue to vote 80% of the time.

The question that is posed for Ireland but also for all the countries currently in Group 2 concerns the future expansion of the euro zone. To date, all the countries of Central and Eastern Europe (CEE) that have not yet adopted the euro have abandoned a timetable for joining the euro zone (Table 1). The only exception is Romania, which has proposed 2019 for joining[\[6\]](#). Though the prospects of the other countries have not been abandoned, they nevertheless appear very distant[\[7\]](#). The likelihood that the euro zone will soon include 21 members is rather low, and the probability of exceeding 22 members even lower. Anyway, whatever the configuration, Ireland will never be part of group 3. It is thus the countries that are lagging in today’s group 2 (Malta, Estonia, Latvia, etc.) that have the most to lose in terms of the frequency of voting.

**Table 2. Rotation system (first and second steps)**

Total no. of governors	Group 1			Group 2			Group 3		
	Governors	Votes	Frequency of vote	Governors	Votes	Frequency of vote	Governors	Votes	Frequency of vote
<b>First step: euro zone from 19 to 21 countries</b>									
19	5	4	80%	14	11	79%			
20	5	4	80%	15	11	73%			
21	5	4	80%	16	11	69%			
<b>Second step: euro zone from 22 to 27 countries</b>									
22	5	4	80%	11	8	73%	6	3	50%
23	5	4	80%	12	8	67%	6	3	50%
24	5	4	80%	12	8	67%	7	3	43%
25	5	4	80%	13	8	62%	7	3	43%
26	5	4	80%	13	8	62%	8	3	38%
27	5	4	80%	14	8	57%	8	3	38%

Source: ECB (2009).

## Conclusion

There can be no talk of a unified Europe while explaining that there are several categories of countries. How can there be congratulations for the euro zone gaining new members while at the same time explaining that only certain members can or should participate in its decision-making. In a unified Europe it is not acceptable for there to be a vote in the Council that is systematic only for certain Governors (but not all) or a right of veto that only a few Governors can exercise. Each country loses its monetary sovereignty by joining the euro zone: why should some countries lose more than others? But is it really desirable to go back to the old system of “one country, one vote”? No. The new voting system in the Governing Council is a good compromise between the need to maintain the Council’s decision-making capacity (and therefore have a reduced number of voters) and the need to allow each Governor to vote on a regular basis. From this point of view, the rotation system used in the euro zone is more balanced than that used in the United States, where some members may not vote for one, two or even three years[8]. In the euro zone, the length of time that a Governor does not vote on monetary policy will not exceed one month for Group 1 countries, and for countries currently in Group 2, it shall not exceed three months (so long as the euro zone consists of just 19



countries).

At least in theory. Because, in practice, while the Governing Council will continue to meet twice a month, the vote on the conduct of monetary policy will now take place only every six weeks ... (previously every four). The voting abstention time will thus be (slightly) longer than what is stated in the official documents of the ECB and the euro zone's national central banks...

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[1] More specifically, on 21 March 2003 the European Council amended Article 10.2 of the statutes of the Eurosystem in order to allow the establishment of a system of rotation in the ECB Governing Council. The amended article provided that the rotation system could be introduced from the entry of the 16th member into the euro zone and at the latest upon the entry of the 19th member.

[2] The Treaty provides for the creation of a third group upon the entry of a 22<sup>nd</sup> country.

[3] For the first time since 2009, consumer prices fell, with prices falling -0.2% year on year.

[4] The other members of the Governing Council are from Italy (Mario Draghi, President of the ECB). Portugal (Vítor Constâncio, Vice-President of the ECB), France (Benoît Cœuré), Luxembourg (Yves Mersch) and Belgium (Peter Praet).

[5] The experience of the US Federal Open Market Committee shows that there is a regional bias in the way the Governors vote (Meade and Sheets, 2005: "Regional Influences on FOMC Voting Patterns", *Journal of Money Credit and Banking*, 33, pp.

661-678).

[\[6\]](#) It will in any case have to respect the Maastricht criteria (criteria on the public deficit, interest rates, inflation, etc.).

[\[7\]](#) This shift is due in part to the fact that many of the Central and East European countries have benefited from the depreciation of their currencies against the euro. They have thus understood that joining the euro zone would not just bring them benefits. In addition, it is assumed here that the United Kingdom, Denmark and Sweden will never join the euro zone because of their opt-out clause.