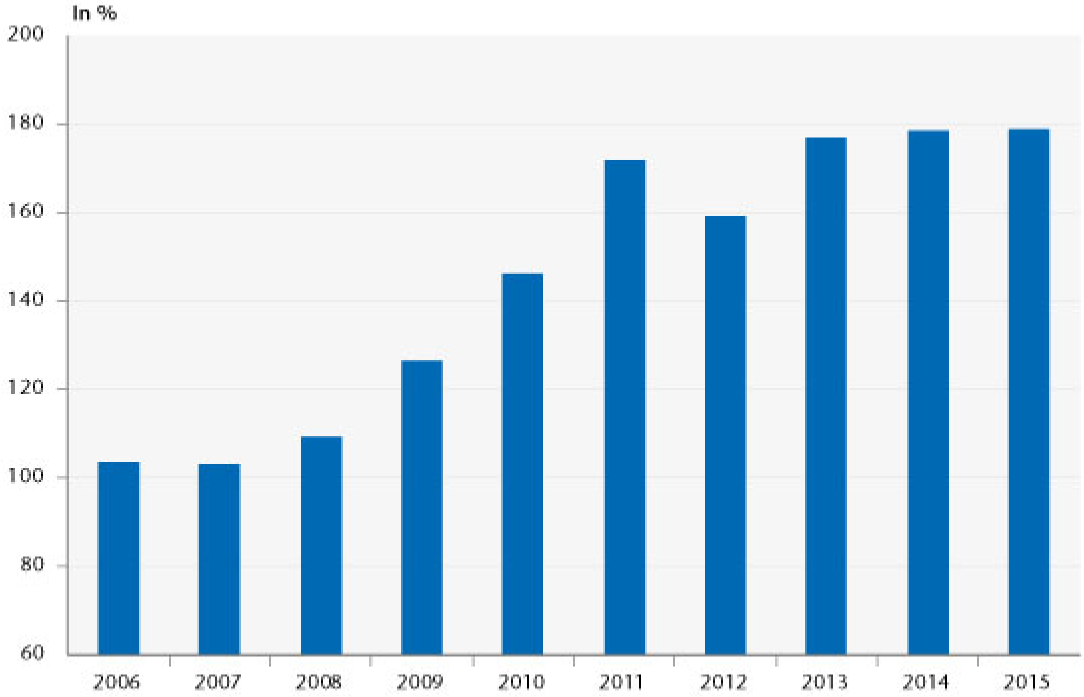
Why can’t Greece get out of debt?

By [Sébastien Villemot]

Between 2007 and 2015, Greece’s public debt rose from 103% to 179% [1] of its GDP (see chart below). The debt-to-GDP ratio rose at an uninterrupted pace, except for a 12-point fall in 2012 following the restructuring imposed on private creditors, and despite the implementation of two macroeconomic adjustment programs (and the beginning of a third) that were aimed precisely at redressing the Greek government’s accounts. Austerity has plunged the country into a recessionary and deflationary spiral, making it difficult if not impossible to reduce the debt. The question of a further restructuring is now sharply posed.

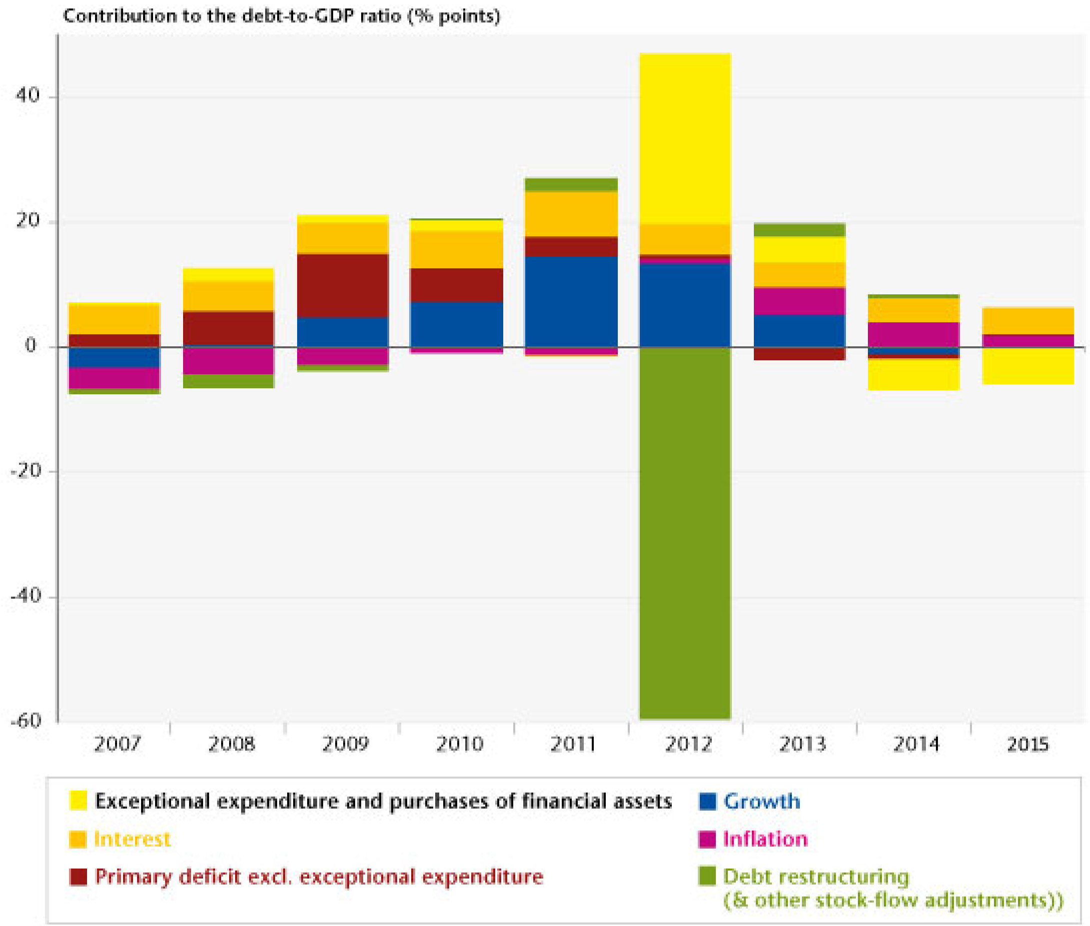
Figure 1. Greece’s public debt as % of GDP, 2006-2015



Sources: Eurostat, European Commission..

What explains this failure? How much have the various factors involved (public deficit, austerity, deflation, restructuring, bank recapitalization, etc.) contributed to changes in the debt? To provide some answers, we conducted an accounting breakdown of the changes in the debt ratio: the result is given in the graph below for the period 2007-2015.

Figure 2. Accounting breakdown of changes in the debt ratio



Sources: Eurostat, European Commission, author's calculations.

Several phases, which correspond to various developments in the Greek crisis, are clearly identifiable on the chart.

In 2007, prior to the financial storm, the GDP-to-debt ratio was stable: the negative effect of the budget deficit (including interest), which increases the ratio's numerator, was offset by the positive impact of growth and inflation, which increase the denominator. So the situation was stable, at least temporarily, even though the debt level was already high (103% of GDP, which also explains the significant interest burden).

This stability was upset with the onset of the global financial crisis in 2008 and 2009: growth disappeared and even entered negative territory, while the primary deficit was rising, partly due to the “automatic stabilizers”, and by 2009 came to 10 percentage points of GDP.

Given the intensity of the fiscal crisis, an initial adjustment plan was implemented in 2010. As the austerity measures began to bite, the primary deficit began to fall (to almost zero in 2012, excluding extraordinary expenses). But austerity also resulted in intensifying the recession: in 2011, growth (very negative) contributed nearly 15 GDP points to the increase in debt. Austerity also led to reducing inflation, which dropped to almost zero, and which is therefore no longer playing its natural role of cushioning debt. Meanwhile, the interest burden remained high (rising to 7.2 GDP points in 2011).

It should be recalled that the accounting breakdown presented here tends to underestimate the negative impact of growth and to overestimate the impact of the budget deficit. Indeed, a recession generates a cyclical deficit, through the automatic stabilizers, and therefore indirectly contributes to debt through the channel of the budget balance. However, to identify the structural and cyclical components of the budget deficit, an estimate of potential growth is needed. In the Greek case, given the depth of the crisis, this exercise is quite challenging, and the few estimates available diverge considerably; for this reason, we preferred to stick to a purely accounting approach.

2012 was a year for big manoeuvres, with two successive debt restructurings in March and December. On paper, there was a substantial cancellation of debt (measured in terms of the stock-flow adjustment): almost 60 GDP points. But what should have been a significant reduction was largely offset by opposing forces. The recession remained exceptionally intense and accounted for 13.5 GDP points of the increase in debt.

Above all, the main negative effect came from bank recapitalizations, which were necessitated by the writing off of public debt securities, which were largely held by domestic banks. In accounting terms, these recapitalisations take two forms: grants to banks (recorded as extraordinary expenses) or purchases of newly issued shares (recorded as purchases of financial assets) [2], which is why these two categories are grouped on the graphic. The category of purchases of financial assets also recognizes the establishment of a financial cushion to finance future bank recapitalizations [3].

In 2013, the debt-to-GDP ratio once again rose sharply, even though the primary balance (excluding exceptional expenses) showed a surplus. Bank recapitalizations (19 billion euros) were a heavy burden and were only partially covered by the sale of financial assets. The recession, although less intense, and deflation, now well established, made the picture even gloomier.

In 2014 and 2015, the situation improved, but without leading to any decline in the debt-to-GDP ratio, even though the primary deficit excluding exceptional spending was almost zero. Deflation persisted, while growth failed to restart (the 2014 upturn was moderate and short-lived), and the banks had to be recapitalized again in 2015 (for 5 billion euros). The interest burden remained high, despite the decision of the European creditors to lower rates on the loans from the European Financial Stability Facility (EFSF): several years would be needed before this shows up in the effective interest burden. Only the sales of financial assets made it possible to hold down the increase in debt, which is clearly not sustainable in the long run since there is a limited stock of these assets.

The table below shows the cumulative contribution of each factor for the period as a whole, and for the sub-period during which Greece was under programme (2010-2015).

Cumulative contribution of each factor

	2007-2015	2010-2015
Growth	41.7	39.7
Inflation	-1.8	8.7
Primary deficit excl. exceptional expenditure	23.9	6.2
Interest	44.7	30.3
Exceptional expenditure & purchase of fin. assets	25.7	22.1
Debt restructuring (& other stock-flow adjustments)	-58.7	-54.6
Total	**75.4**	**52.4**

Sources: Eurostat, European Commission, author's calculations..

The two main contributors to the increase in debt are growth (negative) and the cost of interest. In other words, the total increase in debt is due primarily to a “snowball effect”, which means the automatic increase due to the differential between the real interest rate and growth (the infamous “r-g”). The debt forgiveness in 2012 was not even sufficient to offset the snowball effect accumulated over the period. The bank recapitalizations that became necessary due in particular to the cancellation of debt were a heavy burden. The primary deficit, which is under the more direct control of the Greek government, comes only in 4th position from 2007 to 2015 (and doesn’t contribute much at all over the period 2010-2015).

It is therefore clear that the sharp rise in the debt-to-GDP ratio since 2007 (and especially since 2010) was not primarily the result of the Greek government’s fiscal irresponsibility, but resulted instead from an erroneous consolidation strategy that was based on a logic of accounting austerity and not on coherent macroeconomic reasoning. An upturn in growth and inflation will be necessary to achieve any substantial debt reduction. But the new austerity measures set out in the third adjustment plan could cause a return to recession, while the constraints of price competitiveness within the euro zone make it impossible to foresee any renewal of inflation. A significant reduction of debt that is not conditional on a new destructive phase of austerity would allow a fresh start; in a previous study[4], we showed that a restructuring that cut Greece's debt to 100% of its GDP would correspond to a sustainable scenario. However, Europe's member states, which are now Greece's main creditors, are currently rejecting such a scenario. The path to reducing Greek debt now looks more uncertain than ever…

[1] The data for 2015 are not yet fully available. The figures quoted for this year are projections by the European Commission published on 4 February 2016.

[2] These holdings in bank capital are recorded here at their purchase value. Any subsequent deterioration in these holdings is not reflected in the chart, because this would not lead to a further increase in the gross debt (although it would increase the net debt).

[3] In 2012, Greece bought 41 billion euros worth of EFSF bonds. Of this total, 6.5 billion were immediately given to the Bank of Piraeus, while 24 billion were lent to 4 big banks (which benefited from partial cancellation of their debt in 2013 against equity participations by the Greek State for a lesser value). The remaining 10 billion were returned unused by Greece to the EFSF in 2015, following the agreement of the Eurogroup on 22 February.

[4] See Céline Antonin, Raul Sampognaro, Xavier Timbeau and Sébastien Villemot, 2015, "La Grèce sur la corde raide" [Greece on the tightrope], *Revue de l'OFCE*, no. 138.

Recovery aborted

By Christophe Blot

This text draws on the article "Le piège de la déflation: perspectives 2014-2015 pour l'économie mondiale" [The deflation trap: the 2014-2015 outlook for the world economy], written by Céline Antonin, Christophe Blot, Amel Falah, Sabine Le Bayon, Hervé Péléraux, Christine Rifflart and Xavier Timbeau.

According to a Eurostat press release published on 14 November 2014, euro zone GDP grew by 0.2% in the third quarter of 2014, and inflation stabilized in October at the very low level of 0.4%. Although the prospects of a new recession have receded for now, the IMF evaluates the likelihood of a recession in the euro zone at between 35% and 40%. This dismal prospect reflects the absence of a recovery in the euro zone, which is preventing a rapid reduction in unemployment. What lessons can be drawn?

In the short term, this sluggishness is due to three factors that have held back growth. First, fiscal consolidation, although less extensive than in 2013, has been continued in 2014 in a context where the multipliers remain high. Second, despite the reduction in long-term public interest rates due to the easing of pressure on sovereign debt, financing conditions for households and businesses in the euro zone have worsened, as the banks have not consistently passed on the reduction in long-term rates and lower inflation is leading to a tightening of real monetary conditions. Finally, the euro appreciated by more than 10% between July 2012 and early 2014. Even though the currency's rise reflects the winding down of pressure on euro zone bond markets, this has hurt exports. In addition to these short-term factors, recent data could herald the beginnings of a long phase of moderate growth and low inflation or even deflation in the euro zone.

Indeed, after a period of sharply increasing debt (see Figures), the financial situation of households and firms in the euro zone has deteriorated since 2008 due to a series of crises – financial, fiscal, banking and economic. This deterioration in the financial health of the non-financial sector has weakened its thirst for credit. Furthermore, households may be forced to cut down on their spending on consumption, and firms investment and their need for employment in order to reduce their debt. Adding to this is the fragility of certain banks, which need to absorb a high amount of bad debt; this is leading them to restrict the supply of credit, as is evidenced by the latest SAFE survey conducted by the ECB on SMEs. In a context like this where private agents prefer deleveraging, fiscal policy should play a crucial role. But this is not happening in the euro zone due to the desire to consolidate the trajectory of public finances at the expense of the goal of growth[1]. Furthermore, while many countries could get out of the excessive deficit procedure in 2015 [2], fiscal consolidation is expected to continue because of the rules in the Treaty on Stability, Coordination and Governance

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Commentaires

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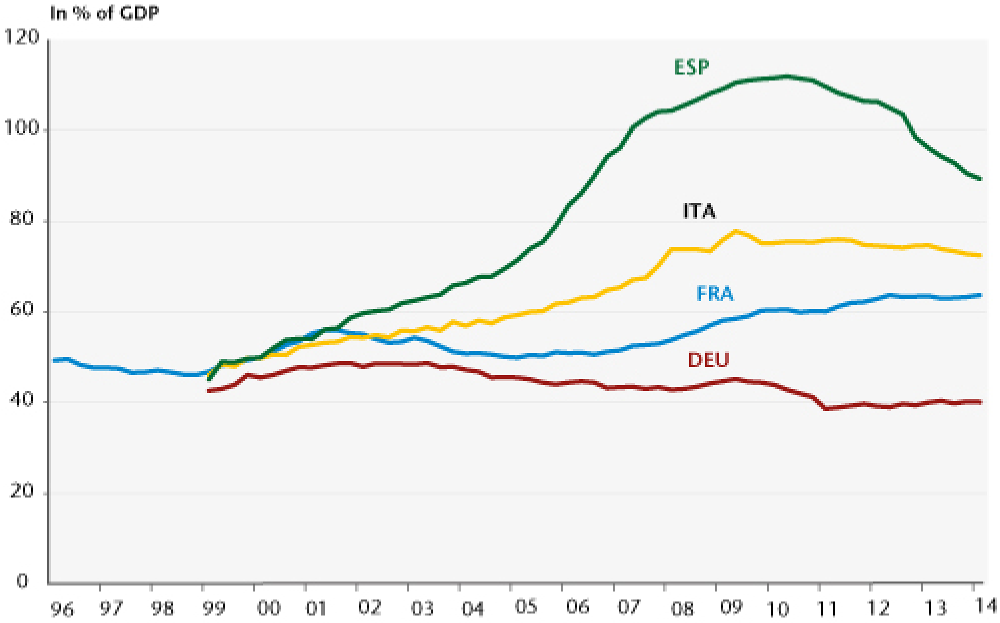
(TSCG) requiring Member countries to make fiscal adjustments to bring public debt down to the 60% threshold within 20 years[3].

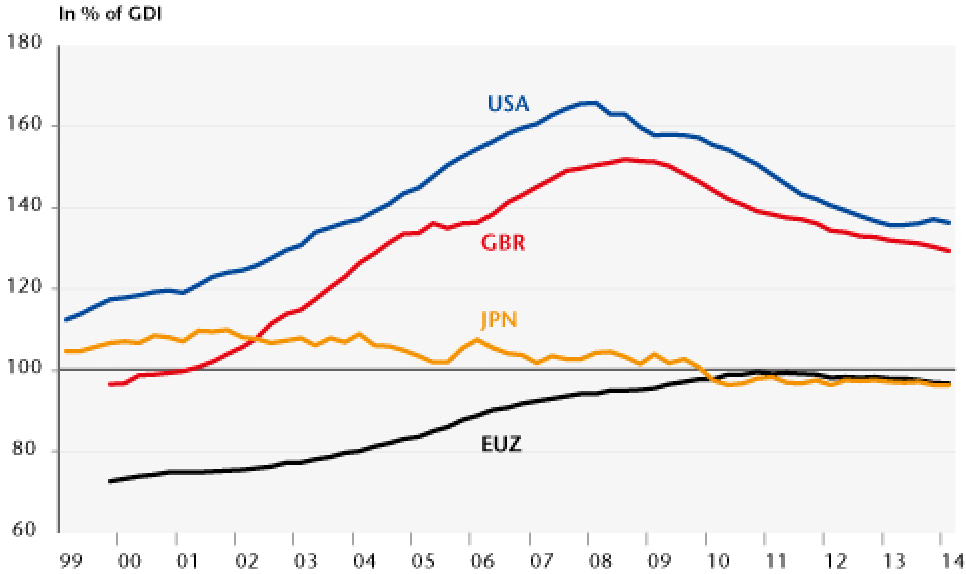
These conditions could push a recovery further down the road, and the euro zone could wind up locked in the trap of deflation. A lack of growth and high unemployment are creating downward pressure on prices and wages, pressure that is being exacerbated by internal devaluations, which are the only solutions being adopted to improve competitiveness and regain market share. This reduction in inflation is making the deleveraging process even more protracted and difficult, thus undercutting demand and strengthening the deflationary process. The Japanese experience of the 1990s shows that it is not easy to pull out of this kind of situation.

Figure 1. Debt of non-financial corporations



Source: Banque de France.

Figure 2. Household debt



Source: Banque de France.

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[1] The costs of this strategy were evaluated in the two preceding iAGS reports (see here).

[2] France and Spain would, however, constitute two major exceptions, with budget deficits of, respectively, 4% and 4.2% in 2015.

[3] See the post by Raul Sampognaro for more on the specific case of Italy.

What options for the European Central Bank?

By Paul Hubert

All eyes are now on the ECB, whose recent statements indicate that it is concerned about the risk of deflation in the euro zone. The further downturn in inflation in May to 0.5% year on year is a reminder that this risk is increasing. This could lead the ECB to take action at the monthly meeting of the Board of Governors being held today, or in the months to come. This post provides a brief summary of the possible options available to the ECB.

1. To lower the key interest rate (main refinancing operations rate, the MRO rate), which is currently 0.25%. The consensus in the financial markets is for a reduction of around 10 to 15 percentage points, which would further cut financing costs for banks that are still dependent on ECB liquidity. However, this would have a marginal impact on the rates of refinancing operations (MRO and long-term refinancing operations, or LTRO), which would not have much influence on financing conditions and thus not much benefit for Spanish and Italian banks (the main users of this option).

2. To lower the deposit facility rate from zero to a negative rate (again by 10 to 15 percentage points). This option has been largely anticipated by the financial markets. A negative interest rate on deposits should also be accompanied by a change in the policy on the ECB’s excess reserves by capping the amount of commercial banks’ excess reserves on the ECB’s balance sheet or by applying the same negative rate to excess reserves. Otherwise the banks would simply transfer their funds from deposit accounts to excess reserves. A combination of these two policies should lead to a lower Euro OverNight Index Average (EONIA) rate of between zero and 0.05%. The incentive for banks to keep their cash at the ECB would thus be reduced, thereby stimulating the distribution of credit to the non-financial sector.

3. An extension of the policy of providing liquidity in unlimited amounts at a fixed rate (fixed-rate full allotment) from mid-2015 to late 2015 or even mid-2016 is considered by most to be an easy and quick option that would provide additional assurance on the markets before the LTRO deadlines in early 2015. This kind of measure would ensure the liquidity of the banking system but its impact on activity and inflation could be limited, in so far as the banks would prefer to place their cash with the central bank.

4. An ECB announcement of the end of sterilization through the Securities Markets Programme (SMP), a programme for purchasing the sovereign bonds of euro zone countries in difficulty. The markets seem divided on this issue. The ECB has not managed to attract sufficient demand to completely sterilize this operation in the last eight weeks. This would add 164.5 bn euros (the SMP target amount) of liquidity to the system and take the EONIA rate to zero or even into negative territory, and could reduce the volatility that has appeared in recent months. This measure would therefore also cut the interbank refinancing rate, which would more or less amount to the first option.

5. A conditional and targeted LTRO programme could see the light of day. This would consist of copying the Funding for Lending Scheme (FLS) set up by the Bank of England, in which cheap financing is arranged for banks in exchange for granting new loans to the real economy. However, it would take time to implement this, and even more before there is any real impact on the economy. It would nevertheless probably be the most effective way to stimulate activity, because it would go beyond interbank operations in influencing refinancing conditions.

In any event, the economic situation in the euro zone for both the business outlook as well as for the situation on the labour market calls for a strong response from the ECB so as to ensure that the euro zone does not incur deflation. The effect of the signal may be just as important as the measure actually implemented by the ECB. By demonstrating in today's meeting that it is active, the ECB would show its determination to fight against the risk of deflation, which could at least change agents' expectations. While any action by the ECB would be welcome, it is still the case that the current economic situation is also the result of the restrictive fiscal policies that have hit activity (see here).

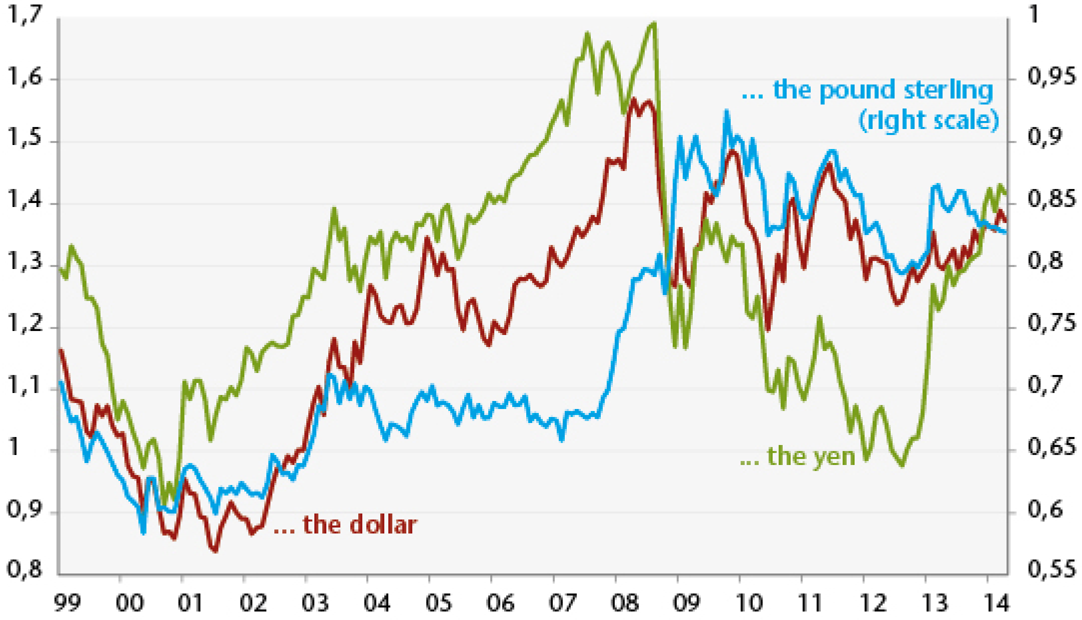
What is a weaker euro likely to mean for the French economy?

By Bruno Ducoudré and Eric Heyer

Faced with the rising risk of deflation in the euro zone, which has been reinforced since mid-2012 by the continued appreciation of the euro against other currencies, the heads of the European Central Bank have begun to change their tone in their communications with the financial markets: they are now evoking the possibility of conducting a new round of quantitative easing. These measures are likely to lower the exchange rate of the euro. This would provide valuable support for the euro zone economies by shoring up their price competitiveness vis-à-vis competitors outside the zone, in a context where fiscal consolidation policies will continue to dampen the growth expected in the zone in 2014 and 2015. What are the likely consequences for the French economy from reducing the euro's value against other currencies? We briefly review past episodes of exchange rate changes, and then present the impact expected from a 10% depreciation of the euro against other currencies using the *emod.fr* model. These effects are more moderate than those projected by the government.

Quantitative easing measures have been used extensively by the US Federal Reserve, the Bank of England and the Bank of Japan. Since mid-2012, the balance sheets of these three banks has continually increased, by respectively 6.5 percentage points of GDP, 1.3 GDP points and 15.3 GDP points. During this same period, the ECB balance has on the contrary declined by 8.4 GDP points. This difference in strategy has led to a continued rise in the strength of the euro: now at 1.38 dollars, the euro has seen its value against the dollar increase by 12% since June 2012. During the same period, the single currency has appreciated 49% against the yen and about 3% against the pound sterling (Figure 1).

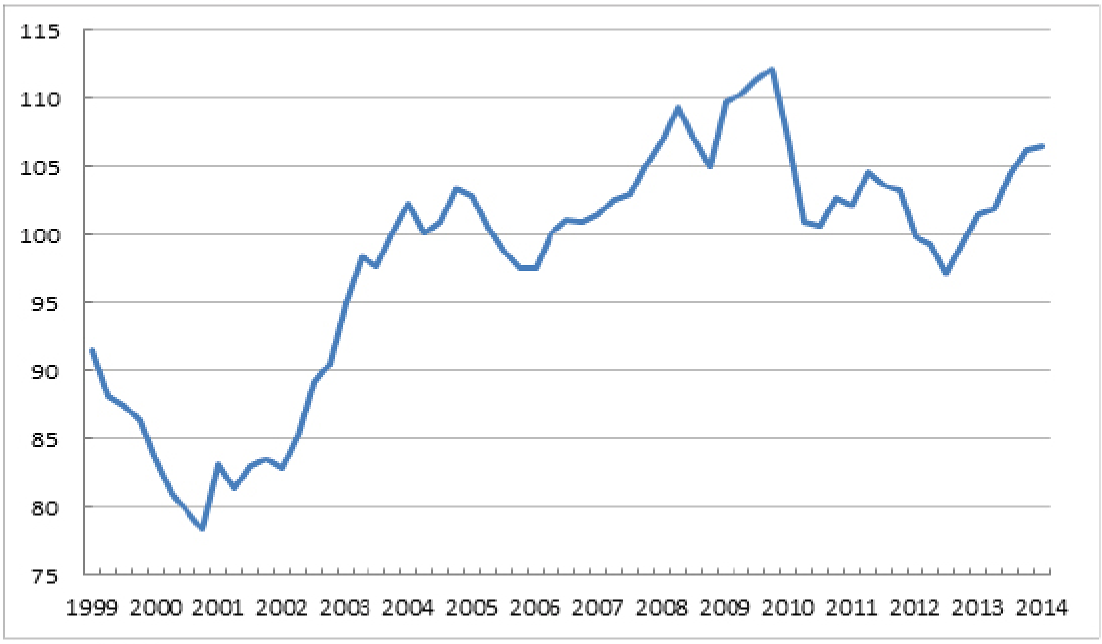
Figure 1. Exchange rate of the euro against…



Source : Datastream.

The nominal effective exchange rate of the euro, which weights the different exchange rates depending on the structure of trade in the euro zone, has thus appreciated by 9.5% since the third quarter of 2012 (Figure 2). This appreciation, combined with austerity policies and the competitive disinflation carried out within the euro zone, has held down GDP growth in the zone, which was negative in 2012 and 2013, as well as inflation. The absence of inflationary pressures and the past appreciation of the euro have now given the ECB leeway to try to influence the course of the euro against other currencies.

Figure 2. Nominal effective exchange rate of the euro



Source : OECD.

What would be the impact of a devaluation of the euro against all currencies?

The depreciation of the euro would have a dual effect:

– **An income effect**: a weak euro would increase the prices of imports. This would result in higher energy costs, a rise in companies' prices of production and a loss of household purchasing power;

– **A substitution effect**: a weak euro would decrease the prices of exports and increase their volume. Depreciation would also decrease the competitiveness of rival manufacturers, causing a decline in imports in favour of domestic production.

These opposite effects would apply only to trade outside the euro zone. Trade with our European partners would not be directly impacted, as the prices of imports and exports to and from this area would remain unchanged. On the other hand, intra euro zone trade would be impacted by a weaker euro. But this involves the channel of addressed demand.

Table 1. Impact on the French economy of a 10% depreciation in the exchange rate of the euro against all currencies combined

(Difference with the reference scenario in %)	n	n+1	n+2	n+8
GDP	0,3	0,4	0,5	0,0
Total waged employment (1000s)	22	53	74	34
Household consumer prices	0,9	1,4	1,9	3,9
Public financing capacity (% of GDP)	0,0	0,2	0,3	0,2

Note: The euro's depreciation would be favourable to short-term activity due to an improvement in France's price competitiveness relative to countries outside the euro zone. The positive impact of the euro's depreciation on the activity of our euro zone partners and the negative impact on our partners outside the zone are taken into account.
Source : emod.fr

As is summarized in Table 1, a 10% depreciation of the euro against all currencies leads to a gain in price competitiveness for French exports vis-à-vis the rest of the world. Other countries in the euro zone would benefit from the same gain in competitiveness across all export markets. In this case, the impact on activity would amount to 0.3% in the first year, 0.5% after three years, and none after nine years. The increase in demand due to this improvement in the activity of our European partners would be broadly offset by a reduction in demand addressed to France from the rest of the world. As for the labour market, this depreciation would create 22,000 jobs in the first year and 74,000 jobs after 3 years. The public deficit would in turn improve by 0.3 GDP point within 3 years.

These results, while more moderate than those published by the DG Treasury[1], are nonetheless significant and are welcome in an economic situation like today's that is marked by sluggish growth and the risk of deflation. A depreciation of the single currency would also undercut the process of competitive deflation engaged in by countries in the euro zone.

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[1] The publication of the DG Treasury argues that a 10% decrease in the effective exchange rate of the euro (against all currencies) would do the following: increase our GDP by

0.6 percentage point of GDP in the first year and 1.2 GDP points after three years; create 30,000 jobs in the first year and 150,000 jobs within three years; and reduce the government deficit by 0.2 GDP point in the first year and 0.6 GDP point after three years.

Euro zone: Recovery or deflation?

By Céline Antonin, Christophe Blot, Sabine Le Bayon and Danielle Schweisguth

This text summarizes the OFCE's forecast for 2014-2015 for the euro zone economy

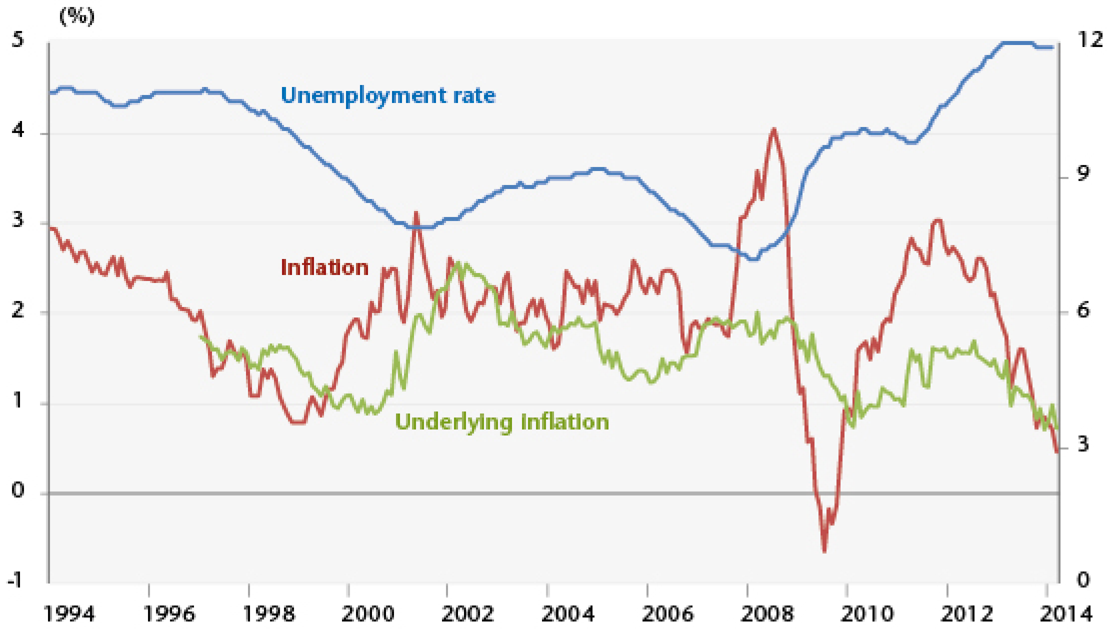
Will the euro zone embark on the road to recovery, or will it sink into a deflationary spiral? The latest macroeconomic indicators are sending out conflicting signals. A return to growth is being confirmed, with three consecutive quarters of rising GDP. However, the level of unemployment in the euro zone remains at a historically high level (11.9% for the month of February 2014), which is fuelling deflationary pressures, as is confirmed by the latest figures on inflation (0.5% yoy for March 2014). While this reduction in inflation is partly due to changes in energy prices, the fact remains that underlying inflation has fallen under 1% (Figure 1). In these conditions, a turnaround in inflationary expectations cannot be excluded, which would undoubtedly push the euro zone into deflation. The ECB has been concerned about this situation for several weeks and says it is ready to act (see here). However, no concrete proposal for a way to ease monetary policy and ensure that expectations are not anchored on a deflationary trajectory has been set out.

After a fall in GDP of 0.4% in 2013, the euro zone will return to positive growth: 1.3% in 2014 and 1.6% in 2015. Even so, at this rate of growth, there will still be an open output gap in most of the euro zone countries, reflecting the idea that the euro zone is only slowly pulling out of the crisis. Indeed, although efforts to reduce deficits will be curtailed, fiscal policies will still be pro-cyclical. Furthermore, financing conditions will continue to improve. The end of the sovereign debt crisis, thanks in particular to the announcements by the ECB in July and September 2012 [1], has reduced the risk premiums on the market for government bonds. The impact of lower long-term market rates has been partly reflected in bank interest rates, and credit supply conditions are generally less restrictive than they were between early 2012 and mid-2013. But there will still not be sufficient growth to trigger a recovery strong enough to lead to a rapid and significant reduction in unemployment. Indeed, the level will fall only very moderately, from 11.9% in the first quarter of 2014 to 11.3% at year end 2015. While Germany will enjoy almost full employment, mass joblessness in Spain and the other countries of southern Europe will persist (Figure 2). Unemployment should stabilize in Italy and continue to grow in France.

However, this continuing underemployment is giving rise to the risk of deflation. It is holding back growth in wages and contributing to the weakness of underlying inflation, which was in fact zero in Spain in March 2013 and negative in Greece and Portugal. For the euro zone as a whole, we do not expect deflation in the short term, but the weakness of growth is increasing the likelihood that private agents' expectations are not anchored in a deflationary scenario.

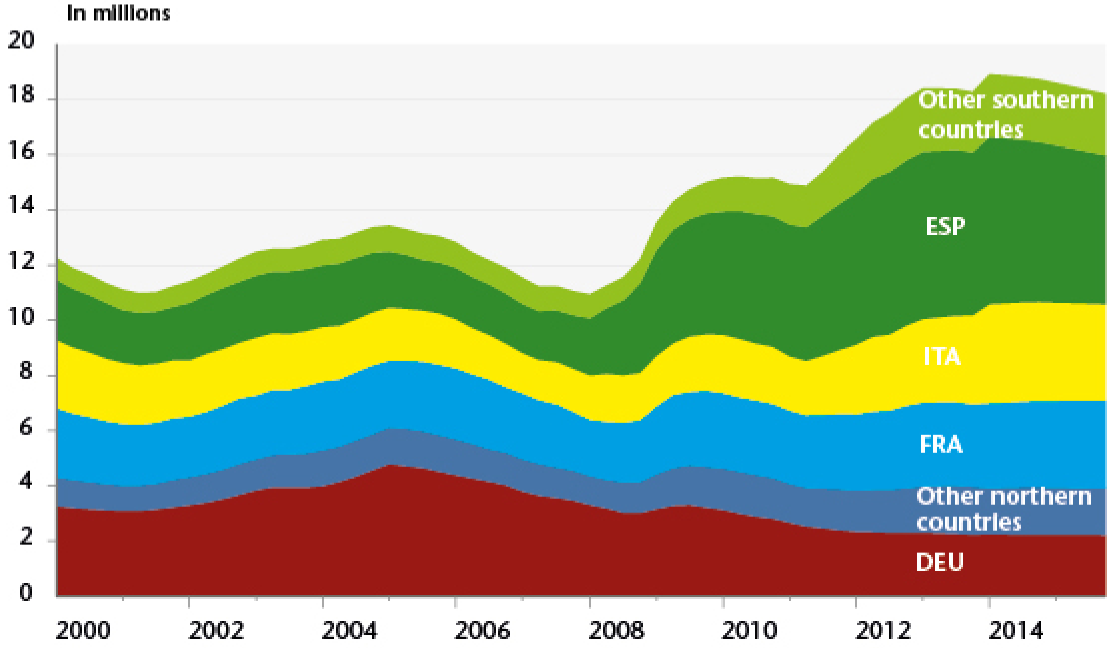
The situation in the euro zone is reminiscent of Japan in the 2000s. The country began to experience deflation in 1999 [2] following the recession associated with the Asian crisis. At that point, despite average growth of 1.4% between 2000 and 2006, prices failed to pick up, and the country's central bank did not find a way out of this trap, despite trying expansionary monetary policies. This is precisely the dynamic threatening the euro zone today, making it crucial to use all possible means to avoid this (monetary policy, fiscal policy and the coordination of wage policy [3]).

Figure 1. Unemployment rate and inflation rate in the euro zone



Source : Eurostat.

Figure 2. Unemployment in the euro zone countries



Note : The other southern countries are Portugal and Greece. The other northern countries are the Netherlands, Belgium, Ireland, Austria and Finland.

Sources : Eurostat, OFCE forecast April 2014.

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[1] In July, ECB President Mario Draghi declared that the central bank would save the euro "whatever it takes". In September, the ECB announced the creation of a new mechanism called Outright Monetary Transactions (see the post by Jérôme Creel and Xavier Timbeau), which enables it to engage in unlimited purchases of sovereign debt.

[2] It should be pointed out that there was an initial period of deflation in 1995 following three years of economic stagnation.

[3] All these elements are discussed in detail in the previous iAGS report (2014).

The onset of deflation

By Xavier Timbeau

This text summarizes the April 2013 forecasts of the OFCE.

The global economic and financial crisis that began in late 2008 is now entering its fifth year. For the European Union, 2012 has been another year of recession, showing just how much the prospect of an end to the crisis, heralded so many times, has been contradicted by economic developments. Our forecasts for 2013 and 2014 can be summarized rather ominously: the developed countries will remain mired in a vicious circle of rising unemployment, protracted recession and growing doubts about the sustainability of public finances.

From 2010 to 2012, the fiscal measures already taken or announced have been unprecedented for the euro zone countries (-4.6% of GDP), the United Kingdom (-6% of GDP) and the United States (-4.7% of GDP). The fiscal adjustment in the US that has been long delayed but finally precipitated by the lack of political consensus between Democrats and Republicans will take place again in 2013 and 2014. In 2014, austerity in the euro zone will ease, although it will continue at an intense level in the countries still in deficit, which are also those with the highest fiscal multipliers.

In a context of high multipliers, the fiscal effort has a cost in terms of activity. This phrase, taken from Marco Buti, chief economist of the European Commission, sounds like both a confession and a euphemism – a confession, because the acknowledgement of the high value of the fiscal multipliers came late and was neglected too long; Olivier Blanchard and David Leigh recall that this problem led to systematic forecast errors and that these errors were much larger in countries in the worst situations undertaking the largest deficit reductions.

But the undervaluation of the multipliers also meant that the hopes accompanying deficit reduction were disappointed. The "unexpectedly" heavy impact of the austerity plans on activity has meant lower tax revenues, and thus a smaller reduction in the deficit. In attempting to meet their nominal deficit targets regardless of the cost, the States have only exacerbated the fiscal effort.

A confession like this might suggest that the error was inevitable and that the lesson has been drawn. This is not the case. First, since 2009, many voices were raised warning that the multipliers might be higher than in "normal times", that the possibility of the kind of expansive consolidation described and documented by Alberto Alesina was an illusion based on a misinterpretation of the data, and that there was a real risk of neglecting the impact of the fiscal consolidation on economic activity.

In October 2010, the IMF, under the impetus even then of Olivier Blanchard, described the risks of pursuing an overly brutal consolidation. The general awareness finally emerging in early 2013 reflected an acknowledgement of such a substantial accumulation of empirical evidence that the opposite view had become untenable. But the damage was done.

Nor was the lesson learned. According to the European Commission, the multipliers *were* high. [1] The use of the past tense reveals the new position of the European Commission: while the multiplier *were* high, they are now back to their pre-crisis value. This means that, according to the European Commission, the euro zone is again in a "normal" economic situation. The argument here is theoretical, not empirical. Normally, economic agents are "Ricardian" in the sense that Robert Barro has given this term. Agents can smooth their consumption and investment decisions and are not constrained by their income over the short-term. The multipliers would therefore be low or even zero. Fiscal consolidation (which is the name given to the unprecedented budgetary efforts made since 2010 in the euro zone) could therefore continue, this time without the hassles previously observed. This argument is undoubtedly relevant in theory, but its use in practice today is puzzling. It amounts to forgetting far too easily that we are in a situation of high unemployment, that long-term unemployment is increasing, that company balance sheets are still devastated by the loss of activity that started in 2008, and have never really recovered except in Germany, that the banks themselves are struggling to comply with accounting standards and that the IMF Managing Director, Christine Lagarde, has urged that some of them be closed. It means forgetting that the famous credit that is supposed to smooth consumption and investment has collapsed, *i.e.* amidst a rampant and powerful credit crunch. It means forgetting that in this era when the injunction to prefer the private sector over the public sector is stronger than ever, panic in the financial markets is leading savers and investment advisers to opt for investments in State sovereign bonds with yields of less than 2% at 10 years. And this is taking place despite downgrades by the credit rating agencies because these States are perceived (and "priced", to use the jargon of the trading floors) as having the lowest risk. Such are the paradoxes of a time when one voluntarily submits to taxation by accepting negative real interest rates on investments and paying dearly for default insurance.

So if the confession seems belated and not to have had much impact on the dogma for escaping the crisis, it also involves a euphemism. For what are these costs that Marco Buti refers to? The price to be paid for an unavoidable financial situation? A hard time to get through before we return to a healthy future? It is by turning away from a detailed analysis of the risks run by continuing the current economic strategy, which has finally been acknowledged as having been incorrectly calibrated, that we miss what is most important. By pursuing the short-term goal of consolidation, while the fiscal multipliers are high, the conditions that make the fiscal multipliers high in the first place are maintained or even reinforced. The period of unemployment and underutilization of capacity are thus prolonged. This prevents the reduction of private debt, the starting point of the crisis, thus perpetuating it.

The fiscal effort has been disappointing in the short term, as the consequence of a high multiplier is that the deficit is reduced less than expected, or even not at all. Public debt in turn increases, as the effect of the denominator outweighs the slower growth of the numerator (see the iAGS report for a discussion and a simple formalization). There are numerous examples, the most recent of which was France, and the most spectacular Spain. But the disappointment is not just in the short term. The persistence of zero growth and a recession changes expectations about future growth: what was analyzed a few quarters ago as a cyclical deficit is now considered structural. The disappointment also modifies the future potential. The hysteresis effects in the labour market, the reduction in R&D, the delays with infrastructure and even, as can be seen now in Southern Europe, the cutbacks in education, in the fight against poverty and in the integration of immigrants all obscure the long-term outlook.

In 2013 and 2014, the developed countries will all continue their fiscal consolidation efforts. For some, this will mean the repetition and thus the accumulation of an unprecedented effort over five consecutive years. For Spain, this amounts to a cumulative fiscal effort of more than 8 percentage points of GDP! With few exceptions, unemployment will continue to rise in the developed countries, reaching a situation where involuntary unemployment exceeds the capacity of the national unemployment insurance systems to replace the lost employment income, especially since these systems are facing budget cuts themselves. In this context, wage deflation will kick off in the countries hit hardest. Since the euro zone has fixed exchange rates, this wage deflation will inevitably be transmitted to other countries. This will constitute a new lever perpetuating the crisis. As wages decrease, it becomes impossible for economic agents to access the financial system to smooth their economic decisions. The debts that have been targeted for reduction since the onset of the crisis will appreciate in real terms. Debt deflation will become the new vector of entrapment in the crisis.

There is, in this situation, a particularly specious argument to justify this conduct: that there was no alternative, *i.e.* that history was written before 2008 and that the errors in economic policy committed before the crisis made it inevitable, and above all that any other choice, such as postponing the consolidation of the public finances to a time when the fiscal multipliers were lower, was simply not possible. Market pressures and the need to restore lost credibility before 2008 made prompt action essential. If the actions carried out had not been carried out just as they were, then the worst would have happened. The euro would have collapsed, and defaults on public and private debt would have plunged the euro zone into a depression like that of the 1930s, or even worse. The great efforts undertaken made it possible to avert a disaster, and the result of these measures is, at the end of the day, quite encouraging. Such is the story.

But this argument ignores the risks being run today. Deflation, the prolongation of mass unemployment, the collapse of the welfare states, the discrediting of their policies, the undermining of consent to taxation, all carry the seeds of threats whose consequences can only be glimpsed today. Above all, this dismisses the alternative for the euro zone of exercising its sovereignty and demonstrating its solidarity. This argument is based on the idea that for the States fiscal discipline is to be exercised through the markets. It obscures the fact that the public debt and currency are inseparable. An alternative does exist; it requires that the public debt in the euro zone be pooled; it requires a leap towards a transfer of sovereignty; and it requires completing the European project.

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[1] "With fiscal multipliers higher than in normal times, the consolidation efforts have been costly in terms of output and employment", Marco Buti and Karl Pichelmann, ECFIN *Economic Brief Issue* 19, Feb. 2013, *European prosperity reloaded: an optimistic glance at EMU@20*.