Europe’s fiscal rules – up for debate

By Pierre Aldama and Jérôme Creel

At the euro zone summit in December 2018, the heads of state and government hit the brakes hard on the reform of fiscal governance: among the objectives assigned to the euro zone’s common budget that they are wishing for, the function of economic stabilization has disappeared. This is unfortunate, since this function is the weak point of the fiscal rules being pursued by the Member States.

In a recent article, we assessed how governments use the fiscal tools at their disposal to respond to information about trends in the public debt or the economic cycle that is at their disposal when they make their budgetary decisions. Thus, instead of evaluating the properties of fiscal rules using data that may well be revised retrospectively, we evaluated them “in real time”.[1]

Three main results emerged from our study. On the one hand, European governments ensure that their public debts are sustainable by improving their fiscal balance when the public debt increases. On the other hand, we found a trend towards fiscal consolidation at the bottom of the cycle in the euro area: fiscal policy is then rather destabilizing. Finally, euro area Member states have adopted a behaviour that was not found in the non-European countries in our sample: the euro zone Member states, unlike the others, continued to stabilize their public debts at the bottom of the cycle and during the crisis years. Thus the fiscal policy in the euro zone countries appears rather clearly to be untimely and inappropriate.

The results obtained as a whole for the euro area argue for a reform of Europe’s fiscal rules, but not necessarily in the sense most commonly accepted. The issue of stabilizing the public debt does not seem to be essential in so far as this is already being taken care of by the fiscal policies being implemented. Rather, what is needed is to rebalance these fiscal policies in favour of macroeconomic stabilization, especially if no common mechanism – such as a euro zone budget – has been set up for this purpose. European fiscal policies need to be more flexible and less prescriptive, with a focus on the dynamics of macroeconomic stabilization. Since no progress is envisaged at the European level, national automatic stabilizers need to be reinforced, increasing tax progressivity and the responsiveness of social spending to changes in economic activity in order to deal with the next cyclical downturn, both individually and collectively.

[1] One of if not the first article that focuses on evaluating fiscal policy using “real-time” data is by Golinelli and Momigliano (Journal of Policy Modeling, 2006). This literature is summarized in Cimadomo (Journal of Economic Surveys, 2016).

The euro is 20 – time to grow up

By Jérôme Creel and Francesco Saraceno [1]

At age twenty, the euro has gone through a difficult adolescence. The success of the euro has not been aided by a series of problems: growing divergences; austerity policies with their real costs; the refusal in the centre to adopt expansionary policies to accompany austerity in the periphery countries, which would have minimized austerity's negative impact, while supporting activity in the euro zone as a whole; and finally, the belated recognition of the need for intervention through a quantitative easing monetary policy that was adopted much later in Europe than in other major countries; and a fiscal stimulus, the Juncker plan, that was too little, too late.

Furthermore, the problems facing the euro zone go beyond managing the crisis. The euro zone has been growing more slowly than the United States since at least 1992, the year the Maastricht Treaty was adopted. This is due in particular to the inertia of economic policy, which has its roots in the euro's institutional framework: a very limited and restrictive mandate for the European Central Bank, along with fiscal rules in the Stability and Growth Pact, and then in the 2012 Fiscal Compact, which leave insufficient room for stimulus policies. In fact, Europe's institutions and the policies adopted before and during the crisis are loaded down with the consensus that emerged in the late 1980s in macroeconomics which, under the assumption of efficient markets, advocated a "by the rules" economic policy that had a necessarily limited role. The management of the crisis, with its fiscal stimulus packages and increased central bank activism, posed a real challenge to this consensus, to such an extent that the economists who were supporting it are now questioning the direction that the discipline should take. Unfortunately, this questioning has only marginally and belatedly affected Europe's decision-makers.

On the contrary, we continue to hear a discourse that is meant to be reassuring, i.e. while it is true that, following the combination of austerity policies and structural reforms, some countries, such as Greece and Italy, have not even regained their pre-2008 level of GDP, this bitter potion was needed to ensure that they emerge from the crisis more competitive. This discourse is not convincing. Recent literature shows that deep recessions have a negative impact on potential income, with the conclusion that austerity in a period of crisis can have long-term negative effects. A glance at the World Economic Forum competitiveness index, as imperfect as it is, nevertheless shows that none of the countries that enacted austerity and reforms during the crisis saw its ranking improve. The conditional austerity imposed on the countries of the periphery was doubly harmful, in both the long and short terms.

In sum, a look at the policies carried out in the euro zone leads to an irrevocable judgment on the euro and on European integration. Has the time come to concede that the Exiters and populists are right? Should we prepare to manage European disintegration so as to minimize the damage?

There are several reasons why we don’t accept this. First, we do not have a counterfactual analysis. While it is true that the policies implemented during the crisis have been calamitous, how certain can we be that Greece or Italy would have done better outside the euro zone? And can we say unhesitatingly that these countries would not have pursued free market policies anyway? Are we sure, in short, that Europe’s leaders would have all adopted pragmatic economic policies if the euro had not existed? Second, as the result of two years of Brexit negotiations shows, the process of disintegration is anything but a stroll in the park. A country’s departure from the euro zone would not be merely a Brexit, with the attendant uncertainties about commercial, financial and fiscal relations between a 27 member zone and a departing country, but rather a major shock to all the European Union members. It is difficult to imagine the exit of one or two euro zone countries without the complete breakup of the zone; we would then witness an intra-European trade war and a race for a competitive devaluation that would leave every country a loser, to the benefit of the rest of the world. The costs of this kind of economic disorganization and the multiplication of uncoordinated policies would also hamper the development of a socially and environmentally sustainable European policy, as the European Union is the only level commensurate with a credible and ambitious policy in this domain.

To say that abandoning the euro would be complicated and/or costly, is not, however, a solid argument in its favour. There is a stronger argument, one based on the rejection of the equation "euro = neoliberal policies". Admittedly, the policies pursued so far all fall within a neoliberal doctrinal framework. And the institutions for the European Union's economic governance are also of course designed to be consistent with this doctrinal framework. But the past does not constrain the present, nor the future. Even within the current institutional framework, different policies are possible, as shown by the (belated) activism of the ECB, as well as the exploitation of the flexibility of the Stability and Growth Pact. Moreover, institutions are not immutable. In 2012, six months sufficed to introduce a new fiscal treaty. It headed in the wrong direction, but its approval is proof that reform is possible. We have worked, and we are not alone, on two possible paths for reform, a dual mandate for the ECB, and a golden rule for public finances. But other possibilities could be mentioned, such as a European unemployment insurance, a European budget for managing the business cycle, or modification of the European fiscal rules. On this last point, the proposals are proliferating, including for a rule on expenditures by fourteen Franco-German economists, or the replacement of the 3% rule by a coordination mechanism between the euro zone members. Reasonable proposals are not lacking. What is lacking is the political will to implement them, as is shown by the slowness and low ambitions (especially about the euro zone budget) of the decisions taken at the euro zone summit on 14 December 2018.

The various reforms that we have just mentioned, and there are others, indicate that a change of course is possible. While some policymakers in Europe have shown stubborn persistence, almost tantamount to bad faith, we remain convinced that neither European integration nor the euro is inevitably linked to the policies pursued so far.

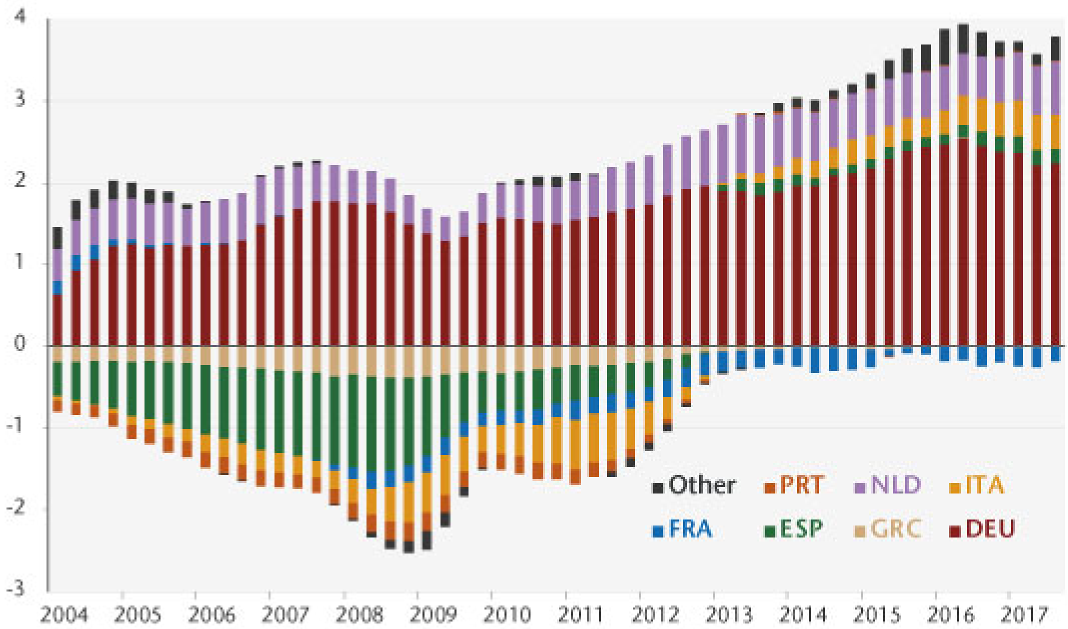
[1] This post is an updated and revised version of the article "Le maintien de l'euro n'est pas synonyme de politiques néolibérales" [Maintaining the euro is not synonymous with neoliberal policy], which appeared in *Le Monde* on 8 April 2017.

Major adjustments are awaiting the euro zone

By Bruno Ducoudré, Xavier Timbeau and Sébastien Villemot

Current account imbalances are at the heart of the process that led to the crisis in the euro zone starting in 2009. The initial years of the euro, up to the crisis of 2007-2008, were a period that saw widening imbalances between the countries of the so-called North (or the core) and those of the South (or the periphery) of Europe, as can be seen in Figure 1.

Figure 1. Current account balances (moving average over four quarters) in % of GDP of the euro zone



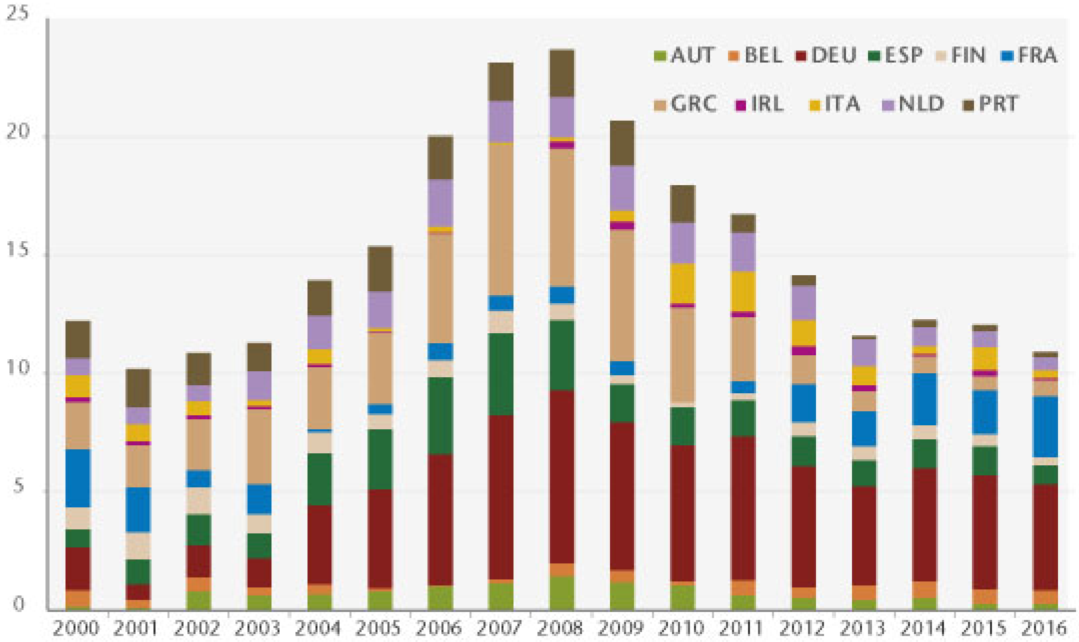
Source: Eurostat.

The trend towards diverging current account balances slowed sharply after 2009, and external deficits disappeared in almost all the euro zone countries. Despite this, there is still a significant gap between the northern and southern countries, so there cannot yet be any talk about reconvergence. Moreover, the fact that the deficits have fallen (Italian and Spanish) but not the surpluses (German and Dutch) has radically changed the ratio of the euro zone to the rest of the world: while the zone's current account was close to balanced between 2001 and 2008, a significant surplus has formed since 2010, reaching 3.3% of GDP in 2016. In other words, the imbalance that was internal to the euro zone has shifted into an external imbalance between the euro zone and the rest of the world, in particular the United States and the United Kingdom. This imbalance is feeding Donald Trump's protectionism and putting pressure on exchange rates. While the nominal exchange rate internal to the euro zone is not an adjustment variable, the exchange rate between the euro and the dollar can adjust.

It seems unlikely that the euro zone can maintain a surplus like this over the long run. Admittedly, the pressures for the appreciation of the euro are now being contained by the particularly accommodative monetary policy of the European Central Bank (ECB), but when the time comes for the normalization of monetary policies, it is likely that the euro will appreciate significantly. In addition to having a deflationary impact, this could rekindle the crisis in the zone by once again deepening the Southern countries' external deficits due to their loss in competitiveness. This will in turn give new grounds for leaving the euro zone.

In a recent study [1], we seek to quantify the adjustments that remain to be made in order to resolve these various current account imbalances, both within the euro zone and vis-à-vis the rest of the world. To do this, we estimate equilibrium real exchange rates at two levels. First, from the point of view of the euro zone as a whole, with the idea that the adjustment of the real exchange rate will pass through an adjustment of the nominal exchange rate, notably the euro vis-à-vis the dollar: we estimate the long-term target of euro / dollar parity at USD 1.35 per euro. Next, we calculate equilibrium real exchange rates within the euro zone, because while the nominal exchange rate between the member countries does not change because of the monetary union, relative price levels allow adjustments in the real exchange rate. Our estimates indicate that substantial misalignments remain (see Figure 2), with the average (in absolute terms) misalignment relative to the level of the euro being 11% in 2016. The relative nominal differential between Germany and France comes to 25%.

Figure 2. Indicator of nominal intra-euro zone adjustments with countries' contributions



Note: Figure 2 relates the average (weighted by GDP) of the absolute value of the nominal adjustments. The contribution of each country to this average is shown. The nominal disadjustments correspond to the changes in price of the added value that must be made simultaneously so that all the countries hit their current account target.
This figure can be interpreted as a summary measure of the level of the internal disadjustments of the euro zone, with the contribution of each country.
Source: OFCE calculations.

In the current situation, claims by some euro zone countries are not accumulating on others in the zone, but there is accumulation by some euro zone countries on other countries around the world. This time the exchange rate (actual, weighted by accumulated gross assets) can serve as an adjustment variable. The appreciation of the euro would therefore reduce the euro zone's current account surplus and depreciate the value of assets, which are probably accumulated in foreign currency. France however now appears as the last country in the euro zone running a significant deficit. Relative to the zone's other countries, it is France that is contributing most (negatively) to the imbalances with Germany (positively). If the euro appreciates, it is likely that France's situation would further deteriorate and that we would see a situation where the net internal position accumulates, but this time between France (on the debtor side) and Germany (creditor). This would not be comparable to the situation prior to 2012, since France is a bigger country than Greece or Portugal, and therefore the question of sustainability would be posed in very different terms. On the other hand, reabsorbing this imbalance by an adjustment of prices would require an order of magnitude such that, given the relative price differentials that would likely be needed between France and Germany, it would take several decades to achieve. It is also striking that, all things considered, since 2012, when France undertook a costly reduction in wages through the CICE tax credit and the Responsibility Pact, and Germany introduced a minimum wage and has been experiencing more wage growth in a labour market that is close to full employment, the relative imbalance between France and Germany, expressed in the adjustment of relative prices, has not budged.

Three consequences can be drawn from this analysis:

1. The disequilibrium that has set in today will be difficult to reverse, and any move to speed this up is welcome. Ongoing moderation in rises in nominal wages in France, stimulating the growth of nominal wages in Germany, restoring the share of German added value going to wages, and continuing to boost the minimum wage are all paths that have been mentioned in the various iAGS reports. A reverse social VAT, or at least a reduction in VAT in Germany, would also be a way to reduce Germany’s national savings and, together with an increase in German social security contributions, would boost the competitiveness of other countries in the euro zone;
2. The pre-crisis internal imbalance has become an external imbalance in the euro zone, which is leading to pressure for a real appreciation of the euro. The order of magnitude is significant: it will weigh on the competitiveness of the different countries in the euro zone and will lead to the problems familiar prior to 2012 resurfacing in a different form;
3. The appreciation of the euro caused by the current account surpluses in certain euro zone countries is

generating an externality for the euro zone countries. Because their current accounts respond differently to a change in relative prices, Italy and Spain will see their current account balance react the most, while Germany's will react the least. In other words, the appreciation of the euro, relatively, will hit the current accounts of Italy and Spain harder than Germany's and will lead to a situation of internal imbalance much like what existed prior to 2012. This externality together with the reduced sensitivity of Germany's current account to relative prices argues for a reduction in imbalances by boosting Germany's internal demand, i.e. by a reduction in its national savings. The tools to do this could include boosting public investment, lowering direct personal taxes, or raising the minimum wage more quickly relative to productivity and inflation.

[1] Sébastien Villemot, Bruno Ducoudré, Xavier Timbeau: "Taux de change d'équilibre et ampleur des désajustements internes à la zone euro" [Equilibrium exchange rate and scale of internal misalignments in the euro zone], *Revue de l'OFCE*, 156 (2018).

The ECB is still worried about the weakness of inflation

By Christophe Blot, Jérôme Creel and Paul Hubert

The President of the European Central Bank, Mario Draghi, recently announced that the increase in the ECB's key interest rate would come "well past" the end of the massive purchases of bonds (scheduled for September 2018), mainly issued by the euro zone countries, and at a “measured pace”. The increase in the key rate could therefore occur in mid-2019, a few weeks before the transfer of power between Mario Draghi and his successor.

In his quarterly hearing with MEPs, Mario Draghi proved to be cautious about the intensity and sustainability of the economic recovery [1]. Listening to him, the euro zone has not necessarily closed its output gap (actual GDP would have remained below its potential) despite the recovery in recent quarters. This is not the time to change the direction of monetary policy at the risk of weakening the recovery. It is also undeniable that the effects of the recovery are only materializing slowly and gradually in wage increases, which partly explains why the euro zone inflation rate remains below its mid-term target.

The ECB President has also been confident that companies are gradually anchoring their price (and wage) expectations on the ECB’s inflation target of 2% per year. Mario Draghi also appeared very confident in the effectiveness of monetary policy. He announced that the measures undertaken since 2014 would contribute to a (cumulative) increase of 2 percentage points, respectively in real growth and inflation between 2016 and 2019.

If the ECB’s forecast of inflation back to its target in 2019 is contradicted by Hasenzagl et al. (2018), we find these same determinants of European inflation. In a recent study, we also show that the two main determinants of inflation in the euro area are inflation expectations and wage growth. Without anchoring the former on the medium-term target of the ECB and without a second-round effect of monetary policy on wages, inflation will not return to its target in the short term. Structural reforms may have increased potential GDP, as argued by Mario Draghi, but they have so far more certainly weighed on wage and price developments.

[1] Once a quarter, a monetary dialogue is organized between the President of the ECB and the members of the Monetary Affairs Committee of the European Parliament. This dialogue allows the President of the ECB to explain the direction of monetary policy in the euro area and to express his point of view on topics defined upstream. Une fois par trimestre un dialogue monétaire est organisé entre le Président de la BCE et les membres de la Commission des Affaires monétaires du Parlement européen. Ce dialogue permet au Président de la BCE d'expliquer l'orientation de la politique monétaire dans la zone euro et d'exprimer son point de vue sur des sujets définis en amont.

Missing deflation – unique to America?

By Paul Hubert, Mathilde Le Moigne

Was the way inflation unfolded after the 2007-2009 crisis atypical? According to Paul Krugman: "If inflation [note: in the United States] had responded to the Great Recession and aftermath in the same way it did in previous big slumps, we would be deep in deflation by now; we aren't." Indeed, after 2009, inflation in the United States remained surprisingly stable given actual economic developments. Has this phenomenon, which has been described as "missing deflation", been observed in the euro zone?

Despite the deepest recession since the 1929 crisis, the inflation rate remained stable at around 1.5% on average between 2008 and 2011 in the United States, and 1% in the euro zone. Does this mean that the Phillips curve, which links inflation to real activity, has lost its empirical validity? In a note in 2016, Olivier Blanchard recalls on the contrary that the Phillips curve, in its simplest original version, remains a valid instrument for understanding the links between inflation and unemployment, despite this “missing disinflation”. Blanchard notes, however, that the link between the two variables has weakened because inflation is increasingly dependent on expectations of inflation, which are themselves anchored in the US Federal Reserve’s inflation target. In their 2015 article, Coibion and Gorodnichenko explain the missing deflation in the United States by the fact that inflation expectations tend to be influenced by the most visible price changes, such as changes in the price of a barrel of oil. Since 2015, we have seen a drop in inflation expectations concomitant with the decline in oil prices.

The difficulty in accounting for recent changes in inflation by using the Phillips curve led us in a recent article to evaluate its potential determinants and to consider whether the euro zone has also experienced a phenomenon of “missing deflation”. Based on a standard Phillips curve, we did not find the conclusions of Coibion and Gorodnichenko when we consider the euro zone as a whole. In other words, real activity and inflation expectations give a good description of the way inflation is behaving.

This result seems to come, however, from a bias in aggregation between national inflation behaviours in the euro zone. In particular, we find a notable divergence between the countries of northern Europe (Germany, France), which show a general tendency towards *missing inflation*, and the more peripheral countries (Spain, Italy, Greece), which are exhibiting periods of *missing deflation*. This divergence nevertheless shows up from the *beginning* of our sample, that is to say, in the first years when the euro zone was created, and seems to be absorbed from 2006, without undergoing any notable change during the 2008-2009 crisis.

In contrast to what happened in the United States, it seems that the euro zone did not experience missing deflation as a result of the 2008-2009 economic and financial crisis. On the contrary, it seems that divergences in inflation in Europe predate the crisis and tended to be absorbed by the crisis.

How can Europe be saved? How can the paradigm be changed?

By Xavier Ragot

There are new inflections in the debate over the construction of Europe. New options from a variety of economic and political perspectives have seen the light of day in several key conferences and workshops, though without the visibility of public statements. The debate is livelier in Germany than in France. This is due probably to the caricature of a debate that took place during France's presidential elections, which took the form of "for or against the single currency", while the debate needed was over how to orient the euro area's institutions to serve growth and deal with inequalities.
Two conferences were held in Berlin one week apart that considered opposing options. The first tackled the consequences of a country leaving the euro area; the second examined an alternative paradigm for reducing inequalities in Europe. In other words, the two conferences covered almost the entire spectrum of conceivable economic policies.

Sowing fear: the end of the euro area?

The first question: What would happen if one or more countries left the euro area? Should we hope for this, or how could we prevent it? A conference held on March 14 under the title "Is the euro sustainable – and what if it isn't?" brought together the heads of influential institutes like Clemens Fuest, one of the five German "wise men", Christoph Schmidt, and economists frequently seen in the German media like Hans-Werner Sinn, as well as economists like Jeromin Zettelmeyer. The presence of the OFCE, which I represented, hopefully helped to serve as a reminder of some simple but useful points.

This first conference sometimes played with the ambiguity of the issue, with some contributions seeming to wish for an end to the euro area while others were more analytical in order to show the risks. The voice of Hans-Werner Sinn stood out during this discussion for its radical stance. Without going so far as to wish that Germany left the euro area, Sinn insisted in a systematic (and skewed) way that Germany was suffering under Europe's monetary policy. He insisted in particular on the role of Germany's hidden exposure to the debt of other countries through the European Central Bank and TARGET2, which books the surpluses and deficits of the national central banks vis-à-vis the ECB. The TARGET2 balance shows that the southern European countries are running a deficit, while Germany has a substantial surplus of almost 900 billion euros, which represents 30% of German GDP. These amounts are very significant, but do not in any way represent a cost for Germany.

In the most extreme case of a national central bank's failure to pay (i.e. an exit from the euro area), the loss would be shared by all the other states independently of the surpluses. The TARGET2 balances are part of Europe's monetary policy, which is aimed at achieving a goal that was agreed on: an average inflation level of 2%. This target has not been hit for many years. Moreover, this policy has led to low interest rates that benefit Germans who pay low interest charges on their public debt, as Jeromin Zettlemeyer pointed out. Finally, Germany's large trade surplus shows that the lack of an exchange rate mechanism in the euro area has benefited Germany significantly. Recall that the volume of Germany's exports exceeded China's in 2016, according to the German institute Ifo!

My presentation was based on the OFCE's numerous studies of the European crisis. The OFCE has published an analytical note on the effects of an exit from the euro area, showing all the related costs. The studies by Durand and Villemot provide the analytical basis for providing orders of magnitude. How much would Germans' wealth decline if the euro area were to collapse? The result is, in the end, not very surprising. The Germans would be the greatest losers, with a loss of wealth on the order of 15% of GDP. These figures are of course very tentative and need to be interpreted with the utmost care. The collapse of the euro area would plunge us into unexplored territory, which could surprise us with unexpected sources of instability.

After these preliminary elements, the heart of my presentation was then focused on a simple point. The real challenge facing us is to build coherent labor markets within the euro area, while reducing inequalities. Following on the common monetary policy, the coordination of fiscal policy that was carried out so painfully after 2014 and the aberrations associated with the recessionary fiscal policy (austerity), the main question facing Europe over the next ten years is to develop coherent labor markets. Indeed, Germany's wage moderation, the result of the difficulties with reunification in the early 1990s, has been a powerful destabilizing force in Europe, as was shown in an article by Mathilde Le Moigne. What is called the supply problem in France is in fact the result of divergences within Europe on the labor market in the wake of Germany's wage moderation. I proposed that the European Parliament initiate a

Europe-wide discussion of national wage dynamics in order to bring about the convergence of wages in a non-deflationary way while avoiding high unemployment in southern Europe. This co-ordination of economic policy on the labor market is designated by the English term "wage stance". Co-ordination of changes in minimum wages and in regulated wages, which orients the direction of wage changes in labour negotiations, are tools for the co-ordination of labor markets.

A second tool is of course the establishment of a European system of unemployment insurance, which would be much less complex than one might think. A European unemployment insurance would aim to be complementary to national unemployment insurance, and not a replacement. National unemployment insurance systems are actually heterogeneous because, on the one hand, the labour markets are distinct, and on the other hand national preferences differ. Unemployment insurance systems are for the most part the result of historical social compromises.

How should this relatively radical German stance against Europe be interpreted today? Perhaps it represents the discontent of economists who are losing influence in Germany. It might seem paradoxical, but many German economists and observers are adjusting to recognize the necessity of building a different Europe, one not based on rules, but leaving room for political choices within strong institutions – i.e. for agile, well respected institutions rather than rules. This position is associated with France in the European debate: choices rather than rules. The German coalition agreement that paved the way for an SPD/CDU government has placed the issue of Europe at the center of the agreement, but with a great deal of vagueness about the content. Certain developments will test the relevance of this hypothesis, in particular the issue of a euro area minister and the nature of the decision-making rules within the key crisis-resolution mechanism, the European stability mechanism.

Europe: Changing the software / model / paradigm / narrative

A second, more confidential conference proved to be even more exciting, with the presence of the European Climate Foundation on the climate issue, the INET institute on developments in economic thought, and the OFCE on European imbalances. The aim of the conference was to reflect on a shift in the paradigm, or narrative, and come up with a new articulation between politics and economics, the state and the market, in order to think sustainable growth in terms of both the climate and society. A narrative is a vision of the world conveyed by simple language. Thus the “neoliberal” narrative is built on positive words like “competition”, “markets” and “freedom” as well as negative words like “profit”, “interventionism” and “egalitarianism”, which allowed the creation of a language. Donald Trump produces an equally effective narrative: “giving power back to the people”, “America first”; this narrative marks the return of politics to a mode that assumes an underlying nationalism.
How could another narrative be built that has a central focus on the evidence for the fight against global warming and the aggravation of inequality and financial instability?

For one day economists who are renowned in Europe spoke about artificial intelligence, global warming, current forms of economic and industrial policies, the dynamics of credit and financial bubbles, and more. Empirical work at the forefront of current research as well as reflections about the possibility of a coherent storyline were combined in the promise of an alternative narrative. It was just the start. The possibility of a renewal of thought that transcended political divisions and spoke about what was essential came to light: how could the economy be placed at the service of a political project that aims not to rebuild borders to exclude but to imagine our common humanity?

These two conferences show the vitality of the European debate, which is presented from an overly technical perspective in France. The *raison d'être* of the euro is a common project. It is at this level that we need to conduct the discussion leading into the 2019 European elections.

The 2018 European economy: A hymn to reform

By [Jérôme Creel]

The OFCE has just published the [2018 European Economy] [in French]. The book provides an assessment of the European Union (EU) following a period of sharp political tension but in an improving economic climate that should be conducive to reform, before the process of the UK's separation from the EU takes place.

Many economic and political issues crucial to better understanding the future of the EU are summarized in the book: the history of EU integration and the risks of disintegration; the recent improvement in its economic situation; the economic, political and financial stakes involved in Brexit; the state of labour mobility within the Union; its climate policy; the representativeness of European institutions; and the reform of EU economic governance, both budgetary and monetary.

The year 2018 is a pivotal year prior to the elections to the European Parliament in spring 2019, but also before the 20th anniversary of the euro on 1 January 2019. The question of the euro's performance will be central. However, in 2018 gross domestic product will finally begin to increase at well above its pre-crisis level, thanks to renewed business investment and the support of monetary policy, henceforth unhindered by fiscal policy.

The year 2018 will also mark the beginning of negotiations on the future economic and financial relationship of the United Kingdom and the EU, after at end 2017 the two parties found common ground on arrangements for the UK leaving the Union. The EU’s renewed growth will reduce the potential costs of the divorce with the British and could also lessen Europeans’ interest in this issue.

Brexit could have served as a catalyst for reforming Europe; the fact that the mechanisms for this may now seem less crucial to the EU’s future functioning should not take away from the reforms needed by the EU, as if these were superfluous. In the political and monetary fields, there is a great need to strengthen the democratic representativeness of EU institutions (parliament, central bank) and to ensure the euro’s legitimacy. In the fields of fiscal and immigration policy, past experience has demonstrated the need for coordinated tools to better manage future economic and financial crises.

There is therefore an urgent need to revitalize a project that is over sixty years old, one that has managed to ensure peace and prosperity in Europe, but which lacks flexibility in the face of the unpredictable (crises), which lacks vigour in the face of the imperatives of the ecological transition, and which is singularly lacking in creativity to strengthen the convergences within it.

Labour force participation rates and working time: differentiated adjustments

By Bruno Ducoudré and Pierre Madec

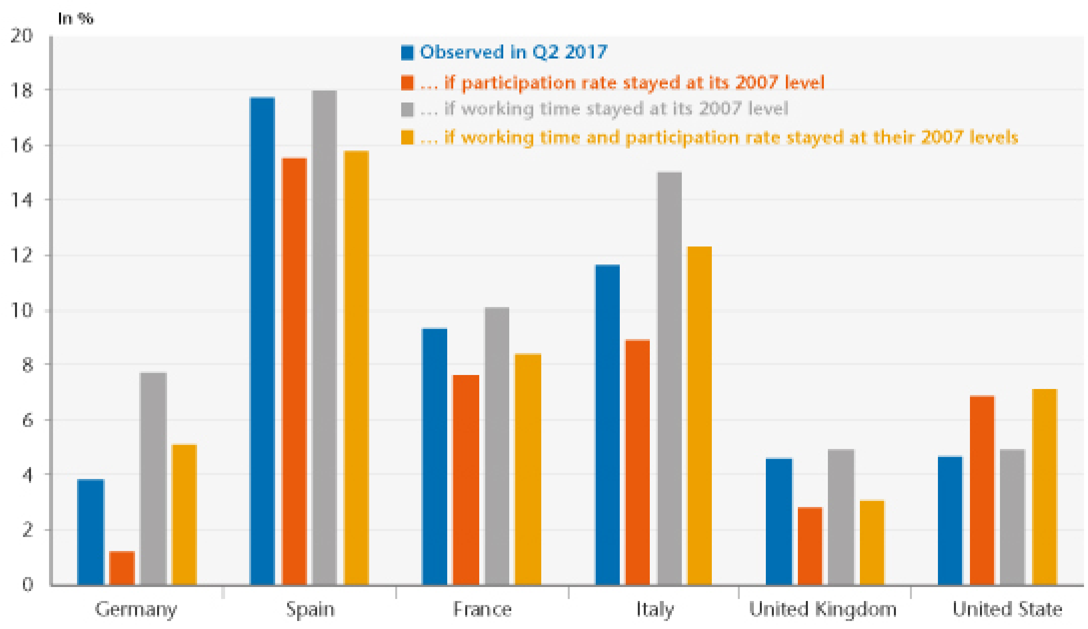
In the course of the crisis, most European countries reduced actual working time to a greater or lesser extent by making use of partial unemployment schemes, the reduction of overtime or the use of time savings accounts, but also through the expansion of part-time work (particularly in Italy and Spain), including involuntary part-time work. In contrast, the favourable trend in US unemployment is explained in part by a significant fall in the participation rate.

Assuming that, for a given level of employment, a one-point increase in the participation rate (also called the "activity rate") leads to a rise in the unemployment rate, it is possible to measure the impact of these adjustments (working time and participation rates) on unemployment, by calculating an unemployment rate at a constant employment level and controlling for these adjustments. In all the countries studied, the active population (employed + unemployed) increased by more than the general population, except in the United States, which was due in part to pension reforms. Mechanically, without job creation, demographic growth results in increasing the unemployment rate of the countries in question.

If the participation rate had remained at its 2007 level, the unemployment rate would be lower in France by 1.7 points, by 2.7 points in Italy and by 1.8 points in the United Kingdom (see figure). On the other hand, without the sharp contraction in the US labour force, the unemployment rate would have been more than 3 points higher than that observed in 2016. Germany has also experienced a significant decline in unemployment since the crisis (-5.1 points) even though its participation rate increased by 2.2 points. Given the same participation rate, Germany's unemployment rate would be… 1.2%. However, changes in participation rates are also the result of structural demographic factors, meaning that the hypothesis of a return to 2007 rates is arbitrary. For the United States, part of the decline in the participation rate can be explained by changes in the structure of the population. The underemployment rate might well also be overstated.

As for working time, the lessons seem very different. It thus seems that if working time had stayed at its pre-crisis level in all the countries, the unemployment rate would have been 3.9 points higher in Germany, 3.4 points higher in Italy and 0.8 point higher in France. In Spain, the United Kingdom and the United States, working time has not changed much since the crisis. By controlling for working time, the unemployment rate is therefore changing along the lines seen in these three countries.

Figure. Unemployment rate observed at Q2 2017 and unemployment rate if….



Sources: National accounts, OFCE calculations.

It should not be forgotten that there is a tendency for working time to fall, which is reflected in developments observed during the crisis independently of the specific measures taken to cushion the impact on employment through mechanisms such as short-time working or the use of time savings accounts. Since the end of the 1990s, working time has fallen substantially in all the countries studied. In Germany, between 1998 and 2008, it fell by an average of 0.6% per quarter. In France, the switch to the 35-hour work week resulted in a similar decline over the period. In Italy, the United Kingdom and the United States, average working hours fell each quarter by -0.3%, -0.4% and -0.3%, respectively. In total, between 1998 and 2008, working time declined by 6% in Germany and France, 4% in Italy, 3% in the United Kingdom and the United States and 2% in Spain, which was de facto the only country that during the crisis intensified the decline in working time begun in the late 1990s.

Where are we at in the euro zone credit cycle?

By Christophe Blot and Paul Hubert

In December 2016, the European Central Bank announced the continuation of its Quantitative Easing (QE) policy until December 2017. The continuing economic recovery in the euro zone and the renewal of inflation are now raising questions about the risks associated with this programme. On the one hand, isn't the pursuit of a highly expansionary monetary policy a source of financial instability? Conversely, a premature end to unconventional measures could undermine growth as well as the ECB's capacity to achieve its objectives. Here, we study the dilemma facing the ECB [in French] based on an analysis of credit cycles and banking activity in the euro zone.

The ECB's announcement gives us two signals about the direction of monetary policy. On the one hand, by delaying the end date of QE, the ECB is implicitly announcing that the normalization of monetary policy, in particular a hike in its key rate, will not take place before early 2018. The ECB will thus continue its expansionary policy of increasing the size of its balance sheet. On the other hand, the reduction in monthly purchases is also a sign that it is toning down its expansionary character. The announcement is similar to the "tapering" that began in January 2014 by the US Federal Reserve. Purchases of securities were cut back gradually, until they actually stopped at the end of October 2016.

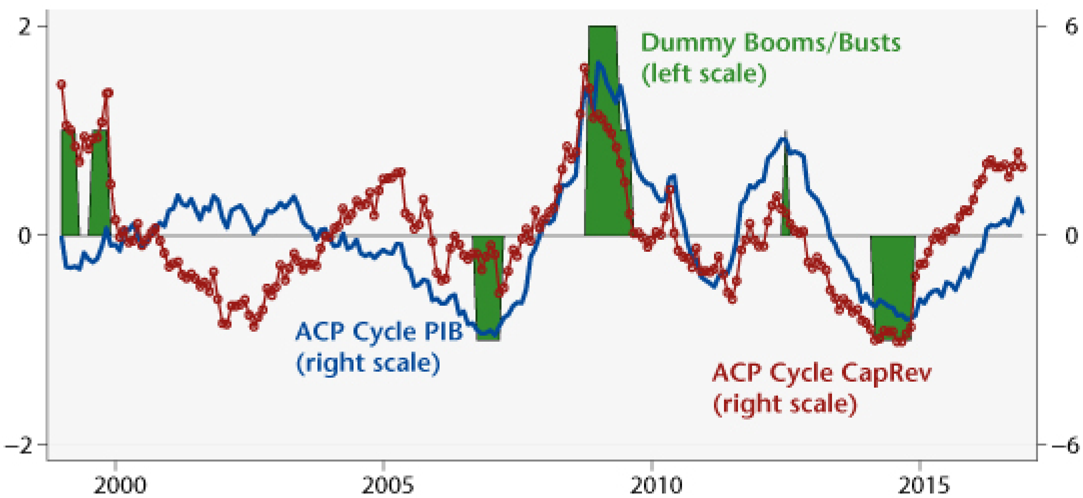
The undeniably expansionary nature of monetary policy in the euro zone suggests that the ECB still considers it necessary to implement a stimulus in order to achieve its ultimate monetary policy objectives. The first of these is price stability, which is defined as inflation that is lower than but close to 2% per year. There are no signs of either runaway inflation or growth [1] [2]. The securities buyback programme should help to consolidate growth and push inflation towards the 2% target. At the same time, the liquidity issued by the central bank in its securities purchase programmes and the low level of interest rates (short and long term) are fuelling fears that monetary stability might have an adverse effect on financial stability[3].

The result leaves the ECB facing a dilemma. Putting a premature end to quantitative easing could keep the euro zone in a state of low inflation and low growth. Unnecessarily prolonging QE, while the US Federal Reserve has begun normalizing its monetary policy, could create a risk of financial instability, resulting in an uncontrolled surge in asset prices, credit, and more broadly the risk taken on by the financial system.

We assess this dual risk using indicators on the activity of the banking system of the euro zone as a whole and of the countries that make it up. Credit, whether granted to households or to non-financial enterprises, is central to bank assets and often at the heart of risks to financial instability[4]. Here we propose extending the analysis to the size of the balance sheet and to total loans granted – including credit to other monetary and financial institutions – which makes it possible to measure the risk associated with the banking system as a whole[5].

These different variables are related either to GDP, which makes it possible to capture the disconnection between banking activity and real activity, or to the capital and reserves of the banking system, which makes it possible to capture the leverage effect, i.e. the capacity of the system to absorb losses. Here we focus on quantities rather than prices, using indicators such as the ratio of credit granted on equity and the ratio of credit received on income. These are central to reflecting the transmission of monetary policy and to assessing the risk of financial instability.

Figure. Credit in the euro zone



Sources : Blot and Herbert (2017) and ECB data.

The graph shows the changes in the credit cycle, relative to GDP (blue line) and relative to the capital and reserves of the banking system (red line) [6]. The green areas indicate periods when credit deviates significantly above or below its long-term trend. In general, the analysis of credit and of the size of the banking system's balance sheet points to a recovery in activity but it does not suggest either a credit boom or an excessive contraction in the euro zone in the recent period. While credit is evolving in a relatively more favorable direction relative to its trend in France and Germany, the cycle does not indicate an excessive increase. The Netherlands and Spain are distinguished by a low level of credit relative to GDP. For the Netherlands, this trend is confirmed by the indicators relative to the banking system's capital and reserves, while in Spain, outstanding loans relative to capital and reserves are at a historically high level, suggesting an excessive level of risk-taking given the economic situation.

[1] Translation errorDespite the recent rebound in inflation, which is largely linked to the rise in oil prices and inflation expectations, inflationary pressures are still moderate, and getting inflation back to the 2% target is not sufficiently sure to warrant a change in the direction of monetary policy.

[2] Unemployment is still high, fuelling deflation.

[3] A recent analysis by Borio and Zabai (2016) of the effectiveness of unconventional monetary policy suggests that its effectiveness could decrease even as the risks involved increase. The role of asset prices has been studied by Andrade et al. (2016), showing that asset prices had reacted, as expected, following the measures taken by the ECB, and by Blot et al. (2017) on an assessment of the risk of bubbles.

[4] See Jorda *et al.*, 2013 and 2015.

[5] Translation errorThe Basel III legislation is based on risk indicators calculated at the level of banking establishments, while our approach is based on macroeconomic indicators.

[6] Translation errorThese cycles are obtained using a principal component analysis (PCA) of several types of trend / cycle breakdowns: the Hodrick-Prescott filter, the Christiano-Fitzgerald filter, and the moving average.

Is the recovery on the right path?

Analysis and Forecasting Department

This text is based on the 2016-2018 outlook for the world economy and the euro zone, a full version of which is available here [in French].

The growth figures for 2016 have confirmed the picture of a global recovery that is gradually becoming more general. In the euro zone, which up to now had lagged behind, growth has reached 1.7%, driven in particular by strong momentum in Spain, Ireland, the Netherlands and Germany. The air pocket that troubled US growth at the start of the year translated into slower GDP growth in 2016 than in 2015 (1.6% vs. 2.6%), but unemployment has continued to decline, to below the 5% threshold. The developing countries, which in 2015 were hit by the slowdown in the Chinese economy and in world trade, picked up steam, gaining 0.2 point (to 3.9%) in 2016.

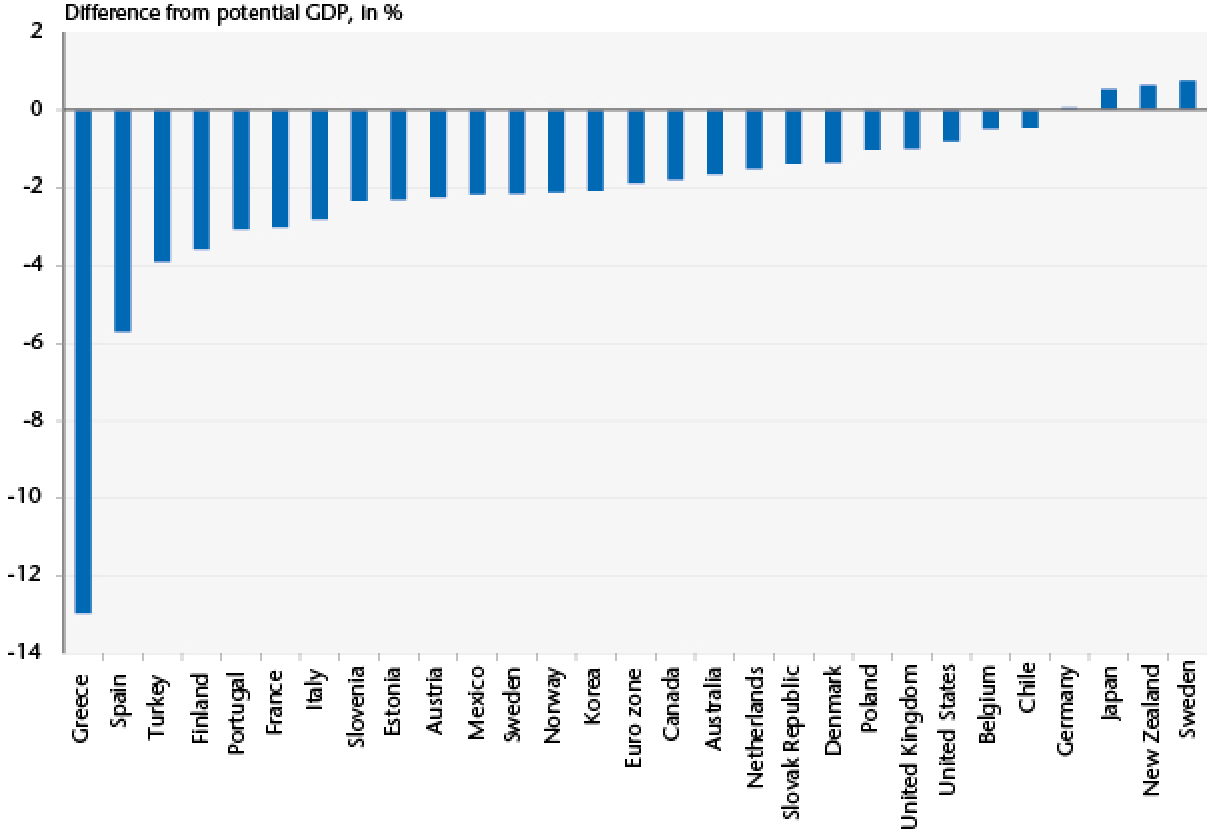
With GDP growing at nearly 3%, the world economy thus seems resilient, and the economic situation appears less gloomy than was feared 18 months ago – the negative factors have turned out to be less virulent than expected. The Chinese economy’s shift towards a growth model based on domestic demand has led not to its abrupt landing but to a controlled slowdown based on the implementation of public policies to prop up growth. Even though the sustainability of Greece’s debt has still not been resolved, the crisis that erupted in the summer of 2015 did not result in the disruption of the monetary union, and the election of Emmanuel Macron to the presidency of the French Republic has calmed fears that the euro zone would break up. While the question of Brexit is still on the table, the fact remains that until now the shock has not had the catastrophic effect some had forecast.

This pattern is expected to continue in 2017 and 2018 as a result of monetary policies that will continue to boost economic activity in the industrialized countries and somewhat scaled down fiscal efforts. US fiscal policy should become even more expansionary, allowing for a rebound in growth, which should once again surpass 2% in 2018. While oil prices have recently risen, they are not expected to soar, which will limit the negative impact on household purchasing power and business margins. The rise should even revive the previously moribund rate of inflation, thereby lowering the deflationary risk that has hovered over the euro zone. Pressure on the European Central Bank to put an end to unconventional measures could mount rather quickly.

Although the recovery process is consolidating and becoming more widespread, output in most of the developed economies is still lagging behind in 2016, as is illustrated by the gap in output from the potential level, which is still negative (Figure). This situation, which contrasts sharply with the past cyclical behavior of economies as GDP swung back towards its potential, raises questions about the causes for the breakdown in the growth path that has been going on for almost ten years now. One initial element in an explanation could be the weakening of potential GDP. This could be the result of the scale of the crisis, which would have affected the level and / or growth of the supply capacity of the economies due to the destruction of production capacity, the slowdown in the spread of technological progress and the de-skilling of the unemployed.

A second factor would be the chronic insufficiency of demand, which would keep the output gap in negative territory in most countries. The difficulty in once again establishing a trajectory for demand that is capable of reducing underemployment is related to the excessive indebtedness of private agents prior to the recession. Faced with swelling liabilities, economic agents have been forced to cut their spending to shed debt and restore their wealth. In a situation like this, unemployment or underemployment should continue to fall, but this will take place more slowly than in previous recovery phrases. Ten years after the start of the Great Recession, the global economy has thus still not resolved the macroeconomic and social imbalances generated by the crisis. The recovery is therefore well under way, but it is still not fast enough.

Figure: Output gaps in 2016



Sources : OECD, *Economic Outlook*, November 2016, OFCE Calculations.