

# A new Great Moderation?

by Analysis and Forecasting Department

This text summarizes the OFCE's 2017-2019 forecast for the global economy and the euro zone; the full version can be found [here](#).

Ten years after the financial crisis broke out in the summer of 2007, the world economy finally seems to be embarking on a trajectory of more solid growth in both the industrialized and most of the emerging countries. The figures for the first half of 2017 indicate that global growth is accelerating, which should result in GDP growth of 3.3% over the year as a whole, up 0.3 percentage point over the previous year. Some uncertainty remains, of course, in particular concerning the outcome of Brexit and the ability of the Chinese authorities to control their economic slowdown, but these are the types of irreducible uncertainties characteristic of an economic system that is subject to political, technological, economic and financial shocks<sup>[1]</sup>. Beyond these risks, which should not be underestimated, lies the question of the ability of the world's economies to reduce the imbalances inherited from the crisis. While current growth is sufficient to bring down the unemployment rate and improve the employment rate, it needs to be long-lasting enough to get back to full employment, reduce inequalities, and promote debt reduction.

In this respect, not all the doubts have been lifted by the current upturn in the world's economic situation. First, growth has remained moderate in light of the past recession and previous episodes of recovery. Since 2012, the global economy has grown at an average rate of 3.2%, which is lower than in the 2000s (graphic). The growth trajectory seems to be closer to what was observed in the 1980s and 1990s. This period, the so-called Great Moderation, was characterized by lower macroeconomic volatility and a disinflationary trend,

first in the advanced countries, then in the emerging countries. This second element is also an important point in the global economic situation today. Indeed, the pick-up in growth is not translating into renewed inflation. The low rate of inflation reflects the persistence of underemployment in the labor market, which is holding back wage growth. It also illustrates the difficulties the central banks are having in (re)-anchoring inflation expectations on their target.

Finally, there is the matter of the growth potential. Despite numerous uncertainties about measuring growth potential, many estimates are converging on a projection of weaker long-term growth, due mainly to a slowdown in trend productivity. It should be noted, however, that the methods used to determine this growth trajectory sometimes lead to prolonging recent trends, and can therefore become self-fulfilling if they lead private and public agents to reduce their spending in anticipation of a slowdown in growth. Conversely, boosting future growth requires private and public investment. Economic policies must therefore continue to play a leading role in supporting the recovery and creating the conditions for future growth.

**Figure. The recovery of the global economy**



Sources: National accounts, OFCE calculations, October 2017.

[1] See OFCE (2017): [La routine de l'incertitude](#) [in French].

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# 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

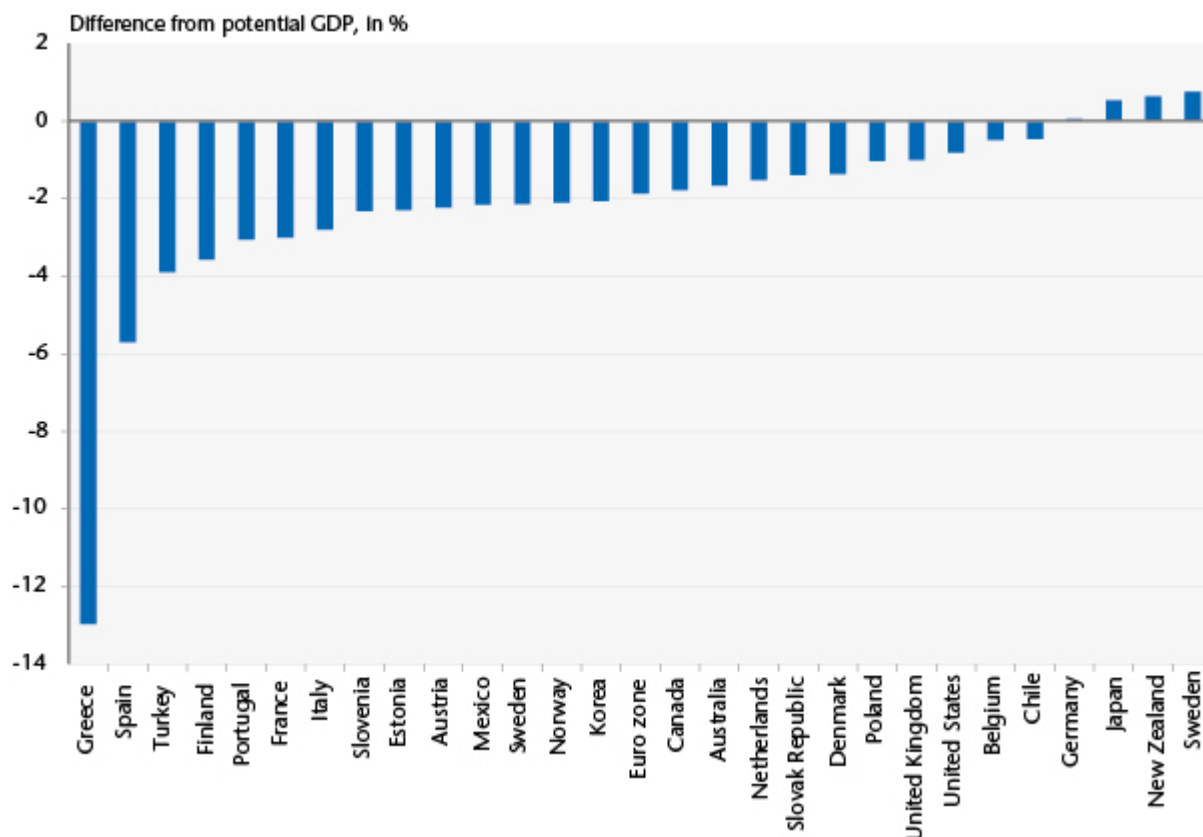
been resolved, the crisis that erupted in the summer of 2015 did not result in the disruption of the monetary union, and the election of Emmanuel Macron to the presidency of the French Republic has calmed fears that the euro zone would break up. While the question of Brexit is still on the table, the 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 phases. 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.

# Leave the euro?

By [Christophe Blot](#), [Jérôme Creel](#), [Bruno Ducoudré](#), [Paul Hubert](#), [Xavier Ragot](#), [Raul Sampognaro](#), [Francesco Saraceno](#), and [Xavier Timbeau](#)

Evaluating the impact of France leaving the euro zone (“Frexit”) is tricky, as many channels for doing this exist and the effects are uncertain. However, given that this proposal is being advanced in the more general debate over the costs and benefits of membership in the European Union and the euro, it is useful to discuss and estimate what is involved.

There is little consensus about the many points involved in an analysis of the issue of membership in the euro. On the one hand, the benefits linked to the single currency 18 years after its creation are not viewed as completely obvious; on the other, it is not evident that the monetary zone has become less heterogeneous, and, possibly linked to that, the current account imbalances built up in the first decade of the euro zone’s existence, which have grown since then due to the consequences of the 2008 global financial crisis, are putting constraints on economic policy.

The dissolution of Europe’s monetary union would be an unprecedented event, not only for the member states but also from the point of view of the history of monetary unions. Not that there have been no experiences of dissolution – [Rose](#) (2007) counted 69 cases of withdrawal from a monetary union since the end of the Second World War – but in many respects these experiences offer little if any basis for comparison ([Blot & Saraceno, 2014](#)). Nor do they reveal any empirical patterns that could inform us about the possible misfortunes or chances of success that a break-up of the euro zone might have.

However, the reference to past episodes is not the only tool

with which the economist can carry out an analysis of a break-up of the euro zone. It is indeed possible to highlight the mechanisms that would be at work if the monetary union project in Europe were to be wound up. There are numerous possible pathways to a break-up of the euro zone, and any analysis of the costs and benefits must be interpreted with the utmost caution, since in addition to uncertainty about any quantitative assessment of what is involved, there is also the issue of what scenario an exit would create. In these circumstances, a departure from the euro zone cannot necessarily be understood solely from the point of view of its impact on exchange rates or its financial effects. It is very likely that an exit would be accompanied by the implementation of alternative economic policies. The analysis carried out here does not enter this territory, but merely explains the macroeconomic mechanisms at work in the event of a break-up of the euro zone, without detailing the reaction of economic policy or second-round effects.

The central hypothesis adopted here is that involving a complete break-up of the monetary union, and not the simple departure of France alone. Indeed, if France, the second-largest euro zone economy, were to exit, the very existence of the monetary zone would be called into question. The devaluation of the French franc against the southern Europe countries remaining in the euro zone would destabilize their economies and push them out of the scaled-down euro zone. We do not deal here with all the technical elements related to how a break-up would be organized [\[1\]](#) – launching the circulation of new currencies, liquidation of the ECB and termination of the TARGET system, etc. – but rather on an analysis of the macroeconomic effects [\[2\]](#). Two types of effects would then be at work. First, the dissolution of the European monetary union would de facto lead to a return to national currencies, and therefore to a devaluation or revaluation of the currencies of the euro zone countries vis-à-vis not only their euro zone partners but also non-euro zone

countries. Second, the redenomination of assets and liabilities now denominated in euros and the prospect of exchange movements would have financial effects that we analyze in the light of past financial crises. Our scenario is therefore for a contained crisis.

A unilateral exit from the euro zone by France and the ensuing break-up of the euro zone exclude a scenario for a common currency where strong cooperation between the old member states would help to maintain a high level of exchange stability and effectively continue the economic status quo. There is little likelihood of a scenario like this, since it would lead to not using the margins of maneuver opened up by the exit and to maintaining the much-denounced and presumed straitjacket. The crisis would be contained in that the most violent effects would be reduced by coordinated policies. This would mean exchange movements that are rapid and substantial, but which stabilize over a time horizon of a few quarters [\[3\]](#). We assume, furthermore, that each country pursues its own interest without special co-operation.

## **I – A summary of the economic mechanisms at work**

### *The gains expected from leaving the euro zone*

In the first place, leaving the euro zone would mean that the exchange rates between the currencies of the countries that compose it could once again vary against each other. Given this, the question arises of the value at which the exchange rates of these currencies will tend to converge. The expected gains would be, on the one hand, an improvement in competitiveness due to the devaluation of the franc. A devaluation would lead to imported inflation in the short term, before increasing purchasing power and spurring growth. The second gain involves the possibility of defining a monetary and fiscal policy that is differentiated by country, and therefore more appropriate to France's situation.



An exit from the euro zone would also make it possible to set tariffs less favorable to imports from other countries, and thus more favorable to producers on the national territory, but which would also affect consumer prices and thus consumer purchasing power[\[4\]](#).

### *The costs of leaving the euro zone*

France's exit from the euro zone would lead to the departure of other countries, which would see their currencies depreciate against the franc, especially the southern European countries. The net effect on competitiveness may prove ambiguous.

A Frexit would lead to currency movements, which would translate into a return of transaction costs on currency exchanges between euro zone countries. Moreover, the break-up of the euro zone would also lead to a redenomination of assets and debts in the national currency. Beyond the legal aspects, these balance sheet effects would impoverish agents who hold assets denominated in a depreciating currency or debts redenominated in an appreciating currency (and enrich those in the reverse situation). Uncertainties about balance sheet effects, particularly for financial intermediaries and banks, could be expected to lead to a period experiencing a sharp downturn in lending.

How much additional autonomy would be acquired for monetary policy is uncertain at present. Indeed, it is difficult to conceive of a monetary policy that is much more expansionary than the ECB's policy of negative rates and security redemptions [\[5\]](#). The Banque de France could, of course, buy back the national public debt by creating money, but, in light of the low current interest rates on French sovereign debt, it is not clear that this would lead to significant gains [\[6\]](#). It should be noted that a persistent current account deficit would need to be financed by external savings and that this external constraint could affect monetary policy, for example

by requiring an increase in short-term and long-term interest rates that could impose capital controls by the government.

Finally, the introduction of trade protectionism would obviously lead to retaliation by the aggrieved partners, which would hurt French exports. The overall net effect on world trade would be negative, with no gain at the national level.

## **II – The impact on exchange rates and competitiveness**

A Frexit would not lead to strong gains in competitiveness. We simulated the effect of a Frexit in the following way:

1. We assume that a Frexit would lead to a rapid disintegration of the euro zone;
1. We then use our estimates of long-run equilibrium exchange rates presented in Chapter 4 of the *2017 iAGS Report*. It appears that the equilibrium parity for the new franc would correspond to an actual effective devaluation of 3.6% compared to the current level of the euro. This is a real change, once it has been corrected for the effects of inflation and is effective, that is, taking into account exchange rate fluctuations in relation to different trading partners, possibly in the opposite direction. The new franc would be devalued relative to the German currency, but would appreciate relative to the Spanish currency;
2. Using the empirical estimates of exchange rate adjustments (Cavallo et al., 2005), we determine a short-term exchange rate trajectory. Our estimate is for a 13.7% depreciation of France's effective exchange rate with respect to the other euro zone countries, and an appreciation of 8.6% with respect to the countries that do not belong to the euro zone.

Using simulations with the emod.fr model, we estimate a modest increase in competitiveness. The effect on GDP would be close to 0 in the first year and 0.4% after three years. These

figures are low and refer to a scenario without any readjustment within the euro zone. If we consider the possibility of a gradual adjustment within the euro zone (based on the mechanisms, for example, referred to in *iAGS 2016*), the potential gain would be even lower. Once again it is possible to envisage that the monetary policy conducted by the Banque de France would seek to devalue the French currency more strongly than that of its competitors. But in such a scheme, it is very likely that the latter will in turn wish to preserve their competitiveness and engage in a policy of competitive devaluations.

### **III – The financial impact: The effects of the banking crises**

The dissolution of the euro zone and the return to national currencies would have significant repercussions for the national banking and financial systems through their international business, and it would bring about a return of exchange rate risk within the euro zone. We first assess the risks that the collapse of the euro zone would have for the banking system. The mechanisms at work are likely to provoke a banking crisis, which could have a high cost for economic activity.

The return to national currencies in a financially integrated space would necessarily entail a major upheaval for the financial system. These effects would not be comparable to those observed at the time the euro was adopted. Indeed, as [Villemot et Durand \(2017\)](#) have shown, potentially the balance sheet effects would be significant for a low coordination scenario.

The balance sheet effects could be reduced if there were international coordination when leaving the euro. Such co-ordination would make it possible to distribute the ECB's assets and liabilities in a coherent way, notably within the framework of TARGET 2. However, it's difficult to assume a significant level of coordination when leaving the eurozone,

and it is illusory to believe that the difficulties in achieving coordination will lessen. On the contrary, they are likely to increase in a climate of instability instead of one with a shared destiny. As a result, the scenario we use for leaving the euro zone excludes the establishment of a new financial or monetary architecture.

The risk of a banking or financial crisis is central to understanding the impact of the break-up of the euro zone. The impacts would pass through three main channels. The first involves a flight of deposits and savings and the distress liquidation of financial assets. The second is related to the effects of currency misalignments on banks' balance sheets and insurers. The third concerns the sovereign risk that would affect either the public debt and its financing, or if this debt were subject to uncontrolled monetization, the return of intense external pressure. The economic literature includes recent efforts (notably Rogoff and Reinhart, Borio, Schularik, the IMF) to try to evaluate banking or financial crises. It should be clarified at the outset that this literature does not deal with the dissolutions of monetary unions. In the various banking crises recorded since the 1970s by Laeven and Valencia (2010 and 2012), there is no mention of a crisis linked to the dissolution of a monetary union. Nevertheless, the financial dynamics in play in the event of the break-up of the euro zone would be, as mentioned above, risk factors for a banking or financial crisis.

Moreover, the economic literature on currency crises has pointed to the link with banking crises (Kaminsky and Reinhart, 1999). The collapse of a monetary union in reality reflects a crisis situation for the exchange rate system, which leads to revaluations and devaluations with the over-adjustment of exchange rates, as highlighted in the previous section. The reference to the cost of banking crises thus illustrates the potentially negative effects of exiting the euro zone. However, it should be remembered that these costs

correspond to an overall assessment of banking crises that does not make it possible to identify precisely the mechanisms through which the financial shock is propagated into the real economy – an assessment that would involve identifying the impact of rising risk premiums and the effect of credit rationing, where it is much more difficult to determine the uncertainty. An analysis by Bricongne et al. (2010) of the various channels through which the 2007-2008 financial crisis was transmitted suggests that a significant amount remains unexplained. Also, in the absence of a more detailed analysis, we make the assumption that the historical experiences of banking crisis are the main quantitative element that can be used to get close to the eventual negative impact – via the financial effects – of a break-up of the euro zone.

Laeven and Valencia (2012) analysed 147 banking crises in developed and emerging countries over the last few decades (1970-2011). They calculated the losses in production as the three-year cumulative loss of actual GDP relative to trend GDP [\[7\]](#). For the developed countries, the cumulative loss of growth was on average 33 GDP points. During these three crisis years, the public debt increased on average by 21 GDP points (partly due to bank recapitalizations), the central bank's balance sheet increased by 8 GDP points, and the level of non-performing loans increased by 4 percentage points. It should be noted that there was a high degree of heterogeneity in the cost of the crises, depending on the crisis and country in question. For example, the authors' assessment of the cost of the 2008 banking crisis in terms of growth following the bankruptcy of Lehman Brothers was 31 GDP points for the United States and 23 GDP points for the euro zone as a whole. Hoggarth, Reis and Saporta (2002) conducted a similar study and sought to provide robust assessments of trend GDP. They noted cumulative production losses during crisis periods ranging from 13 to 20 GDP points, depending on the indicator chosen. However, these estimates of the cost of banking crises are to be taken with caution, since they are based on numerous

assumptions, in particular on the trajectories that countries would have followed in the absence of a crisis.

#### **IV – The gains from monetary autonomy**

The gains from an alternative monetary policy would depend on the new direction taken by a monetary policy that remains to be defined and that will determine the conditions for financing the economy. Such a policy would probably be ultra-accommodative due to the financial and banking instability generated by the balance sheet effects.

Evaluations of the contribution of financial conditions in France from 2014 to 2018, however, suggest that these are not the most important factor explaining the sluggishness of economic activity. Over this period, the contribution of financial and monetary conditions to GDP growth is between -0.1 and 0.2 points [\[8\]](#). There is thus little gain to be expected from a new ultra-accommodative monetary policy (independently of the effects on exchange rates discussed in the first section or the impact of external pressure).

#### **Conclusion**

This text has attempted to outline the possible consequences of a Frexit, without going into too detailed and therefore perilous quantification.

1. Contrary to what is sometimes advanced, there is little to be expected in terms of competitiveness or manoeuvring room for short-term monetary policy;
2. The main cost would come from the banking or financial crisis arising from balance sheet effects, particularly given the context of a disorderly exit.

At this stage of the analysis, it is difficult to identify the potential positive economic effects of a Frexit, while the risks of a negative impact due to financial effects seem to be very significant.

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[\[1\]](#) These points are to a large extent discussed in *Capital Economics* (2012).

[\[2\]](#) It is difficult to develop a long-term counterfactual scenario in the case of exiting the euro. We therefore focus on the short- and medium-term effects of possible transitions.



[3] We implicitly eliminate the scenario of a currency war where each country would try to gain competitiveness by devaluations that would permanently lead us away from convergence towards a real equilibrium exchange rate.

[4] The introduction of tariffs like this calls for leaving the European Union. Without developing this analysis here, it is very likely that leaving the euro zone would lead to leaving the European Union. There have been assessments of the EU's contribution to intra-European trade and growth that we are not using here in our short-term approach.

[5] Through its quantitative easing program, the ECB essentially purchases sovereign debt bonds, including French debt securities. In February 2017, the outstanding securities held by the ECB under this programme ([PSPP](#)) amounted to € 1,457.6 billion. Breaking down the purchases based on the share of the ECB's capital subscribed by the central banks of the member states, the fraction of French debt securities exceeds 200 billion euros.

[6] Getting free from the constraints of the Stability and Growth Pact could be a gain in itself. This assumes that the constraints of the SGP go beyond simply the sustainability of the public debt demand.

[7] These evaluations show, however, that there is a high degree of heterogeneity in the assessed costs depending on the country in question.

[8] <https://www.ofce.sciences-po.fr/pdf/documents/prev/prev1016/france.pdf>

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# The European economy in 2017 – or, the post-Brexit EU

By [Jérôme Creel](#)

The just released [L'économie européenne 2017](#) provides a broad overview of the issues being posed today by the European Union project. Brexit, migration, imbalances, inequality, economic rules that are at once rigid and flexible... the EU remains an enigma. Today it gives the impression of having lost the thread of its own history or to even to be going against History, such as the recent international financial crisis or in earlier times the Great Depression.

A few months after the bankruptcy of Lehman Brothers, the G-20 Summit of the heads of State and Government held in London in April 2009 drew up a list of recommendations to revive the global economy. These included implementing active fiscal and monetary policies, supporting the banks and improving banking regulation, rejecting the temptation of protectionism, fighting against inequality and poverty, and promoting sustainable development.

These recommendations were in contrast to the policies implemented shortly after the Great Depression back in the 1930s. At that time, economic policies started with restrictive measures, thereby fueling the crisis and rising inequality. Protectionism in that epoch became not just a temptation but a reality: tariff and non-tariff barriers were erected in an effort to protect local business from international competition. We know what happened later: the rise of populism and extremism that plunged Europe, and then the world, into a terrible war. The economic lessons learned from the catastrophic management of the 1930s crisis thus contributed to the recommendations of the London G-20 Summit.

What now remains of these lessons in Europe? Little, ultimately, other than a resolutely expansionary monetary policy and the establishment of a banking union. The first is meant to alleviate the current crisis, while the second is intended to prevent a banking crisis in Europe. While this is of course not nothing, it is based on a single institution, the European Central Bank, and is far from sufficient to answer all the difficulties hitting Europe.

Brexit is one of these: as the first case of European disintegration, the departure of the United Kingdom poses the issue of the terms of its future partnership with the European Union (EU) and re-raises the question of protectionism between European states. The temptation to turn inwards is also evident in the way that the refugee crisis has been managed, which calls for the values of solidarity that have long characterized the EU. Differences between EU Member States in terms of inequality, competitiveness and the functioning of labour markets require differentiated and coordinated policies between the Member States rather than the all-too homogeneous policies adopted up to now, which fail to take an overall view.

This is particularly true of the policies aimed at reducing trade imbalances and those aimed at cutting public debts. By applying fiscal rules to manage the managing public finances, even if these are not perfectly respected, and by imposing quantitative criteria to deal with economic and social imbalances, we lose sight of the interdependencies between the Member States: fiscal austerity is also affecting our partners, as is the search for better price competitiveness. Is this useful and reasonable in a European Union that is soon to be the EU-27, which is seeing rising inequalities and struggling to find a way to promote long-term growth?

*L'économie européenne 2017* takes stock of the European Union in a period of severe tensions and great uncertainty, following a year of average growth and before the process of

separation between the EU and the UK really begins. During this period, several key elections in Europe will also serve as stress tests for the EU: less, more or better Europe – it will be necessary to choose.

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## Balance sheets effects of a euro break-up

By Cédric Durand (Université Paris 13), and [Sébastien Villemot](#)

When it was introduced at the turn of the millennium, the euro was widely perceived as a major achievement for Europe. The apparent economic successes, coupled with cross-country convergence of several economic indicators, fueled this sentiment of success. A couple of years later, the picture looks dramatically different. The world financial crisis has revealed imbalances that have led to the sovereign debt crisis and brought the euro area on the verge of dislocation. The austerity policies that became the norm on the continent in 2011 fueled a protracted stagnation<sup>[1]</sup>, with growth rates that look bleak in comparison to the United States and the United Kingdom.

This economic underperformance has fueled popular resentment against the euro, now seen by a growing number of European people as the problem rather than the solution. The financial community itself seems to be prepared to the possibility of an exit or a dissolution of the single currency by cutting back on cross-border positions. Greece was on the verge to leave in 2015. And the intellectual mood is also shifting: leading thinkers, such as US economist Joseph Stiglitz, or German

Sociologist Wolfgang Streeck are among the most visible figures of a wider change of attitude.

A country exiting the euro, or even the dissolution of the single currency, has therefore become a concrete possibility. Such an event would obviously have a major impact in several dimensions. On the economic side, the most obvious consequence would be the changing conditions in products markets due to the new exchange rates; uncertainty would prevail in the short run, but in the longer run the possibility of adjusting nominal parities would help with the unfolding of current account imbalances.

There however exists another impact, less discussed, but potentially more disruptive: the changes in the balance sheet position of economic actors, resulting from the currency redenomination process. This process could introduce significant currency mismatches between the asset and liability sides. Assessing the unfolding of these balance sheet effects is crucial, because they could affect financial relations, investment and trade, have unexpected redistributive effects and, if not adequately managed, lead to productive disruption.

The concrete questions that we ask are the following. If a country exits the euro and depreciates its new national currency, what will be the consequences for domestic economic agents which have liabilities denominated in euros: will they be able to repay in the new national currency? and if not, will they be able to avoid bankruptcy despite the increase of their debt burden? Conversely, what are the consequences for exiting countries whose new currency appreciates and who have accumulated foreign assets?

In a [recent research paper](#), we propose such an assessment of the redenomination risk in the euro area, by country and by main institutional sector, for two scenarios: a single country exit and a complete break-up.

Our analysis relies on the concept of “relevant” liabilities and assets: those are the balance sheet items that will not be redenominated into the new currency after the exit, because of legal or economic reasons. In practice, the most important factor for determining which debt or assets are “relevant” is their governing law: if a financial contract is governed by domestic law, the chances are high that the government of the exiting country will be able to redenominate it into the new currency, by simply passing a law in parliament. Conversely, contracts under foreign law (typically English or New York law) will remain in euros—or be redenominated in some other foreign currency if the euro disappears. In the first case, the lender bears the economic loss; in the second case, the risk is borne by the borrower whose debt burden is increased, unless she decides to default and therefore to impose losses on the lender.

Focusing on the liability side, Table 1 presents our estimates for the relevant debt, by country and institutional sector. It therefore gives an estimate of the exposure of the various sectors and countries to a euro-exit followed by a depreciation. Since the first months after a euro exit will be the most critical, potentially with an exchange rate overshooting, the short-term component of the relevant debt is also reported.

**Table 1. Relevant debt by sector (% of GDP, Q3 2015)**

In %						
	Greece	Italy	Portugal	Spain	Ireland	France
General government	142	8	57	12	35	2
<i>incl. short term</i>	3	1	1	0	2	0
Financial corporations	42	30	18	43	395	42
<i>incl. short term</i>	29	4	2	8	98	8
Non-financial corps. + households	13	18	20	15	312	33
<i>incl. short term</i>	5	8	8	4	53	17
	Germany	Netherlands	Austria	Luxembourg	Belgium	Finland
General government	6	5	35	7	10	17
<i>incl. short term</i>	2	2	4	0	2	6
Financial corporations	28	225	35	876	22	59
<i>incl. short term</i>	9	36	8	135	1	17
Non-financial corps. + households	20	66	23	910	23	20
<i>incl. short term</i>	5	18	6	385	13	4

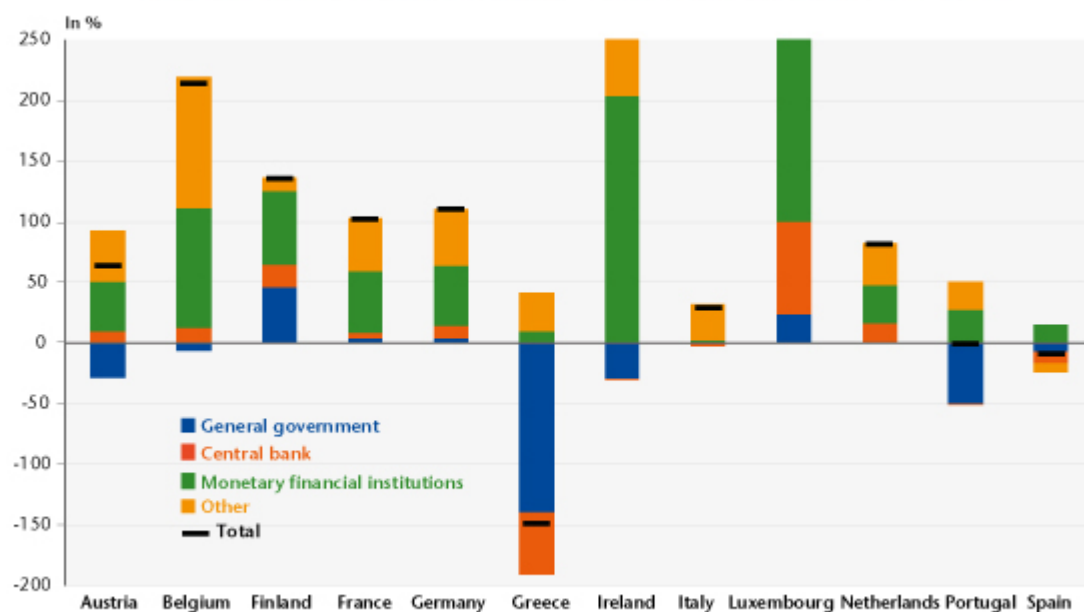
Sources : BIS, World Bank QEDS, authors' computations.

On the side of public debt, the countries most at risk are Greece and Portugal, since they have large external loans that will have to be reimbursed in euros. Conversely, France or Italy are quite safe on their public debt, because almost all of it is under domestic law and can therefore be easily redenominated into Francs or Lira. The financial sector is more exposed, especially in countries acting as financial intermediaries like Luxembourg, the Netherlands or Ireland. The exposure of the non-financial private sector looks much more limited (and due to data limitations, the figures are overestimated in countries with a highly developed non-banking financial system).

However, relevant liabilities are not the whole story. Relevant assets also matter: for countries which are expected to depreciate (typically southern countries including France), those help mitigating the debt problem, since assets in foreign currency will become more valuable in the domestic currency; conversely, in the case of a currency appreciation (typically northern countries), it is from the asset side that difficulties can arise.

The figure shows our estimates for relevant net positions, *i.e.* for the difference between relevant liabilities and assets. A positive number means that a depreciation will improve the balance sheet, while an appreciation will deteriorate it.

Figure. Relevant net position (% of GDP, excl. fin. derivatives, Q3 2015)



Sources: Eurostat, IMF, BIS, World Bank, Banca d'Italia, Bank of Finland, authors' computations.

The striking fact is that, for most countries and sectors, the relevant net position is positive. This means that northern countries can make a significant loss on their foreign assets if they leave. Conversely, for southern countries and France, there is no aggregate balance sheet risk for the private sector (except for Spain), and even no risk for the public sector in some cases. This does not mean that there is no problem because, at the micro level, the holders of the relevant assets may not be the same as those of the relevant liabilities, but at least there is room for maneuver.

In order to give a broader picture that takes into account the fact that assets can mitigate liabilities problem—but only to some extent—and that short-term debt is the most critical issue, we have constructed a composite risk index that synthesizes all these dimensions, as shown in Table 2. In particular, this indicator was constructed using estimates for the expected exchange rate movements after the exit from the euro.



**Table 2. Composite risk index (Q3 2015)**

	General government + central bank	Financial corporations	Non-financial corps. + households
Austria	0	1	1
Belgium	1	0	1
Finland	0	2	1
France	0	0	1
Germany	0	1	1
Greece	3	3	1
Ireland	1	3	2
Italy	0	0	0
Luxembourg	1	3	3
Netherlands	0	0	1
Portugal	2	1	1
Spain	1	1	1

*Légend:*

0 = No risk	2 = Medium risk
1 = Low risk	3 = High risk

*Source:* authors' computations.

Though this exercise necessarily entails some arbitrary thresholds, it helps identifying a few specific vulnerabilities: the public debts of Greece and Portugal, for which a substantial restructuring or even a default would be the likely outcome; the financial sectors of Greece, Ireland, Luxembourg, and potentially Finland, which would have to undergo a deep restructuring; and potentially the non-financial sector of Ireland and Luxembourg, though that latter result may be an artifact caused by our data limitations.

The broad conclusion that can be drawn from our analysis is that, even though the problem of balance sheets is real and should be taken seriously, its overall order of magnitude is not as large as some claim. In particular, in the non-financial private sector, the issue should be manageable provided that proper policy measures are implemented, and disruptions should in that case be limited.

Assessing the costs of a euro exit obviously matters for properly dealing *ex post* with the event, if it were to materialize because of some unexpected political or economic shock. But this assessment is also interesting from an *ex ante*

perspective, especially for a country which is considering whether to leave or to stay. In this respect, our analysis leads to a somewhat unexpected conclusion: the costs are probably not so high for some deficit countries (Italy, Spain), while they are higher than usually thought for surplus countries who could suffer capital losses through depreciations or defaults. The awareness of this fact should give a stronger bargaining power to southern countries in their negotiations with northern countries concerning the future of the Eurozone.

[1] See the [independent Annual Growth Survey \(iAGS\) reports](#).

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## Matteo Renzi's Jobs Act: A very guarded optimism

By Céline Antonin

At a time when the subject of labour market reform has aroused passionate debate in France, Italy is drawing some initial lessons from the reform it introduced a year ago. It should be noted that the labour market reform, dubbed the Jobs Act, had been one of Matteo Renzi's campaign promises. The Italian labour market has indeed been suffering from chronic weaknesses, including segmentation, a duality between employees with and without social protection, high youth unemployment, and a mismatch between costs and labour productivity. Renzi's reform takes a social-liberal approach, advocating flexicurity, with the introduction of a new permanent employment contract with graduated protection, lower social charges on companies, and better compensation and

support for the unemployed. Although the initial assessment is surely positive in terms of both unemployment and job creation, there's no cause for hasty triumphalism: the reform has been implemented in especially favourable circumstances, marked by a return of growth, an accommodative policy mix, and a stagnating work force.

### ***Jobs Act Italian-style: The key points***

The Jobs Act is actually the latest in a series of measures adopted since the Fornero Act of 2012 that are aimed at a more flexible labour market. Act I of the Jobs Act, the Poletti Decree (DL 34/2014), was adopted on 12 May 2014, but went relatively unnoticed because it targeted fixed-term contracts and apprenticeships. It allowed in particular extending the duration of fixed-term contracts from 12 to 36 months, suppressing gap periods, and allowing for more fixed-term contracts to be renewed, all while limiting the proportion of fixed-term contracts within a single company[\[1\]](#).

The real change came with Act II of the Jobs Act, for which the Italian Senate passed enabling legislation on 10 December 2014. The eight implementing decrees adopted in the first half 2015 have four key points:

- The elimination of Article 18 of the Labour Code, which allowed reinstatement in cases of manifestly unfair dismissal: the reinstatement requirement was replaced by a requirement for indemnification that is capped[\[2\]](#), with reinstatement still being required in case of a dismissal involving discrimination;
- The creation of a new form of permanent (open-ended) contract and graduated protection, lying between permanent contracts and fixed-term contracts: dismissal was facilitated during the first three years on the job, with severance pay that increases with employee seniority;
- The suppression of the abuse of what are called

“collaboration contracts”, [\[3\]](#) precarious contracts that are often used to disguise an actual employment relationship, affecting about 200,000 people. These contracts will be transformed into wage labour contracts from 1 January 2016 (1 January 2017 for public administrations), except for a few limited cases;

– The reform of unemployment insurance, with an extension of compensation schemes. The benefit period, for instance, is extended to two years (from 12 months previously). As for compensation for short-time working (“technical unemployment”), this is extended to cover apprentices and companies with 5-15 employees [\[4\]](#). A National Employment Agency (ANPAL), which introduces a one-stop system that helps to link training and employment, was also established.

Note that only measures related to experimentation with a national minimum wage [\[5\]](#), which are contained in the enabling law in December 2014, were not addressed.

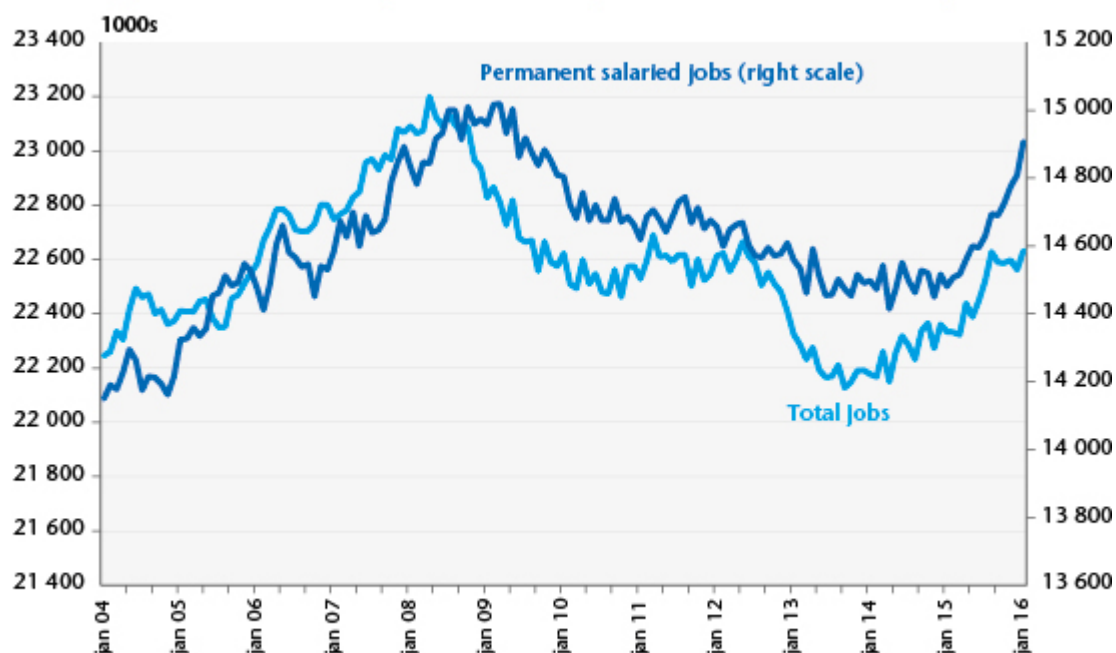
Alongside the Jobs Act, Italy opted to lower taxes on labour: in 2015, the wage part of the IRAP (equivalent to a business tax) for those employed on permanent contracts was eliminated, reducing the amount of the IRAP by about one-third. Above all, Italy’s 2015 Budget Act eliminates social security contributions for 3 years on the new open-ended contracts with graduated protection, up to a limit of 8,060 euros per year for new hires taken on between January 1 and December 31, 2015 who did not have permanent job contracts in the six months preceding their hiring. This measure is expected to cost 3.5 billion euros between now and 2018. It was extended in 2016: companies that hire employees on the new permanent contracts in 2016 will be exempt from 40% of social security contributions for 2 years.

### **Strong jobs growth and a lower unemployment rate**

There has been strong growth in employment, in particular

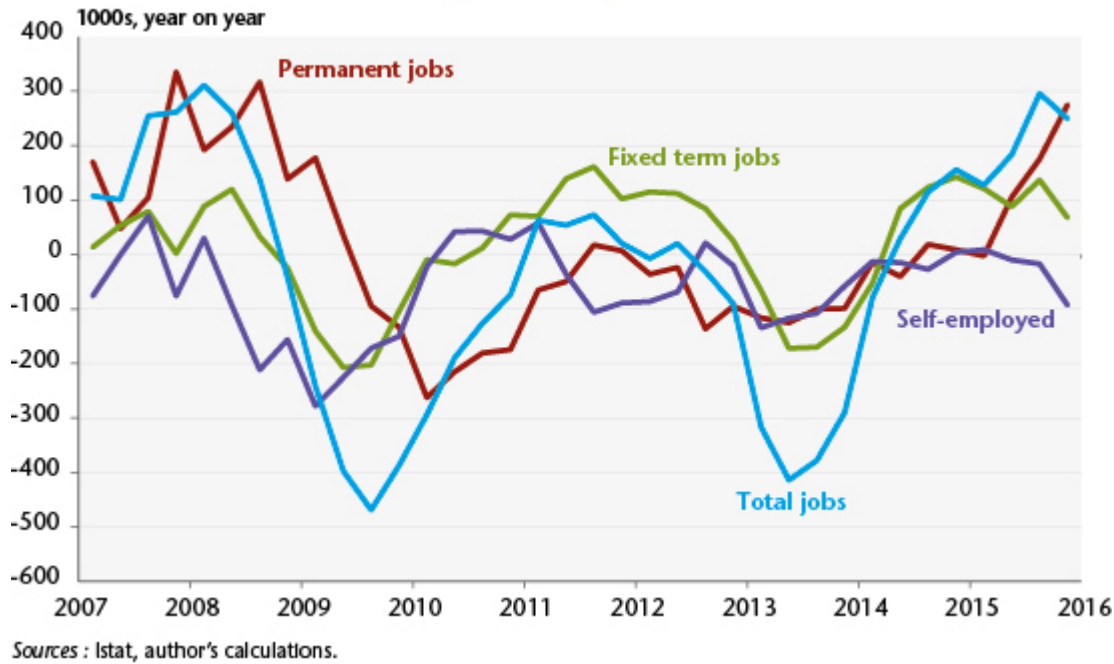
permanent jobs, since the start of 2015: between January 2015 and January 2016, the number of employed increased by 229,000, with strong growth in the number of salaried employees (+377,000) and a decline in the number of self-employed (-148,000). Among employees, there was a sharp increase in the number of permanent positions (+328,000). The number of permanent employees has now returned to the 2009 level of 22.6 million (Figure 1); as for total employment, even if it has not yet reached its pre-crisis level, the decline in the 2012-2014 period has been overcome. At the same time, the annual rate of job creation has returned to its pre-crisis level, with growth of about 250,000 per year (Figure 2).

**Figure 1. Number of jobs (total and permanent), 2004-January 2016**



Sources : Istat, author's calculations.

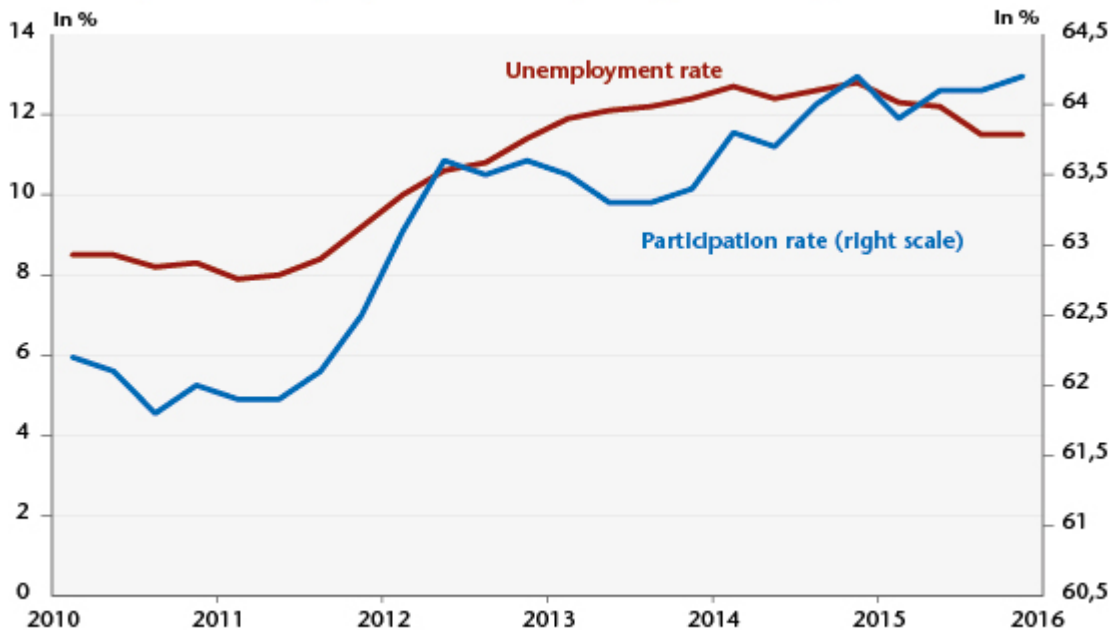
**Figure 2. Annual change in number of jobs by contract type,  
Q1 2007 – Q4 2015**



In addition to new hires on permanent contracts, the Jobs Act has led to replacing precarious jobs with permanent jobs with increasing guarantees. Thus, 5.4 million new jobs were created in 2015 (+11% compared to 2014) [\[6\]](#), mainly permanent jobs. Of the 2.4 million permanent jobs created, there were 1.9 million new open-ended contracts and 500,000 fixed-term contracts that were converted into open-ended contracts (including 85,000 apprenticeship contracts), up sharply from 2014. There were also fewer collaboration contracts (a 45% decrease from Q3 2014 to Q3 2015) and apprenticeship contracts (-24.6%). Note also the 4.3% increase in the number of resignations and the 6.9% decrease in layoffs.

**The corollary to this jobs growth is a marked fall in the unemployment rate** (Figure 3), which fell to 11.4% in the last quarter of 2015 (from 12.8% one year earlier). However, the decline in unemployment was also due to stagnation in the labour force in 2015, unlike previous years that were marked by the pension reform.

**Figure 3. Unemployment rate and participation rates, 2010-2015**



Sources : Istat, author's calculations.

## Uncertainties remain

Matteo Renzi seems to have won his bet. Yet this fall in unemployment should not be over-interpreted, as a number of positive factors have undoubtedly contributed to strengthening this trend.

First, there was a windfall effect related to the announcement of the exemptions on social contributions for hiring new permanent employees, which led some companies to put off new hiring planned for 2014 until 2015 (which led to a rise in unemployment in late 2014). Moreover, part of the fall in unemployment is related to the impact of replacing precarious short-term contracts with the new permanent contracts with graduated protection (see above). The question is whether the new flexibilities allowed by these new contracts will be used over the next three years, and consequently whether there will be an increase in contract terminations.

In addition, the stagnation of the work force (Figure 3) has significantly amplified the downward trend in unemployment. With the improvement observed in the labour market, we expect in the future that the growth in the workforce that began in



the last quarter of 2015 will continue due to what is called in French an “effet de flexion”, or “bending effect”, [\[7\]](#) which would absorb some of the impact of the job creation in 2016 and 2017.

Furthermore, the Jobs Act was adopted when the economy was emerging from a recession, with a recovery that, while soft (+0.6% growth in 2015), still exceeded the growth potential [\[8\]](#). The easing of fiscal constraints had a stimulus effect in 2015, which may partially explain the fall in unemployment. As for monetary conditions, they are particularly favourable, as Italy is one of the main beneficiaries of the quantitative easing measures taken by the ECB.

Notwithstanding these qualifications, it is undeniable that the cut in the social contributions level has had a positive impact. The February 2016 report of the National Social Security Institute (INPS) showed that, of the 2.4 million new permanent jobs created in 2015, 1.4 million benefited from exemptions on employer contributions, or almost two-thirds of these new jobs. Moreover, the reduction of precarious job contracts and their replacement by permanent contracts, even if they offer less protection than before, is a rather encouraging sign for access to long-term employment by groups that have traditionally been more marginal (self-employed, collaboration contracts).

Perhaps the main regret about this reform is the absence of a component aimed explicitly at vocational training, which is one of the main weaknesses of Italy's labour market. The country holds a dismal EU record for the number of young people (15-24) who are neither in employment nor in school or training. Moreover, the workforce has insufficient training, and investment in research and development is low, which results in low productivity. It is legitimate to want to take action on labour costs and the duality of the labour market, but this will not be enough to solve the problem of productivity and the inadequacy of the workforce. Matteo Renzi



would therefore do well to foresee an Act III in his labour reforms to finally pull the country out of its stagnation.

[1] See [C. Antonin, Réforme du marché du travail en Italie : Matteo Renzi au pied du mur](#), [Labour market reform in Italy: Matteo Renzi with his back to the wall], *Note de l'OFCE* no. 48.

[2] The monetary payment is determined by a scale based on the employee's seniority. It is equivalent to two months of the final salary per year of service, for a total that cannot be less than 4 months of salary and is capped at 24 months.

[3] "Intermediate status between salaried employment and self-employment, for workers not subject to a hierarchical subordination but 'coordinated' with the company and creator of certain social rights. These are self-employed workers who are, in fact, dependent on a single client company (which exercises limited management powers, for example in terms of the organization of work and the working time)." [E. Prouet, Contrat de travail, les réformes italiennes](#) [The job contract, the Italian reforms], France Stratégie, *La Note d'Analyse*, no. 30, May 2015.

[4] Other measures concerning short-time work ("chomage technique") are also planned, including that an employee on short-time work may not have their hours cut by more than 80% of their total work hours. Furthermore, the period during which a company may resort to this procedure is a maximum of 24 months over five rolling years.

[5] There is no national minimum wage in Italy, with minimum wages instead set at the industry level, as was the case in Germany before 2015.

[6] This figure of 5.4 million represents gross job creation, including all forms of employment (including very short-term

contracts), and without taking into account job destruction. In terms of net job creation between January 2015 and January 2016, we accept the figure of 229,000.

[7] When unemployment rises, working-age people are discouraged from reporting for the labour market. Conversely, when employment picks up again, some people are encouraged to return to the labour market, slowing the decline in unemployment; this phenomenon is called the “effet de flexion” in French, or the bending effect.

[8] Labour productivity tends to grow relatively slowly in Italy; consequently, an increase in production tends to create more jobs in Italy than in France for example, where labour productivity is higher.

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# **A new EU arrangement for the United Kingdom: European lessons from the February 19th agreement**

By [Catherine Mathieu](#) and [Henri Sterdyniak](#)

Following the demand made by David Cameron on 10 November 2015 for a new arrangement for the United Kingdom in the European Union, the European Council came to an agreement at its meeting of 18 and 19 February. On the basis of this text, the British people will be called to the polls on 23 June to decide whether to stay in the EU. This episode raises a number

of questions about the functioning of the EU.

– The United Kingdom has challenged European policy on matters that it deems crucial for itself and largely got what it wanted. Its firmness paid off. This has given rise to regrets on this side of the Channel. Why didn't France (and Italy) adopt a similar attitude in 2012, for instance, when Europe imposed the signing of the fiscal treaty and the implementation of austerity policies? This is a cause for concern: will what has been accepted for a big country be tolerated for a smaller one? The UK's threat to leave is credible because the EU has become very unpopular among the population (especially in England), and because the UK is independent financially (it borrows easily on the capital markets) and economically (it is a net contributor to the EU budget). A country that is more dependent on Europe would have little choice. This raises worries: won't we see other countries follow suit in the future? Will Europe be able to avoid becoming a Europe à la carte (each country taking part in the activities that interest it)? But is a model based on forced participation preferable? Europe must allow a country to abstain from policies that it deems harmful.

– The United Kingdom will therefore organize a referendum, which is satisfactory from a democratic perspective. The most recent referendums have hardly yielded favourable results for European construction (France and the Netherlands in 2005, Greece in July 2015, Denmark in December 2015). The British will be limited to choosing between leaving the EU (the February agreement clearly rejects the possibility of new renegotiations if the referendum results in a majority in favour of an EU exit) or staying with a reduced status; the possibility of the UK remaining in the EU and seeking to strengthen its social dimensions, as advocated by some of the Labour Party and the Scottish Nationalists, will not be offered. Too bad.

– The United Kingdom is explicitly exempted from the need to

deepen the EMU or from an “ever closer union” or “deeper integration”, all formulas contained in the treaties. The proposed arrangement clarifies that these notions are not a legal basis to extend the competences of the EU. States that are not members of the euro zone retain the right to take part or not in further integration. This clarification is, in our opinion, welcome. It would not be legitimate for the Union’s powers to be extended continuously without the consent of the people. In the recent period, the five presidents and the EU Commission have proposed new steps towards European federalism: creating a European Fiscal Committee; establishing independent Competitiveness Councils; conditioning the granting of Structural Funds on fiscal discipline; implementing structural reforms; creating a European Treasury department; moving towards a financial union; and partially unifying the unemployment insurance systems. These moves would strengthen the technocratic bodies to the detriment of democratically elected governments. Wouldn’t it be necessary to explicitly request and obtain the agreement of the peoples before embarking on such a path?

– The exit of the United Kingdom, a certain distancing by some Central and Eastern Europe countries (Poland, Hungary), plus the reluctance of Denmark and Sweden could push towards an explicit move to a two-tier Union, or even, to take David Cameron’s formulation, to an EU in which countries are heading to different destinations. The countries of the euro zone would for their part accept new transfers of sovereignty and would build a stronger fiscal and political union. In our opinion this proposal should be submitted to the people.

– At the same time, the draft agreement provides that the Eurogroup has no legislative power, which remains in the hands of the Council as a whole. The UK has had it clarified that a non-member state of the euro zone could ask the European Council to take up a decision on the euro zone or the banking union that it believes harms its interests. The principle of

the euro zone's autonomy has thus not been proclaimed.

- The United Kingdom has had it clarified that it is not required to contribute financially to bail out the euro zone or the financial institutions of the banking union. This may be considered discomforting vis-à-vis the European principle of solidarity, but it is understandable. This is because the establishment of the euro zone has abolished the principle: "Every sovereign country is fully backed by a central bank, a lender of last resort", which is posed by the bailout problem. The UK (and its banks) are backed by the Bank of England.
- The United Kingdom has had the principles of subsidiarity reviewed. A new provision states that parliaments representing 55% of the Member States may challenge a law that does not respect this principle. The UK has had it noted that the issues of justice, security, and liberty remain under national competence. It is a pity that countries devoted to their specific social systems and their wage bargaining systems have not done the same.
- It is understandable that countries concerned about national sovereignty are annoyed (if not more) by the EU's relentless intrusions into areas under national jurisdiction, where Europe's intervention does not bring added value. It is understandable that these countries are refusing to have to incessantly justify to Brussels their economic policies or their economic, social or legal regulations when these have no impact on other Member States. Europe must undoubtedly take these feelings of exasperation into account.
- As regards the banking union, the draft text is deliberately confusing. It is recalled that the "single rule book" managed by the European Banking Agency (EBA) applies to all banks in the EU, and that financial stability and equal competitive conditions must be guaranteed. But at the same time, it says that Member States that do not participate in the banking union retain responsibility for their banking systems and can

apply special provisions. Moreover, countries that are not members of the euro zone have a right of veto on the EBA. This raises the question of the very content of the banking union. Will it make it possible to take the measures needed to reduce the scale of speculative financial activity in Europe and steer the banks towards financing the real economy? Or is the objective to liberalize the markets for the development of financial activity in Europe so as to compete with London and non-European financial centres? In the first case, what was needed was to clearly take in hand the market in London, telling it that membership in the EU requires close monitoring of financial activities. And that its departure would allow the EU to take capital control measures to limit speculative activities and encourage banks in the euro zone to repatriate their activities.

– Likewise, Belgium, Luxembourg, the Netherlands and Ireland would have needed to be told that EU membership means the end of tax avoidance schemes for the multinationals.

– The United Kingdom has had a declaration passed affirming the need both to improve regulations and repeal unnecessary provisions to improve competitiveness while at the same time maintaining high standards of protection for consumers, labour, health and the environment. This compatibility undoubtedly amounts to wishful thinking.

– The text recognizes that the disparity in wage levels and social protection in European countries is hardly compatible with the principle of the free movement of persons in Europe. This has long been an unspoken part of European construction. The United Kingdom, which was one of the only countries not to take interim measures to restrict the entry of foreign workers at the time of the accession of central and eastern European countries in 2004, is now demanding that such measures be provided for in any future accessions. The draft agreement states that a European person's stay in a country other than his or her own is not the responsibility of the host country,

meaning that the person either must have sufficient resources or must work.

– The question of the right to family benefits when children are not living in the same country as their parents is a tangled web. In most countries, family benefits are universal (not dependent on parental contributions). Both principles cannot be met at the same time: that all children living in a country are entitled to the same benefit; and that everyone working in a given country is entitled to the same benefits. The United Kingdom has won the right to be able to reduce these allowances based on the standard of living and family benefits in the child's country of residence. But fortunately this right cannot be extended to pension benefits.

– Most European countries currently have mechanisms to promote the employment of unskilled workers. Thanks to exemptions on social contribution, to tax credits and to specific benefits (like in-work credits or housing benefits in France), the income that they receive is largely disconnected from their wage costs. The British example shows that these programmes can become problematic in case of the free movement of workers. How does a country encourage its own citizens to work without attracting too many foreign workers? Here is another of the unspoken issues of open borders. It is paradoxical that it is the United Kingdom that is raising the question, while it is near full employment and is claiming that the flexibility of its labour market allows it to easily take in foreign workers. In any case, the UK was granted that a country facing an exceptional influx of workers from other EU Member States can obtain the right from the Council, for seven years, to grant non-contributory aid to new workers from other member countries in a graduated process over a period of up to four years from the start of their employment. The UK has also had it clarified that it can use this right immediately. This is a challenge to European citizenship, but this concept had already been chipped away for the inactive and unemployed.

The European Union, as currently constructed, poses many problems. The Member States have divergent interests and views. Because of differences in their national situations (the single monetary policy, freedom of movement of capital and people), many arrangements are problematic. Rules without an economic foundation have been introduced into fiscal policy. In many countries, the ruling classes, the political leaders, and the top officials have chosen to minimize these problems so as not to upset European construction. Crucial issues concerning the harmonization of taxes, social conditions, wages and regulations have been deliberately forgotten.

The UK has always chosen to keep its distance from European integration, safeguarding its sovereignty. Today it is putting its finger on sensitive points. To rejoice at its departure would be irrelevant. To use this to move mindlessly towards an “ever closer union” would be dangerous. Europe should seize this crisis to acknowledge that it has to live with a contradiction: national sovereignty must be respected as much as possible; Europe has no meaning in and of itself, but only if it implements a project that supports a specific model of society, adapting it to integrate the ecological transition, to eradicate poverty and mass unemployment, and to solve European imbalances in a concerted and united manner. If the agreement negotiated by the British could contribute to this, it would be a good thing – but will Europe’s countries have the courage to do so?

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## **Why can't Greece get out of**

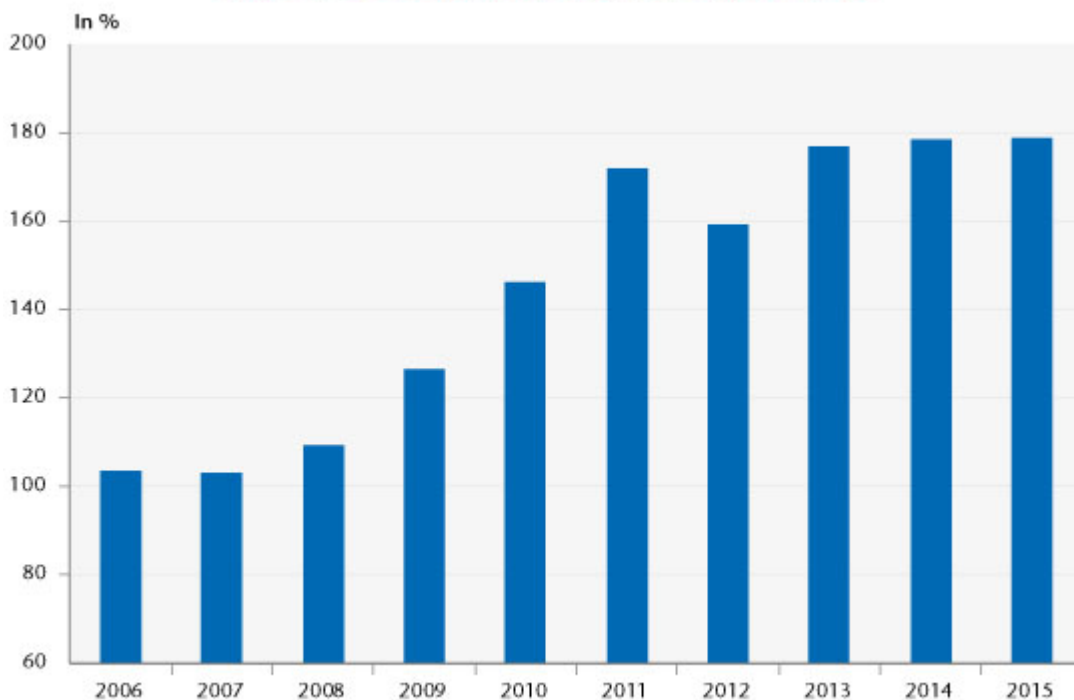


# debt?

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.

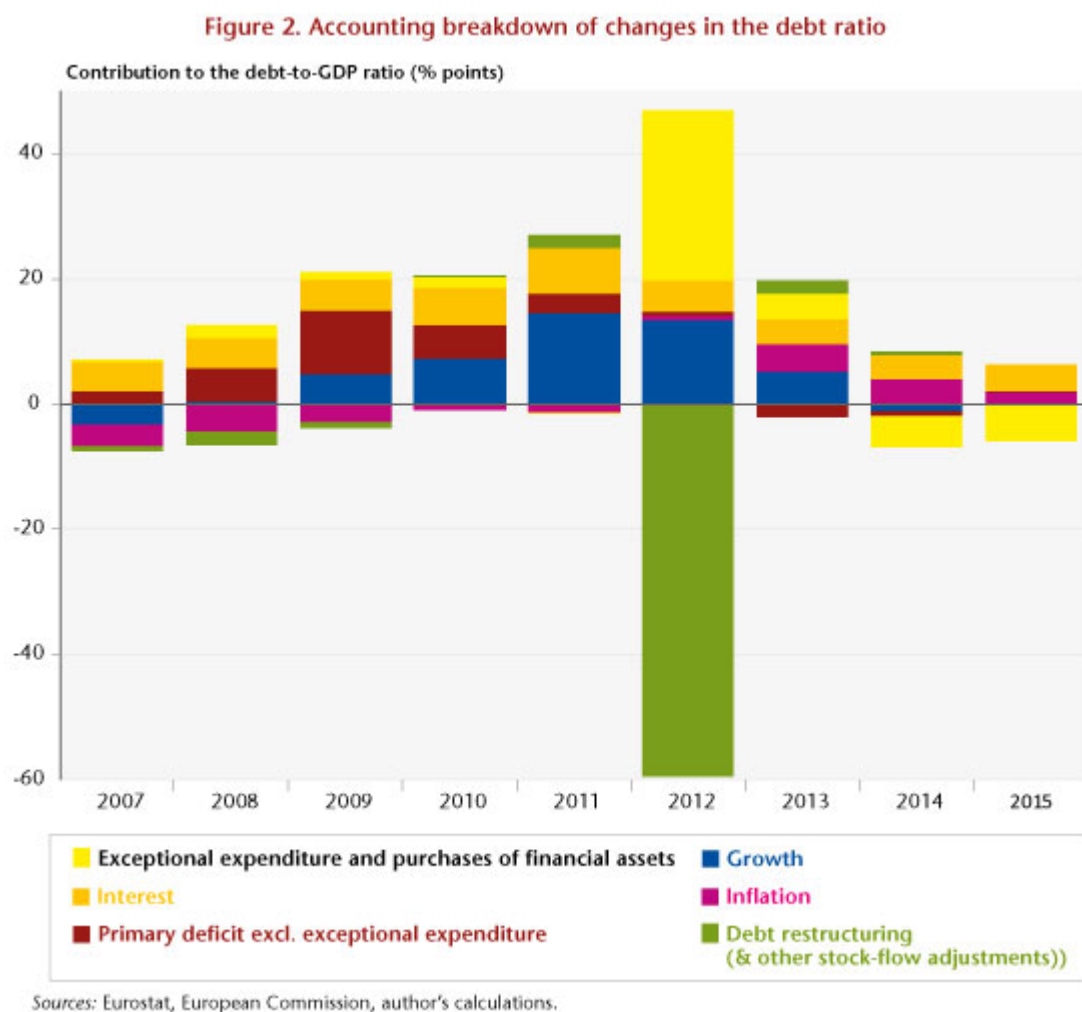
**Figure 1. Greece's public debt as % of GDP, 2006-2015**



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.



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
<b>Total</b>	<b>75.4</b>	<b>52.4</b>

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.

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# Is missing disinflation a uniquely American phenomenon?

By [Paul Hubert](#), Mathilde Le Moigne

Are the dynamics of inflation after the 2007-2009 crisis atypical? According to Paul Krugman, “If inflation had responded to the Great Recession and aftermath the way it did in previous big slumps, we would be deep in [deflation](#) by now; we aren’t.” In fact, after 2009, inflation in the US has remained surprisingly stable in terms of changes in real activity. This phenomenon has been called “missing disinflation”. Can a phenomenon like this be seen in the euro zone?

Despite the worst recession since the 1929 crisis, the inflation rate has remained stable at around 1.5% on average between 2008 and 2011 in the US 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 argued instead that the [Phillips curve](#), in its simplest original version, is still a valid instrument for understanding the relationship between inflation and unemployment, in spite of this “missing disinflation”.

Blanchard nevertheless noted that the relationship between the two variables has weakened, because inflation increasingly depends on inflation expectations, which are themselves anchored to the inflation target of the US Fed. In an [article](#) in 2015, Coibion and Gorodnichenko explained this missing disinflation in the US by the fact that inflation expectations are influenced by variations in the most visible prices, such as fluctuations in the price of oil. Furthermore, since 2015 inflation expectations have declined concomitantly with oil prices.

The difficulty of accounting for recent trends in inflation through the Phillips curve led us to evaluate its potential determinants in a [recent working paper](#) and to consider whether this “missing disinflation” phenomenon was also present in the euro zone. Based on a standard Phillips curve, we did not come up with the results of Coibion and Gorodnichenko when the euro zone was considered in its entirety. In other words, real activity and inflation expectations do describe changes in inflation.

However, this result appears to come from an aggregation bias between the behaviours of national inflation within the euro zone. In particular, we found a significant divergence between the countries of Northern Europe (Germany, France), which demonstrate a general tendency towards *missing inflation*, and countries on the periphery (Spain, Italy, Greece), which exhibit periods of *missing disinflation*. This divergence nevertheless appears right from the start of our sample, that is to say, in the early years of the creation of the euro zone, and seems to reverse around 2006, without any significant change during the crisis of 2008-2009.

Unlike what happened in the US, it appears that the euro zone has not experienced missing disinflation as a result of the economic and financial crisis of 2008-2009. It seems instead that divergences in inflation in Europe preceded the crisis, and tended to subside with the crisis.

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## An ever so fragile recovery

By the Department of Analysis and Forecasting, under the direction of [Eric Heyer](#) and [Xavier Timbeau](#)



This text summarizes the OFCE's [economic forecast for 2015-2017](#) for the euro zone and the rest of the world.

The figures for euro zone growth in the first half of 2015 have confirmed the upswing glimpsed at the end of 2014. While the zone's return to growth might once have been taken to indicate the end of the global economic and financial crisis that struck in 2008, the turbulence hitting the emerging countries, particularly over the summer in China, is a reminder that the crisis ultimately seems to be continuing. China's economic weight and its role in world trade are now so substantial that, even in the case of a soft landing, the impact on growth in the developed countries would be significant. We nevertheless anticipate that the scenario for a recovery need not be called into question, and that euro zone growth will be broadly supported by favourable factors (lower oil prices and ECB monetary support) and by some weakening of unfavourable factors (easing of fiscal policies). But the fact remains that the situation in the developing world will add new uncertainty to an already fragile recovery.

Between 2012 and 2014, the euro zone economies stagnated at the very time that the United States turned in average GDP growth of 2%. The recovery that got underway after the sharp contraction in 2008-2009 was quickly cut short in the euro zone by the sovereign debt crisis, which led almost immediately to the uncontrolled tightening of financial conditions and the reinforcement of the fiscal consolidation being implemented in the Member States, as they searched for market credibility.

The euro zone then plunged into a new recession. In 2015, these economic policy shocks are no longer weighing on demand. The ECB helped to reduce sovereign debt risk premiums by announcing the Outright Monetary Transaction programme (OMT) in September 2012 and then by implementing quantitative easing so as to improve financial conditions and promote a fall in the euro. In terms of fiscal policy, while in some countries

the consolidation phase is far from over, the measures being taken are smaller in scale and frequency. Furthermore, growth will also be helped by the fall in oil prices, which should last, and the resulting gains in household purchasing power should in turn fuel private consumption. These factors thus reflect an environment that is much more favourable and propitious for growth.

However, it is clear that this scenario depends on some volatile elements, such as the fall in oil prices and the weaker euro. The Chinese slowdown adds another element of risk to the scenario, which is based on the assumption that China will make a smooth transition from an export-oriented growth model to one driven by domestic demand. We expect the euro zone to grow at a rate of 1.5% in 2015 and 1.8% in 2016 and 2017. The main short-term risks to this scenario are negative. If oil prices go up and the euro doesn't stay down, and if the slowdown in the emerging countries turns into an economic and financial crisis, then growth worldwide and in the euro zone will be significantly lower. This risk is particularly critical given the very high level of unemployment still plaguing the zone (11% in August 2015). Nevertheless, given the pace of anticipated growth, we expect the unemployment rate to fall in 2016-2017 by around 0.6 percentage point per year. At this pace, it will take almost seven years to bring the rate back to its pre-crisis level. So while the prospects for recovery from the 2008 crisis are uncertain, the social crisis undoubtedly has a long time to run.