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

By Mathieu Plane

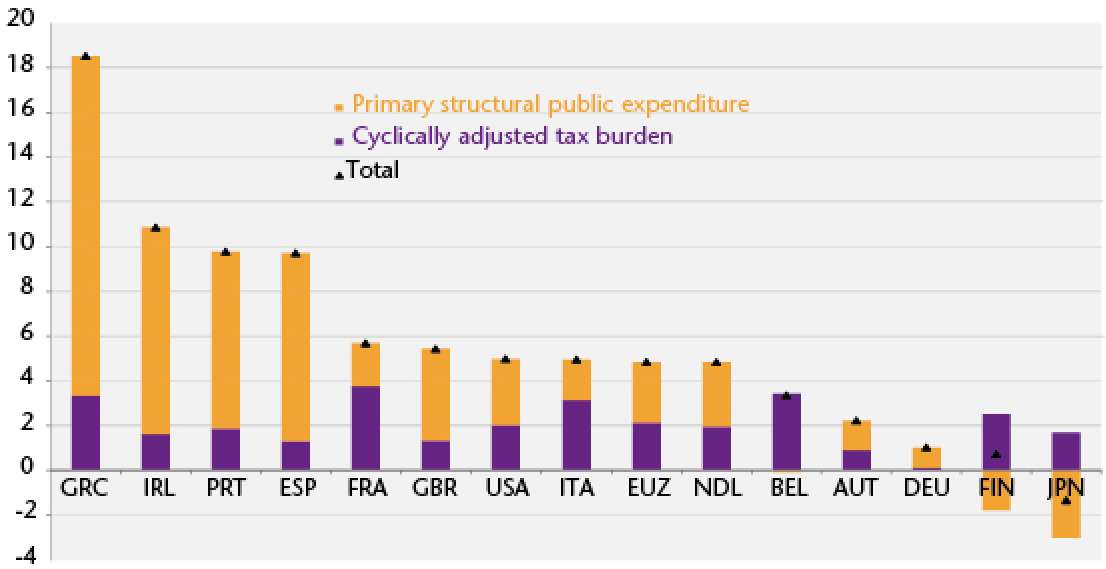
Faced with a rapid and explosive deterioration in their public accounts, the industrialized countries, particularly in Europe, have implemented large-scale austerity policies, some as early as 2010, in order to quickly reduce their deficits. In a situation like this, several questions about France's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

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

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

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

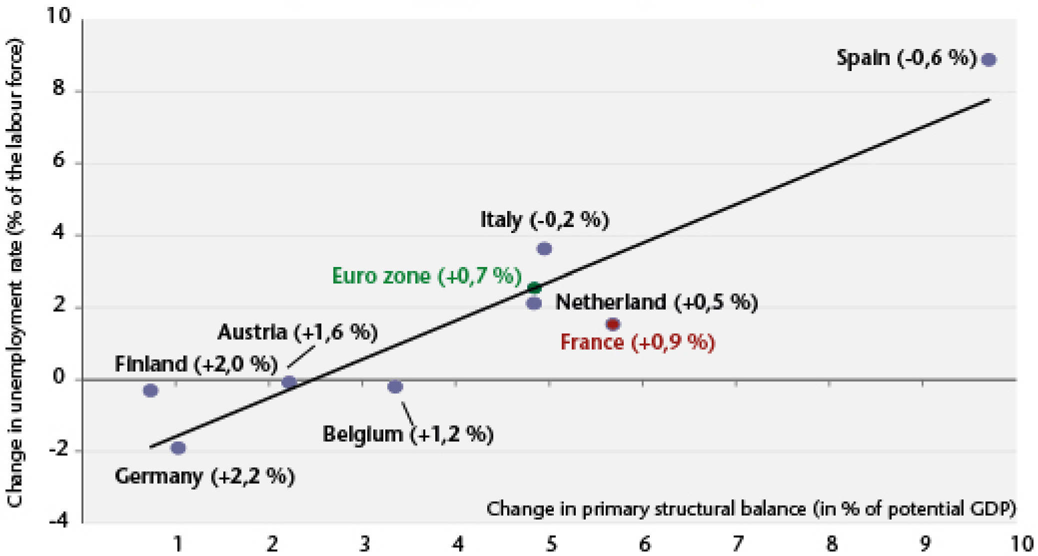
Figure 1. Contribution of each component to the change in the primary structural balance from 2010 to 2013, by country



Sources: OECD, OFCE calculations.

While France’s substantial budgetary efforts have undeniably had a negative impact on economic activity and employment, it is nevertheless true that the budget decisions of the various governments since 2010 appear to have affected growth and the labour market relatively less than in most other countries in the euro zone. Within the euro zone-11, from 2010 to 2013 only four countries – Germany, Finland, Austria and Belgium – experienced average growth of over 1% per year, with unemployment rates that not only did not increase, but occasionally even fell. However, these are also the four countries that made the smallest reductions in their structural deficits over this period. France, on the other hand, is among the countries that made the greatest structural effort since 2010, and it has simultaneously managed to contain the rise in unemployment to some extent. Indeed, compared with the Netherlands, Italy and the euro zone average, France's fiscal policy was more restrictive by about 1 GDP point from 2010 to 2013, yet the unemployment rate increased by 40% less than in the Netherlands, 60% less than the euro zone average and more than two times less than in Italy. Likewise, growth in France was higher on average over this period: 0.9% per year, against 0.5% in the Netherlands, 0.7% in the euro zone and -0.2% in Italy.

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



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

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

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

In % of potential GDP

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

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

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[1] This post makes use of certain parts of the article

published in *Alternatives Economiques*, M. Plane, "L'austérité peut-elle réussir en France ?", Special issue no. 96, 2nd quarter 2013.

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

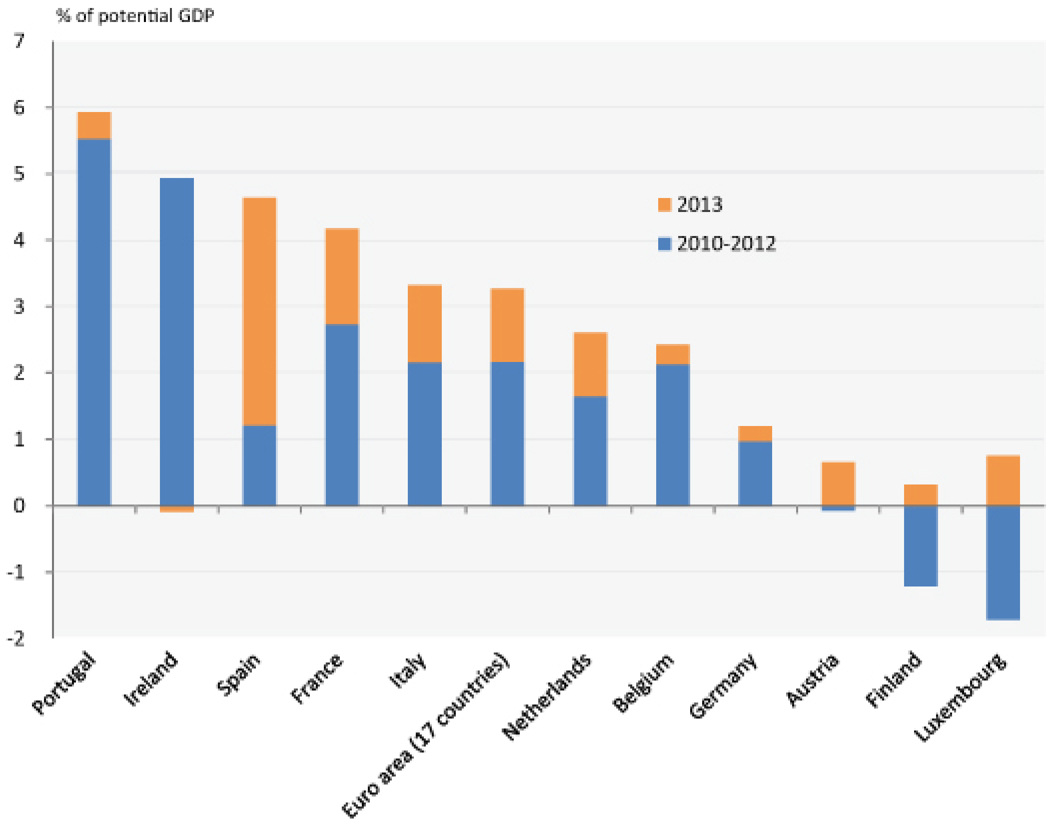
Why France is right to abandon the 3% public déficit target by 2013

By Mathieu Plane

Given the statements by the Minister of Economy and Finance, the government seems to have reached a decision to abandon the goal of a deficit of 3% of GDP by 2013. In addition to the change of tack in the policy announced up to now, which was to bring the deficit down to 3% by 2013 "whatever the cost", we can legitimately conclude that France is right to abandon this goal, and we offer several arguments for this. While in this post we do not review the economic consequences of the fiscal policy being undertaken in France and the euro zone, which has been dictated by nominal targets for the deficit that do not take into account the way it breaks down structurally / cyclically and that have a dangerously pro-cyclical character, we nevertheless present several arguments that the European Commission may find of value:

1 – According to the latest figures from the European Commission on 22 February 2013[1], of the euro zone countries making the greatest fiscal adjustment in 2013 from a structural viewpoint, France, with 1.4 GDP points, comes behind only Spain (3.4) and Greece (2.6). For the 2010-2013 period, the reduction in France’s structural deficit represents 4.2 GDP points, which makes France the euro zone country which, alongside Spain (4.6 GDP points), has carried out the largest budget cutbacks of the major countries in the zone, ahead of Italy (3.3 GDP points), the Netherlands (2.6) and of course Germany (1.2) (Figure 1).

Figure 1. Change in the structural deficit of the euro zone countries*



* For reasons of scale, we have not put Greece in the figure. Over the 2010-2013 period, Greece’s structural fiscal adjustment came to 16.9 GDP points, including 2.6 in 2013.

Sources: European Commission, OFCE calculations.

2 – In 2007, before the crisis, according to the European Commission France had a structural public deficit of -4.4 GDP points, compared with an average of -2.1 for the euro zone and -0.9 for Germany. In 2013, this came to -1.9 GDP points in France, -1.3 for the euro zone, and +0.4 for Germany, which represents an improvement of the structural deficit of 2.5 GDP points for France since the start of the crisis, *i.e.* three times the average for the euro zone and twice that for Germany (Table 1). Leaving aside public investment, France's structural public deficit in 2013 was positive and higher than the euro zone average (1.2 GDP point in France, versus 0.8 for the euro zone average and 1.9 for Germany). Note that France is spending 3.1 GDP points on public investment in 2013 (0.2 GDP point less than in 2007), against a euro zone average of only 2 points (0.6 point less than in 2007) and 1.5 in Germany (equivalent to 2007). However, public investment, which has a positive impact on potential growth, and which also increases public assets, while not changing the public administration's financial situation, can reasonably be excluded from the calculation of the structural public deficit.

Table. Public deficit and structural deficit with and without public investment

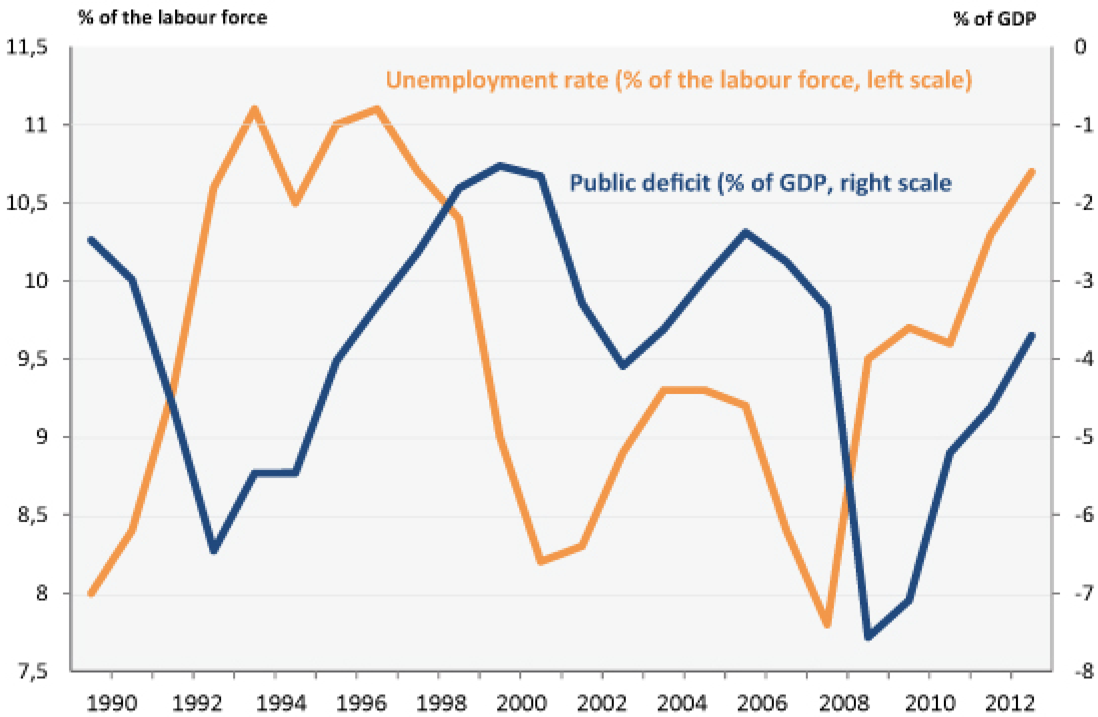
In GDP points	Public balance				Structural public balance				SPB w/o public investment			
	FRA	DEU	EZ	FRA-EZ diff.	FRA	DEU	ZE	FRA-EZ diff.	FRA	DEU	EZ	FRA-EZ diff.
2007	**-2.8**	**0.2**	**-0.7**	**-2.1**	**-4.4**	**-0.9**	**-2.1**	**-2.3**	**-1.1**	**0.6**	**0.5**	**-1.6**
2013	-3.7	-0.2	-2.8	-0.9	-1.9	0.4	-1.3	-0.6	1.2	1.9	0.8	0.4
Change 2007-2013	*-0.9*	*-0.4*	*-2.1*	*1.2*	*2.5*	*1.3*	*0.8*	*1.6*	*2.3*	*1.3*	*0.3*	*2.1*

Sources : European Commission, OFCE calculations.

3 – In 2013, the public deficit, even at 3.7% of GDP according to the European Commission, is once again at a level close to that of 2008, similar to that of 2005, and below that of 2004 and of the entire 1992-1996 period. The public deficit figure expected for 2013 corresponds to the average over the past

thirty years, and thus no longer seems so exceptional, which is easing the pressure that France could experience on the financial markets. In contrast, according to the European Commission the unemployment rate in France in 2013 will reach 10.7% of the workforce, which is very close to its historic peak in 1997 (Figure 2). With an unemployment rate in 2013 that is 1.3 percentage points higher than the average over the last thirty years, an exceptional situation now characterizes the labour market more than it does the government deficit. While new austerity measures would help to reduce the deficit, however painfully, due to the high value of the fiscal multiplier in the short term they will lead on the other hand to going well beyond our historic unemployment peak. Indeed, as we showed in our latest forecast in October 2012, if France really tries to meet its budget commitment for 2013 “whatever the cost”, this will require a new fiscal tightening of over 20 billion euros, in addition to the 36 billion euros already planned. This would lead to a recession, with GDP down -1.2% and 360,000 job losses (instead of expected growth of 0% and the loss of about 160,000 jobs), with the unemployment rate reaching 11.7% of the labour force by late 2013.

Figure 2. Public deficit and unemployment rate



Source: European Commission.

To restore its public accounts since 2010, France has undertaken a historic fiscal effort, well beyond the average of its European partners, which has cost it in terms of growth and employment. Adding another layer of austerity in 2013 to the already historic build-up of austerity would lead us this year straight into a recession and an unprecedented worsening in the labour market. If there is a choice, are a few tenths of a point in the public deficit worth such a sacrifice? Nothing is less certain. It is thus essential to put off the goal of reducing the deficit to 3% of GDP to at least 2014.

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[1] We have a different evaluation of the level of the structural deficit. For example, for 2013 we evaluate the improvement in France’s structural public deficit at 1.8 GDP points, but in order not to prejudice the analysis we are

using the figures provided by the Commission.

So far so good …

By Christophe Blot

The euro zone is still in recession. According to Eurostat, GDP fell again in the fourth quarter of 2012 (-0.6%). This figure, which was below expectations, is the worst quarterly performance in the euro zone since the first quarter of 2009, and it is also the fifth consecutive quarter of a decline in activity. For 2012 as a whole, GDP decreased by 0.5%. This annual figure masks substantial heterogeneity in the zone (Figures 1 and 2), since Germany posted annual growth of 0.9% while for the second consecutive year Greece is likely to suffer a recession of more than 6%. Moreover, taking all the countries together, the growth rate will be lower in 2012 than in 2011, and some countries (Spain and Italy to name but two) will sink deeper into depression. This performance is all the more worrying as several months of renewed optimism had aroused hopes that the euro zone was recovering from the crisis. Were there grounds for such hope?

Although it is very cautious about growth for 2012, the European Commission, in its annual report on growth, noted the return of some good news. In particular, the fall in long-term sovereign rates in Spain and Italy and the success on the financial markets of the public debt issues by Ireland and Portugal reflected renewed confidence. It is clear now however that confidence is not enough. Domestic demand has stalled in

France and is in freefall in Spain. All this is hurting trade within the zone, since a decline in imports by one country means a decline in exports from others, which is amplifying the recessive dynamics afflicting the countries in the zone as a whole. As we noted in our previous forecasting exercise and on the occasion of the publication of the iAGS (independent Annual Growth Survey), a recovery cannot in any case rely solely on a return of confidence so long as highly restrictive fiscal policies are being carried out synchronously throughout Europe.

Since the third quarter of 2011, the signals have all confirmed our scenario and showed that the euro zone has gradually sunk into a new recession. Unemployment has continued to rise, setting new records every month. In December 2012, according to Eurostat 11.7% of the euro zone working population were jobless. However, neither the European Commission nor the European governments have adjusted their fiscal strategy, arguing that fiscal efforts were needed to restore credibility and confidence, which would in turn lower interest rates and create a healthy environment for future growth. In doing this, the Commission has systematically underestimated the recessionary impact of the fiscal consolidation measures and has ignored the increasingly abundant literature showing that the multipliers rise in times of crisis and may be substantially higher than one (see the post by Eric Heyer on this subject). Advocates of fiscal austerity also believe that the costs of such a strategy are inevitable and temporary. They view fiscal consolidation as a prerequisite for a return to growth and downplay the long-term costs of such a strategy.

This dogmatic blindness recalls the final comment in the film *La Haine* (directed by Mathieu Kassovitz): “This is the story of a society that is falling, and to reassure itself as it falls constantly repeats, so far so good, so far so good, so far so good … what’s important is not the fall, it’s the landing." It is time to recognize that the economic policy in force since 2011 has been a mistake. It is not creating the conditions for a recovery. Worse, it is directly responsible for the return of recession and for the social catastrophe that is continuing to deepen in Europe. As we have shown, other strategies are possible. They do not neglect the importance of eventually making the public finances sustainable once again. By postponing and reducing the scale of austerity (see the note by Marion Cochard, Bruno Ducoudré and Danielle Schweisguth), it would be possible to make more rapid progress in restoring growth and cutting unemployment.

Is the euro crisis over?

By Catherine Mathieu and Henri Sterdyniak

As of early 2013, it is possible to make two contrasting assessments of the crisis. On the one hand, the euro has survived. Europe's institutions and Member states have of course been slow and hesitant to react, and their reluctance has often fueled speculation. But its institutions have gradually managed to develop solidarity mechanisms, such as the European Financial Stability Facility and then the European Stability Mechanism, and they were able to impose strong fiscal discipline on Member states (strengthening the Stability and Growth Pact, adjustment programs, fiscal treaty).

The Member states have agreed to implement austerity policies and structural reforms. From the beginning of the crisis, the European Central Bank was willing to put in place unconventional policies, and it has supported the public debt of countries in difficulty by intervening in the secondary markets. It then undertook to commit unlimited resources to support countries in trouble that implemented satisfactory policies, which helped to reassure the financial markets and to lower risk premiums.

On the other hand, the euro zone has been unable to regain a satisfactory level of growth or to recover the 9 points of activity lost to the crisis. The Member states have been forced to implement austerity policies during a recession. According to the outlook of the Commission itself, the unemployment rate is expected to stay at about 11.8% in 2013. Imbalances between countries persist, even if they are somewhat mitigated by the deep depression that has engulfed the countries of southern Europe. The rigid standards that have been imposed on the Member states, with no real economic foundation, cannot replace the genuine coordination of economic policies. The solidarity mechanisms implemented are conditional on the loss of any autonomy and the introduction of drastic austerity policies. In the future, national policies will be paralyzed by European constraints and by the threats of the financial markets. Social Europe is not making progress, and, even worse, Europe is requiring countries in difficulty to call into question universal health care and to cut pension, unemployment and family benefits. Tax competition is continuing, and the crisis has not been seen as a time to challenge tax havens and tax evasion. While Europe is at the forefront of the fight against climate change, it is hesitating to make a robust commitment to the ecological transition. Although many countries in the area are suffering from continuing deindustrialization, no industrial policy has been implemented. A banking union will be established, but its content is not being democratically decided. The European authorities are persisting in a strategy – paralyzing national policies and imposing free market structural reforms – which has so far failed to boost growth and has made Europe unpopular. Europe is sorely lacking a socially unifying project, an economic strategy and a means of functioning democratically.

* Issue 127 of the "Debates et Politics" collection of the *Revue de l'OFCE*, which appeared in January, contains analyses that provide contrasting insights into the origins of the euro zone crisis and into strategies for resolving the crisis. This issue brings together twelve papers following the 9th EUROFRAME conference [1] in June 2012 on issues concerning the European Union's economic policy.

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[1] EUROFRAME is a network of European economic institutes, which includes: the DIW and IFW (Germany), WIFO (Austria), ETLA (Finland), OFCE (France), ESRI (Ireland), PROMETEIA (Italy), CPB (Netherlands), CASE (Poland) and NIESR (United Kingdom).

The euro zone in crisis

By Catherine Mathieu and Henri Sterdyniak

The 9th EUROFRAME Conference [1], which was held in Kiel on 8 June 2012, focused on economic policy issues in the European Union. The topic was "The euro zone in crisis: Challenges for monetary and fiscal policies". Issue 127 of the "Débats et

Politiques" collection of the OFCE Revue has published revised versions of twelve papers presented in the Conference[2], gathered in five themes: exchange rate imbalances, indicators of the debt crisis, budget rules, banking and financial issues, and strategies for resolving the crisis.

The analysis of the origins of the euro zone crisis and economic policy recommendations to get out of the crisis have been the subject of great debate among economists, which was illustrated in the EUROFRAME Conference. In the course of these articles, the reader will see several fault-lines:

– For some, it is the irresponsible policies of the South that are the cause of the imbalances: they have allowed the development of wage and property bubbles, while the Northern countries have been implementing virtuous policies of wage austerity and structural reform. The Southern countries thus need to adopt the North's strategy and undergo a lengthy austerity cure. For others, the single currency has led to the development of twin opposing imbalances: this has led to under-valuing the economies of the North, which enabled them to offset their excessive policies on wage and social austerity with excessive external surpluses, and it has allowed the persistence of the South's external deficits; this has resulted in the need for a controlled convergence, whereby recovery in the North facilitates the absorption of the South's external imbalances.

– Some argue that each country must implement policies that combine a strong reduction in public spending – to absorb the budget deficits and reduce the public debt burden – with structural reforms (liberalization of the markets for goods and services, deregulation of the labour market) in order to offset the depressive effect on the labour market. The financial markets have to be allowed to impose the necessary discipline on the countries. Others hold that the public deficits have to be tolerated as long as necessary to support economic activity, public debt needs to be guaranteed by the European Central Bank (ECB) to ensure that domestic interest rates converge at low rates, and an EU-wide growth strategy is needed (in particular to finance the investments required for the ecological transition).

– Some even believe that we must avoid any further extension of European solidarity, as it would enable some countries to put off the reforms needed, which would lead to persistent imbalances and thus to money creation and inflation. Others argue that errors have been made on economic policy since the inception of the euro zone, and that these have led to sharp disparities in the zone, which now need to be reduced by means of a coherent solidarity strategy. Europe is one big family and must demonstrate its solidarity and accept compromises to continue to live together.

– For some, ending the debt crisis of the euro zone countries requires the establishment of a fiscal union, which means the establishment of binding rules enshrined in the Fiscal Pact and a certain degree of fiscal federalism; the European Commission and Council should have a say on the fiscal policies of the Member States. Others think that the Member States should have a degree of autonomy to practice the fiscal policy they choose; this is a matter of both democracy and economic efficiency: the economic situations of the different countries are too diverse to invoke a uniform fiscal policy; what is needed is the open coordination of economic policy, without rigid pre-established standards on public finances, with the aim of ensuring satisfactory growth and the winding down of external imbalances.

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[1] EUROFRAME is a network of European economic institutes, which includes: the DIW and IFW (Germany), WIFO (Austria), ETLA (Finland), OFCE (France), ESRI (Ireland), PROMETEIA (Italy), CPB (Netherlands), CASE (Poland), NIESR (United Kingdom).

[2] Ten of which are in English and two in French.

Could France have a different fiscal policy?

By Jérôme Creel

Shouldn't the economic crisis that is gripping the euro zone, including France, lead to calling into question the approach being taken by fiscal policy? In light of the unprecedented broad consensus among economists about the impact of fiscal policy on the real economy, it is clear that the austerity measures being adopted by France are a mistake. Moreover, invoking European constraints is not a good enough argument to exclude a much more gradual process of putting the public purse in order (also see the iAGS project).

There is no need to go beyond what European legislation requires, and doing so can be especially harmful if in fact the additional budgetary efforts generate less growth and, ultimately, further deterioration in the public finances due to higher social spending and lower tax revenue. What do the existing European treaties actually demand? In the case of a government deficit that exceeds 3% of GDP, the minimum effort required for fiscal adjustment consists of reducing the cyclically adjusted deficit, *i.e.* the structural deficit, by at least 0.5% of GDP per year. Furthermore, the time period for reducing the debt to 60% of GDP is 20 years. Finally, exceptional circumstances now include an "unusual event" that could justify deviating from the current standards for the deficit.

Based on these exceptional circumstances and on the rule requiring an annual improvement of at least 0.5% of GDP in the structural deficit, it can be shown that the French government has fiscal maneuvering room in 2012 and 2013, while still complying with European fiscal rules.

Table 1 lists the sequence of public deficits and of GDP growth from 2011 to 2013 according to two forecasts produced by the European Commission in the Spring and then the Autumn of 2012. According to the Spring forecast, the French structural deficit was supposed to decrease by 1.2% of GDP between 2011 and 2013, on average slightly above what is required by the Commission. In fact, the improvement from 2011 to 2012 exceeded 0.5% of GDP, while it fell below that from 2012 to 2013.

What about the Autumn 2012 forecast? The expected improvement in France's structural deficit was now expected to be 1.1% of GDP between 2011 and 2012 and then 1.4% of GDP between 2012 and 2013, taking into account the government's commitment to reduce public spending and raise taxes. These projected improvements in the structural deficit are two and three times greater than what European fiscal rules require, which is a lot! For the year 2013, this amounts to almost 20 billion euros that need not be levied on French households and businesses. Abandoning this levy does not mean abandoning fiscal austerity, but rather *spreading it out over time*.

Furthermore, the European Commission now expects a slowdown in the French economy in 2013. Unless one argues that the French government is responsible for this slowdown – and while this might indeed be the case in light of the austerity budget the government is imposing on the French economy, it is far from clear that the European Commission would want to employ such an argument, given its role in championing austerity! – this deterioration in the country’s growth prospects could fall within the category of an “unusual event,” thus giving France an opening to invoke exceptional circumstances in order to *stagger* and *extend* its fiscal adjustment efforts.

Instead of awaiting the miraculous effects of structural reform – a potentially lengthy and uncertain process – all that is really needed is to apply the regulations in force, without imposing an overly restrictive reading of what they contain, so as to limit the reduction in growth being caused by austerity and avoid a new period of rising unemployment. According to the conclusions of the iAGS report, staggering the fiscal austerity measures in France would lead to adding 0.7 GDP point to growth every year from 2013 to 2017.

The “unusual event” constituted by yet another year of very low growth in 2013 for France also opens the possibility of suspending the austerity policies, at least temporarily. Once again according to the findings of the iAGS report, the French government should put off till 2016 its policy of consolidating the public finances. The gain in terms of growth would be 0.9 percentage point per year between 2013 and 2017. Provided that this policy is actually conducted carefully and not postponed indefinitely, it would enable France to reduce its public debt to GDP ratio in compliance with existing EU treaties.

Forecast for the French economy

		2011	2012	2013
Public deficit (*% of GDP*)	Spring 2012	5.2	4.5	4.2
	Autumn 2012	5,2	4.5	3.5
Structural deficit (*% of GDP*)	Spring 2012	4.1	3.2	2.9
	Autumn 2012	4.5	3.4	2.0
PIB (*%*)	Spring 2012	1.7	0.5	1.3
	Autumn 2012	1.7	0.2	0.4

Source: European Commission forecasts.

Has monetary policy become ineffective?

By Christophe Blot, Catherine Mathieu and Christine Rifflart

This text summarizes the special study of the October 2012 forecast.

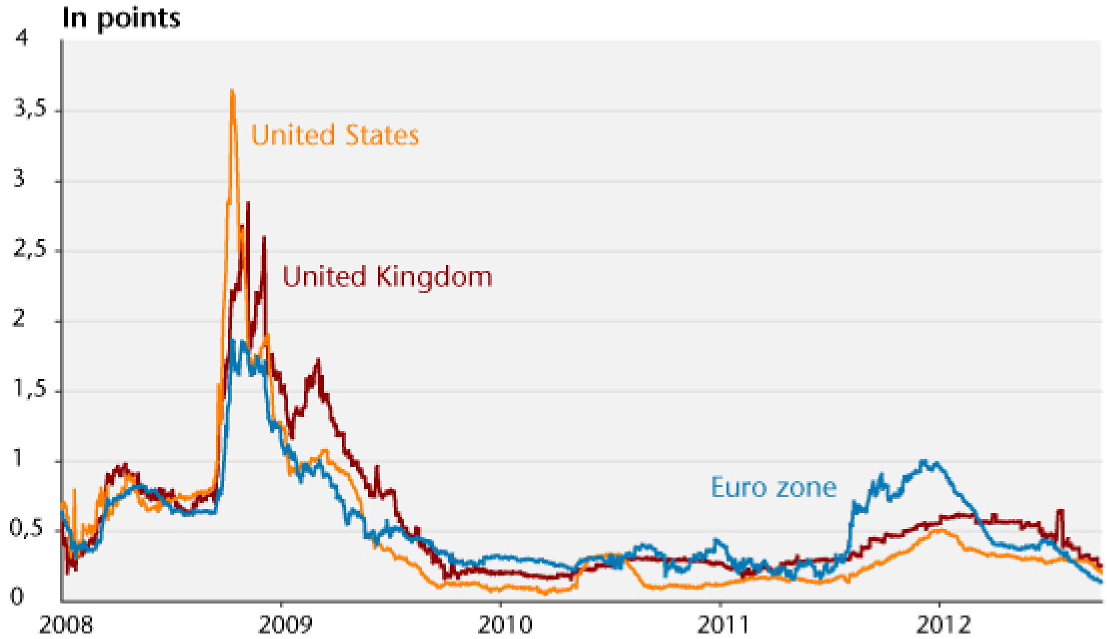
Since the summer of 2007, the central banks of the industrialized countries have intervened regularly to counter the negative impact of the financial crisis on the functioning of the banking and financial system and to help kick-start growth. Initially, key interest rates were lowered considerably, and then maintained at a level close to 0 [1]. In a second phase, from the beginning of 2009, the central banks implemented what are called unconventional measures. While these policies may differ from one central bank to another, they all result in an increase in the size of their balance sheets as well as a change in the composition of their balance sheet assets. However, three years after the economies in the United States, the euro zone and the United Kingdom hit bottom, it is clear that recovery is still a ways off, with unemployment at a high level everywhere. In Europe, a new recession is threatening [2]. Does this call into question the effectiveness of monetary policy and of unconventional measures more specifically?

For almost four years, a wealth of research has been conducted on the impact of unconventional monetary policies [3]. Cecioni, Ferrero and Sacchi (2011) [4] have presented a review of recent literature on the subject. The majority of these studies focus on the impact of the various measures taken by the central banks on financial variables, in particular on money market rates and bond yields. Given the role of the money market in the transmission of monetary policy, the ability of central banks to ease the pressures that have emerged since the beginning of the financial crisis constitutes a key vector for effective intervention. More recently, this was also one of the reasons motivating the ECB to conduct an exceptional refinancing operation in two stages, with a maturity of 3 years. This intervention has indeed helped to reduce the tensions on the interbank market that had reappeared in late 2011 in the euro zone, and to a lesser extent in the United States and the United Kingdom (see graph). This episode seems to confirm that central bank action can be effective when it is dealing with a liquidity crisis.

Another critical area of debate concerns the ability of unconventional measures to lower interest rates in the long term and thereby to stimulate activity. This is in fact an important lever for the transmission of monetary policy. The findings on this issue are more mixed. Nevertheless, for the United States, a study by Meaning and Zhu (2012) [5] suggests that Federal Reserve programs to purchase securities have contributed to lowering the rates on 10-year US Treasury bills: by 60 points for the first “Large-scale asset purchase” program (LSAP1) and by 156 points for LSAP2. As for the euro zone, Peersman [6] (2011) shows that the impact of unconventional measures on activity has in general closely resembled the effect of lowering the key interest rate, and Gianone, Lenza, Pill and Reichlin [7] (2012) suggest that the various measures taken by the ECB since the beginning of the crisis have helped offset the rise in the unemployment rate, although the impact is limited to 0.6 point.

Under these conditions, how is it possible to explain the weakness or outright absence of a recovery? One answer evokes the hypothesis of a liquidity trap [8]. Uncertainty is still prevalent, and the financial system is still so fragile that agents are continuing to express a preference for liquidity and safety, which explains their reluctance to undertake risky projects. Thus, even if financing conditions are favourable, monetary policy will not be sufficient to stimulate a business recovery. This hypothesis probably explains the timidity of the recovery in the United States. But in the euro zone and the United Kingdom this hypothesis needs to be supplemented with a second explanation that recognizes the impact of restrictive fiscal policies in holding back recovery. The euro zone countries, like the UK, are pursuing a strategy of fiscal consolidation that is undermining demand. While monetary policy is indeed expansionary, it is not able to offset the downward pressure of fiscal policy on growth.

Graphique. Tensions on the interbank markets*



* The tensions are measured by the spread between the interbank rates (Libor ou Euribor) and the overnight interest rate swap (OIS).

Source : Datastream.

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[1] One should not, however, forget the exception of the ECB, which prematurely raised its key interest rate twice in 2011. Since then it has reversed these decisions and lowered the key rate, which has stood at 0.75% since July 2012.

[2] The first estimate of UK GDP for the third quarter of 2012 indicates an upturn in growth following three quarters of decline. However, this rebound is due to unusual circumstances (see Royaume-Uni: l'enlisement), and activity will decline again in the fourth quarter.

[3] Unconventional monetary policies have already been analyzed repeatedly in the case of the Bank of Japan. The implementation of equivalent measures in the United States, the United Kingdom and the euro zone has contributed to greatly amplifying the interest in these issues.

[4] "Unconventional monetary policy in theory and in practice", *Banca d'Italia Occasional Papers,* no.102.

[5] "The impact of Federal Reserve asset purchase programmes:

another twist", *BIS Quarterly Review*, March, pp. 23-30.

[6] "Macroeconomic effects of unconventional monetary policy in the euro area", ECB Working Paper no.1397.

[7] "The ECB and the interbank market", CEPR Discussion Paper no. 8844.

[8] See OFCE (2010) for an analysis of this hypothesis.

The debacle of austerity

By Xavier Timbeau

This text summarizes the OFCE's October 2012 forecasts.

The year 2012 is ending, with hopes for an end to the crisis disappointed. After a year marked by recession, the euro zone will go through another catastrophic year in 2013 (a -0.1% decline in GDP in 2013, after -0.5% in 2012, according to our forecasts – see the table). The UK is no exception to this trend, as it plunges deeper into crisis (-0.4% in 2012, 0.3% in 2013). In addition to the figures for economic growth, unemployment trends are another reminder of the gravity of the situation. With the exception of Germany and a few other developed countries, the Western economies have been hit by high unemployment that is persisting or, in the euro zone, even rising (the unemployment rate will reach 12% in the euro zone in 2013, up from 11.2% in the second quarter of 2012). This persistent unemployment is leading to a worsening situation for those who have lost their jobs, as some fall into the ranks of the long-term unemployed and face the exhaustion of their rights to compensation. Although the United States is experiencing more favourable economic growth than in the euro zone, its labour market clearly illustrates that the US economy is mired in the Great Recession.

Was this disaster, with the euro zone at its epicentre, an unforeseeable event? Is it some fatality that we have no choice but to accept, with no alternative but to bear the consequences? No – the return to recession in fact stems from a misdiagnosis and the inability of Europe’s institutions to respond quickly to the dynamics of the crisis. This new downturn is the result of massive, exaggerated austerity policies whose impacts have been underestimated. The determination to urgently rebalance the public finances and restore the credibility of the euro zone’s economic management, regardless of the cost, has led to its opposite. To get out of this rut will require reversing Europe’s economic policy.

The difficulty posed by the current situation originates in widening public deficits and swelling public debts, which reached record levels in 2012. Keep in mind, however, that the deficits and public debts were not the cause of the crisis of 2008-2009, but its consequence. To stop the recessionary spiral of 2008-2009, governments allowed the automatic stabilizers to work; they implemented stimulus plans, took steps to rescue the financial sector and socialized part of the private debt that threatened to destabilize the entire global financial system. This is what caused the deficits. The decision to socialize the problem reflected an effort to put a stop to the freefall.

The return to recession thus grew out of the difficulty of dealing with the socialization of private debt. Indeed, in the euro zone, each country is forced to deal with financing its deficit without control of its currency. The result is immediate: a beauty contest based on who has the most rigorous public finances is taking place between the euro zone countries. Each European economic agent is, with reason, seeking the most reliable support for its assets and is finding Germany’s public debt to hold the greatest attraction. Other countries are therefore threatened in the long-term or even immediately by the drying up of their market financing. To attract capital, they must accept higher interest rates and urgently purge their public finances. But they are chasing after a sustainability that is disappearing with the recession when they seek to obtain this by means of austerity.

For countries that have control of their monetary policy, such as the United States or the United Kingdom, the situation is different. There the national savings is exposed to a currency risk if it attempts to flee to other countries. In addition, the central bank acts as the lender of last resort. Inflation could ensue, but default on the debt is unthinkable. In contrast, in the euro zone default becomes a real possibility, and the only short-term shelter is Germany, because it will be the last country to collapse. But it too will inevitably collapse if all its partners collapse.

The solution to the crisis of 2008-2009 was therefore to socialize the private debts that had become unsustainable after the speculative bubbles burst. As for what follows, the solution is then to absorb these now public debts without causing the kind of panic that we were able to contain in the summer of 2009. Two conditions are necessary. The first condition is to provide a guarantee that there will be no default on any public debt, neither partial nor complete. This guarantee can be given in the euro zone only by some form of pooling the public debt. The mechanism announced by the ECB in September 2012, the Outright Monetary Transaction (OMT), makes it possible to envisage this kind of pooling. There is, however, a possible contradiction. In effect this mechanism conditions the purchase of debt securities (and thus pooling them through the balance sheet of the ECB) on acceptance of a fiscal consolidation plan. But Spain, which needs this mechanism in order to escape the pressure of the markets, does not want to enter the OMT on just any conditions. Relief from the pressure of the markets is only worthwhile if it makes it possible to break out of the vicious circle of austerity.

The lack of preparation of Europe's institutions for a financial crisis has been compounded by an error in understanding the way its economies function. At the heart of this error is an incorrect assessment of the value of the multipliers used to measure the impact of fiscal consolidation policies on economic activity. By underestimating the fiscal multipliers, Europe's governments thought they could rapidly and safely re-balance their public finances through quick, violent austerity measures. Influenced by an extensive economic literature that even suggests that austerity could be a source of economic growth, they engaged in a program of unprecedented fiscal restraint.

Today, however, as is illustrated by the dramatic revisions by the IMF and the European Commission, the fiscal multipliers are much larger, since the economies are experiencing situations of prolonged involuntary unemployment. A variety of empirical evidence is converging to show this, from an analysis of the forecast errors to the calculation of the multipliers from the performances recorded in 2011 and estimated for 2012 (see the full text of our October 2012 forecast). We therefore believe that the multiplier for the euro zone as a whole in 2012 is 1.6, which is comparable to the assessments for the United States and the United Kingdom.

Thus, the second condition for the recovery of the public finances is a realistic estimate of the multiplier effect. Higher multipliers mean a greater impact of fiscal restraint on the public finances and, consequently, a lower impact on deficit reduction. It is this bad combination that is the source of the austerity-fuelled debacle that is undermining any prospect of re-balancing the public finances. Spain once again perfectly illustrates where taking this relentless logic to absurd lengths leads: an economy where a quarter of the population is unemployed, and which is now risking political and social disintegration.

But the existence of this high multiplier also shows how to break austerity's vicious circle. Instead of trying to reduce the public deficit quickly and at any cost, what is needed is to let the economy get back to a state where the multipliers are lower and have regained their usual configuration. The point therefore is to postpone the fiscal adjustment to a time when unemployment has fallen significantly so that fiscal restraint can have the impact that it should.

Delaying the adjustment assumes that the market pressure has been contained by a central bank that provides the necessary guarantees for the public debt. It also assumes that the interest rate on the debt is as low as possible so as to ensure the participation of the stakeholders who ultimately will benefit from sustainable public finances. It also implies that in the euro zone the pooling of the sovereign debt is associated with some form of control over the long-term sustainability of the public finances of each Member State, *i.e.* a partial abandonment of national sovereignty that in any case has become inoperative, in favour of a supranational sovereignty which alone is able to generate the new manoeuvring room that will make it possible to end the crisis.

OFCE growth forecasts, October 12

Annual growth in GDP, %

	2011	2012	2013
Euro zone	1,5	-0,5	-0,1
Germany	3,1	0,8	0,6
France	1,7	0,1	0,0
Italy	0,5	-2,4	-1,1
Spain	0,4	-1,4	-1,2
Netherlands	1,1	-0,2	0,3
Belgium	1,8	-0,1	0,9
Finland	2,8	0,8	1,1
Austria	2,7	1,0	0,5
Portugal	-1,7	-2,8	-1,2
Greece	-6,2	-6,2	-3,7
Ireland	0,8	-0,4	-0,1
United Kingdom	0,9	-0,4	0,3
United States	1,8	2,2	0,9
Japan	-0,7	2,4	1,3

Sources : National calculations, OFCE forecasts October 2012.

Banking union: a solution to the euro crisis?

By Maylis Avaro and Henri Sterdyniak

The European summit on 28th and 29th June marked a new attempt by Europe's institutions and Member states to overcome the crisis in the euro zone. A so-called Growth Pact was adopted, but it consists mainly of commitments by the Member states to undertake structural reform, and the limited funds made available (120 billion over several years) were for the most part already planned. The strategy of imposing restrictive fiscal policies was not called into question, and France pledged to ratify the Fiscal Compact. The interventions of the European Financial Stability Facility (EFSF) and the European Stability Mechanism (ESM) will now be less rigid, as, without additional conditions, they can help countries that the financial markets refuse to finance so long as they meet their objectives in terms of fiscal policy and structural reform. But euro-bonds and the mutual guarantee of public debt were postponed. The summit also launched a new project: a banking union. Is this an essential supplement to monetary union, or is it a new headlong rush into the unknown?

The current crisis is largely a banking crisis. The European banks had fed financial bubbles and housing bubbles (especially in Spain and Ireland), and they had invested in mutual funds and hedge funds in the United States. After major losses during the crisis of 2007-2010, the Member states came to their rescue, which was particularly costly for Germany, the UK, Spain and above all Ireland. The sovereign debt crisis in the euro zone has compounded their woes: the sovereign debt that they hold has become a risky asset. The problem of regulating the banks has been raised at the international level (new Basel III standards), in the United States (Volkers rule and Dodd-Frank law) and in Britain (Vickers report).

In June 2012, doubts about the soundness of Europe’s banks surfaced yet again. The measures taken since 2008 to stabilize the financial system have proved insufficient. When Bankia, Spain’s fourth-largest bank, announced that it was requesting State assistance of 19 billion euros, worries about the balance sheets of Spanish banks rose sharply. The rate of bad loans of the country’s banks, whose balance sheets were hit hard by the real estate crash, rose from 3.3% at end 2008 to 8.7% in June 2012 [1]. Furthermore, many Greeks, fearing an exit from the euro zone, began to reduce their deposits in the banks there [2].

In response to these dangers, the proposal for a European banking union was given a new boost by Mario Monti. Italy's PM suggested developing the proposals in preparation for the European Commission Single Market DG, an idea that currently has the support of the Commission, the European Central Bank, and several Member states (Italy, France, Spain, etc.) On the other hand, Germany believes that a banking union is impossible without a fiscal union. While Angela Merkel acknowledged [3] that it was important to have a European supervisory authority, with a supranational banking authority with a better general overview, she clearly rejected the idea of Germany taking a risk of further transfers and guarantees without greater fiscal and policy integration [4]. The euro zone summit meeting on 29 June asked the Commission to make proposals shortly on a single monitoring mechanism for the euro zone's banks.

This kind of banking union would rest on three cornerstones:

– a European authority in charge of centralized oversight of the banks,

– a European deposit guarantee fund,

– a common mechanism for resolving bank crises.

Each of these cornerstones suffers specific problems: some are related to the complex way the EU functions (Should a banking union be limited to the euro zone, or should it include all EU countries? Would it be a step towards greater federalism? How can it be reconciled with national prerogatives?), while others concern the structural choices that would be required to deal with the operations of the European banking system.

As to the institution that will exercise the new banking supervisory powers, the choice being debated is between the European Banking Authority (EBA) and the ECB. The EBA was established in November 2010 to improve oversight of the EU banking system, and it has already conducted two series of "stress tests" on the banks. As a result of the tests, in October 2011 Bankia reported a 1.3 billion euro shortage of funds. Five months later, the deficit was 23 billion; the EBA's credibility suffered. In addition, the London-based EBA has authority over the British system, while the United Kingdom does not want to take part in the banking union. The ECB has, for its part, received support from Germany. Article 127.6 of the Treaty on the Functioning of the European Union [5], which was cited at the euro zone summit of June 29th as a basis for the creation of a European Banking Authority, would make it possible to give the ECB supervisory authority. On 12 June, the Vice-President of the ECB, Mr. Constancio, said that, "the ECB and the Eurosystem are prepared" to receive these powers; "there is no need to create a new institution".

European oversight implies a common vision of banking regulation. There must be agreement on crucial issues, such as: "Does commercial banking need to be separated from investment banking?" "Should banks be prohibited from operating on the financial markets for their own account?" "Should public or mutual or regional banks be encouraged rather than large internationalized banks?" "Should banks be encouraged to extend credit primarily to businesses and government in their own country, or on the contrary to diversify?" "Should the macro-prudential rules be national or European?" In our opinion, entrusting these matters to the ECB runs the risk of taking a further step in the depoliticization of Europe.

Applying the guidelines of this new authority will be problematic. A banking group in difficulty could be ordered to divest its holdings in large national groups. But would a country's government expose a national champion to foreign control? Governments would lose the ability to influence the distribution of credit by banks, which some people might find desirable (no political interference in lending), but in our opinion is dangerous (governments would lose a tool of industrial policy that could be used to finance Small and Medium Enterprises [SMEs] and Economic and technological intelligence [ETI] projects or to support the ecological transition).

For example, in a case involving Dexia, the opposition between the European Commission on the one hand and France, Belgium and Luxembourg on the other is blocking a restructuring plan. The plan includes the takeover of Dexia Credit Local's financing of local authorities by a banking collectivity that would be created based on cooperation between La Banque postale and the Caisse des depots. In the name of fair competition, Brussels is challenging the financing of local communities by such a bank, as Dexia has received public funding for its restructuring plan. This is threatening the continuity of the financing of the French local authorities, and could put a halt to their plans; in particular, it could prevent France from providing specific secure mechanisms for financing local authorities through local savings.

The purpose of a deposit guarantee fund is to reduce the risk of a massive withdrawal of deposits during a banking panic.

This fund could be financed through contributions by the European banks guaranteed by the fund. According to Schoenmaker and Gros [6], a banking union must be created under a “veil of ignorance”, that is to say, without knowing which country poses the greatest risk: this is not the case in Europe today. The authors propose a guarantee fund that at the outset would accept only the strongest large transnational banks, but this would immediately heighten the risk of the zone breaking apart if depositors rushed to the guaranteed banks. The fund would thus need to guarantee all Europe’s banks. According to Schoenmaker and Gros, assuming a 100,000 euro ceiling on the guarantee, the amount of deposits covered would be 9,700 billion euros. The authors argue that the fund should have a permanent reserve representing 1.5% of the deposits covered (*i.e.* about 140 billion euros). But this would make it possible to rescue only one or two major European banks. During a banking crisis, amidst the risk of contagion, such a fund would have little credibility. The guarantee of deposits would continue to depend on the States and on the European Stability Mechanism (ESM), which would have to provide support funds, ultimately by requiring additional contributions from the banks.

The authority in charge of this fund has not yet been designated. While the ECB appears well positioned to undertake supervision of the banking system, entrusting it with management of the deposit guarantee fund is much more problematic. According to Repullo [7], deposit insurance should be separated from the function of lender of last resort. Indeed, otherwise the ECB could use its ability to create money to recapitalize the banks, which would increase the money supply. The objectives of monetary policy and of support for the banks would thus come into conflict. What is needed is a body that handles deposit insurance and crisis resolution and is separate from the ECB, and which must have a say on the behavior of the banks, and which would be additional to the EBA, the ECB, and the national regulators.

The ECB on the other hand would continue to play its role as lender of last resort. But it is difficult to see how such a complicated system would be viable.

As the risk of a country leaving the euro zone cannot yet be dismissed, the question arises as to what guarantee would be offered by a banking union in the case of a conversion into national currency of euro-denominated deposits. A guarantee of deposits in the national currency would, in the case of an exit from the euro, heavily penalize customers of banks that suffer a devaluation of the national currency against the euro, whose purchasing power would decline sharply. This kind of guarantee does not solve the problem of capital flight being experienced today by countries threatened by a risk of default. What is needed is a guarantee of deposits in euros, but in today's situation, given the level of risk facing some countries, this is difficult to set up.

German and Finnish politicians and economists such as H. W. Sinn are, for instance, denouncing an excessive level of risk for Germany and the Nordic countries. According to several German economists, no supranational authority has the right to impose new burdens (or risk levels) on the German banks without the consent of Parliament, and the risk levels need to be explicitly limited. The German Constitutional Court might oppose the deposit guarantee fund as exposing Germany to an unlimited level of risk. Moreover, according to George Osborne, the Chancellor of the British Exchequer, a bank deposit guarantee at the European level would require an amendment to existing treaties and the consent of Great Britain.

On 6 June, the European Commission began to develop a common framework for resolving banking crises by adopting the proposal of Michel Barnier, which has three components. The first is to improve prevention by requiring banks to set up *testaments*, that is, to provide for recovery strategies and even disposal plans in case of a serious crisis. The second gives the European banking authorities the power to intervene to implement the recovery plans and to change the leadership of a bank if it fails to meet capital requirements. The third provides that, if a bank fails, the national governments must take control of the establishment and use resolution tools such as divestiture, the creation of a defeasance bank, or “bad” bank, or an internal bailout (by forcing shareholders and creditors to provide new money). If necessary, the banks could receive funds from the ESM. Bank-related risks would therefore be better distributed: the shareholders and creditors not covered by the guarantee would be first to be called upon, so that the taxpayers would not pay to reimburse the creditors of insolvent banks. In return, bank loans and shares would become much riskier; bank reluctance about inter-bank credit and the drying up of the interbank market due to the crisis would persist; and the banks would find it difficult to issue securities and would have to raise the level of compensation. However, Basel III standards require banks to link their lending to the level of their capital. This would pose a risk of constraining the distribution of credit, thereby helping to keep the zone in recession. Based on the decisions of the summit on 29 June, Spain could be the first country whose banks would be recapitalized directly by the ESM. However, this would not take place until early 2013; the terms of the procedure and the impact of ESM aid on the governance of the recapitalized banks still need to be determined. As can be seen in the Dexia example, what terms are set for the reorganization of a bank can have serious consequences for the country concerned: are governments (and citizens) willing to lose all power in this domain?

A banking union can help break the correlation between a sovereign debt crisis and a banking crisis. When the rating agencies downgrade a country’s debt, the securities suffer a loss in value and move into the category of “risky assets”, becoming less liquid. This increases the overall risk faced by the banks in the country concerned. If a bank is facing too much overall risk and it is no longer able to meet the capital requirements of Basel III, the State must recapitalize it, but to do this it must take on debt, thereby increasing the risk of a default. This link between the banks’ fragile balance sheets and public debt generates a dangerous spiral. For instance, since the announcement of the bankruptcy of Bankia, Spain’s 10-year refinancing rates reached the critical threshold of 7%, whereas last year the rates were about 5.5%. In a banking union, the banks would be encouraged to diversify on a European scale. However, the crisis of 2007-09 demonstrated the risks of international diversification: many European banks lost a great deal of money in the US; foreign banks are unfamiliar with the local business scene, including SMEs, ETIs and local government. Diversification based on financial criteria does not fit well with a wise distribution of credit. Moreover, since the crisis, European banks are tending to retreat to their home countries.

The proposal for a banking union assumes that the solvency of the banks depends primarily on their own capital, and thus on the market’s evaluation, and that the links between a country’s needs for financing (government, business and consumers) and the national banks are severed. There is an argument for the opposite strategy: a restructuring of the banking sector, where the commercial banks focus on their core business (local lending, based on detailed expertise, to businesses, consumers and national government), where their solvency would be guaranteed by a prohibition against certain risky or speculative transactions.

Would banking union promote further financialization, or would it mark a healthy return to the Rhineland model? Would it require the separation of commercial banks and investment banks? Would it mean prohibiting banks whose deposits are guaranteed to do business on the financial markets for their own account?

[1] According to the Bank of Spain.

[2] The total bank accounts of consumers and business fell by 65 billion in Greece since 2010. Source: Greek Central Bank.

[3] “La supervision bancaire européenne s’annonce politiquement sensible”, *Les Echos Finance*, Thursday 14 June 2012, p. 28.

[4] “Les lignes de fracture entre Européens avant le sommet de Bruxelles”, *AFP Infos Economiques* 27 June 2012*.*

[5] Art 127.6: ”The Council, acting by means of regulations in accordance with a special legislative procedure, may unanimously, and after consulting the European Parliament and the European Central Bank, confer specific tasks upon the European Central Bank concerning policies relating to the prudential supervision of credit institutions and other financial institutions with the exception of insurance undertakings.”

[6] D. Schoenmaker and Daniel Gros (2012), “A European Deposit Insurance and Resolution Fund”, *CEPS working document*, No. 364, May.

[7] Repullo, R. (2000), “Who Should Act as Lender of Last Resort? An Incomplete Contracts Model”, *Journal of Money, Credit, and Banking* 32, 580-605.

Would returning to the drachma be an overwhelming tragedy?

by Céline Antonin

Following the vote in the Greek parliamentary elections on 17 June 2012, the spectre of the country leaving the euro zone has been brushed aside, at least for a while. However, the idea is not completely buried, and it is still being evoked in Greece and by various political forces around the euro zone. This continues to pose the question of the cost of a total default by Greece for its creditors, foremost among them France. The analysis published in the latest *OFCE Note (No. 20, 19 June 2012)* shows that, despite the magnitude of the potential losses, several factors could mitigate the consequences for the euro zone countries of a default by the Greek state.

The withdrawal of Greece from the euro zone, which is not covered in the Treaties, would cause a major legal headache, as it would involve managing the country's removal from the Eurosystem [1]. In case of a return to a new drachma, which would depreciate sharply against the euro [2], the burden of the public debt still outstanding would be greatly increased, as would private debt, which would still be denominated in euros. Many financial and nonfinancial firms would go to the wall. Legally, Greece could not unilaterally convert its debt into new drachmas. Since the country's public debt is not very sustainable and it is denominated almost exclusively in euros, Greece would certainly default (at least partially) on its public debt, including its foreign debt [3]. Given that the main holders of Greek debt are euro zone countries, what would be the magnitude of the shock in the case of a Greek default?

While more detail about this can be found in the *OFCE Note (No. 20, 19 June 2012)*, the focus here is on providing a breakdown of the exposure of the euro zone countries (in particular France) to Greek public and private debt. Exposure to Greek public debt involves three main channels:

1) The two aid packages of May 2010 and March 2012;

2) Participation in the Eurosystem;

3) The exposure of the commercial banks.

An analysis of these channels shows that the main source of exposure of the euro zone countries to losses is the two support plans. The maximum exposure of the euro zone countries through this channel is 160 billion euros (46 billion euros for Germany and 35 billion euros for France). Euro zone countries are also exposed to Greek government debt through their participation in the Eurosystem: indeed, the Eurosystem's balance sheet swelled dramatically to support the vulnerable countries in the euro zone, notably Greece. However, given the Eurosystem's capacity to absorb losses (over 3,000 billion euros), we believe that the potential losses for the countries of the euro zone are not likely to be realized if Greece were to default unilaterally on its public debt. Finally, the euro zone's banking system is exposed to 4.5 billion euros in Greek sovereign risk and up to 45 billion euros from the Greek private sector [4].

The cumulative exposure of the euro zone to Greek debt, excluding the Eurosystem, amounts to a maximum of 199 billion euros (2.3% of the euro zone's GDP, cf. Table), including 52 billion euros for Germany (2% of GDP) and 65 billion euros for France (3.3% of GDP). If we include exposure to the Eurosystem, the cumulative exposure of the euro zone to Greek debt comes to 342 billion euros (4% of euro zone GDP), including 92 billion for Germany (3.6% of GDP) and 95 billion (4.8%) for France. France is the most heavily exposed euro zone country, due to the exposure of its banks to Greek private debt through subsidiaries in Greece. If we consider only Greek government debt, however, it is Germany that appears to be the country most exposed to a Greek default.

Summary of the exposure of different countries to Greek debt

In billion euros

	1) Support lans		2) Eurosystem		3) Commercial banks			
	1st plan	2e plan	SMP	TARGET2	Public debt	Private debt	Total	Total excl. Eurosystem
Germany	14.7	31.4	12.5	27.3	1.3	5.1	92.3	**52.5**
Austria	1.5	3.2	1.3	2.8	NC*	NC*	8.8	4.7
Belgium	1.9	4.0	1.6	3.5	0.1	0.0	11.1	6.0
Cyprus	0.1	0.2	0.1	0.2	NC	NC	0.6	0.3
Spain	6.5	13,8	5.5	12.0	0.1	0.5	38.4	20.9
Estonia	0.0	0.3	0.1	0.3	NC	NC	0.7	0.3
Finland	1.0	2.1	0.8	1.8	NC	NC	5.7	3.1
France	11.1	23.6	9.4	20.5	1.3	29.1	95.0	**65.1**
Ireland	0.9	0.0	0.7	1.6	NC	NC	3.2	0.9
Italy	9.7	20.7	8.3	18.0	0.2	1.1	58.0	31.7
Luxembourg	0.1	0.3	0.1	0.3	NC	NC	0.8	0.4
Malta	0.1	0.1	0.0	0.1	NC	NC	0.3	0.2
Netherlands	3.1	6.6	2.6	5.7	NC	NC	18.0	9,7
Portugal	1.4	0.0	1.2	2.5	NC	NC	5.1	1.4
Slovakia	0.5	1.1	0.5	1.0	NC	NC	3.1	1.6
Slovenia	0.3	0.6	0.2	0.5	NC	NC	1,6	0.9
Total EZ	**52.9**	**107.7**	**45.0**	**98.0**	**2.9**	**35.8**	**342.3**	**199.3**

[NC => NA]
NA: Not available, as the BIS gives only the exposures of Germany, Belgium, France, Italy and Spain. The totals are thus calculated without taking into account the second tier banks, except for Germany, Belgium, France, Italy and Spain and the Euro Zone Total.
Sources: "The Economic Adjustment Programme for Greece – First review summer 2010", ECB, EFSF, BIS *Quarterly Review* (June 2012), Bank of Greece, author's calculations.

These amounts constitute an upper bound: they represent the maximum potential losses in the worst case scenario, namely the complete default of Greece on its public and private debt. Furthermore, it is impossible to predict with certainty all the chain reactions associated with a Greek exit from the euro zone: everything depends on whether the exit is coordinated or not, whether a debt rescheduling plan is implemented, the magnitude of the depreciation of the drachma against the euro, and so on.

The ”reassuring” element in this analysis is the magnitude of the potential losses (Table): the shock of a Greek exit would be absorbable, even if it would generate a shock on each member country and widen its deficit, undermining the members’ efforts to restore balanced budgets. However, this analysis also points out how intertwined the economies of the euro zone are, even if only through the monetary union, not to mention the mechanisms of the solidarity budget. A Greek exit from the euro zone could therefore open a Pandora’s Box – and if other countries were tempted to imitate the Greek example, it is the euro zone as a whole that could go under.

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[1] The Eurosystem is the European institution that groups the European Central Bank and the central banks of the countries in the euro zone.

[2] On this point, see A. Delatte, What risks face the Greeks if they return to the drachma?, OFCE blog, 11 June 2012.

[3] The foreign debt designates all the debt that is owed by all a country’s public and private debtors to foreign lenders.

[4] This refers to a textbook case, where the drachma’s depreciation would be so great that the currency would no longer be worth anything.