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"Economic reforms in the euro area: fiscal and macrostructural challenges"

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Abstract

The euro area economic situation appears stabilized as concerns about the future of the common currency vanish. Despite this significant improvement, euro area economies have still to recover from the crisis. 2013 Country Specific Recommendations propose a way out of the crisis, mainly based on structural reforms and the continuation of fiscal consolidation. We argue here that fiscal consolidation has been a factor explaining poor economic performance for the years 2010 to 2012 and will probably again be a negative factor for the years 2013 and 2014. Ease of the fiscal consolidation path is not sufficient for allowing a clear decrease in unemployment, at least for southern countries. Fiscal consolidation may have been the very reason why the euro area debt crisis was overcome, but implicit debt mutualisation is a concurrent explanation. Debt mutualisation necessitates a long term credible commitment toward debt and unemployment reduction. 2013 CSRs propose some structural reforms for improving growth and reducing unemployment. Among them, labour market reforms and services sector opening is seen as a major tool for recovery. We point out that such line of reforms may be set on the wrong timing and is difficult to combine with strong fiscal consolidation. Fiscal consolidation pace could be slowed, especially for large negative output gap countries, allowing for unemployment reduction and prudent planning of structural reforms. It is also suggested that a narrative about growth and development could be a positive factor needed in CSRs.

1. Introduction: the main challenges for the euro area in the aftermath of the financial and economic crisis of 2008

The late Friedman (he was nearly 90 when interviewed about the euro) was not a believer of the euro area economic and political construction. His prediction was that the euro as a single currency was doomed to disappear 5 to 10 years after its introduction and that the project was not likely to survive an economic downturn.

Friedman was clearly not foreseeing the kind of crisis that we have been through, and the mere fact that the euro zone is still standing after a series of crisis and panics the size and the kind we have experienced during the last 4 years, is a proof that he was wrong. However, although political will to sustain the euro currency (to pay back euro denominated debt, to keep a single central bank and to preserve free circulation of capital inside and outside the euro area) has been well demonstrated, the consequences of the crisis on both economic social developments are heavy. The trust in Europe has never been so low (according to the latest Eurobarometer, "trust in European Union" and "trust in national parliaments or governments" are at the lowest level since 2004, the main concerns being unemployment (according to 51% of EU population) and the economic situation (according to 33% of EU population).

This briefing paper recalls in the first section the economic situation of the euro area. Based on the work of a team of economists, the 2013 iAGS (independent Annual Growth Survey, see box 1); it then presents a causal explanation of this situation. The last part of the briefing paper deals with the Country Specific Recommendations (CSRs).

Box 1. iAGS

The iAGS seeks to irrigate and inform the public debate on economic strategy in Europe. Sustainability of public debt, fiscal adjustment and exit strategies from the recession will be fundamental concerns in years to come. These issues are complex and cannot be addressed with off-the shelf or one-size-fits-all expertise. Instead, an open and in-depth analysis of hypotheses, empirical evidence, options and foreseeable consequences of possible policies is required.

iAGS highlights topics, topics that often go overlooked, yet are essential, such as the role of monetary policy in the policy mix, the social consequences of the crisis, the importance of public investment. The project tackles public finances, unemployment, public debt, and formulates alternative and more efficient strategies that can move the economy towards balanced economic growth while maintaining price stability and full employment and preserving social progress.

The iAGS 2013 report is available on www.iags-project.org (Andersen et al., 2012). iAGS 2014 will be published in late November 2013.

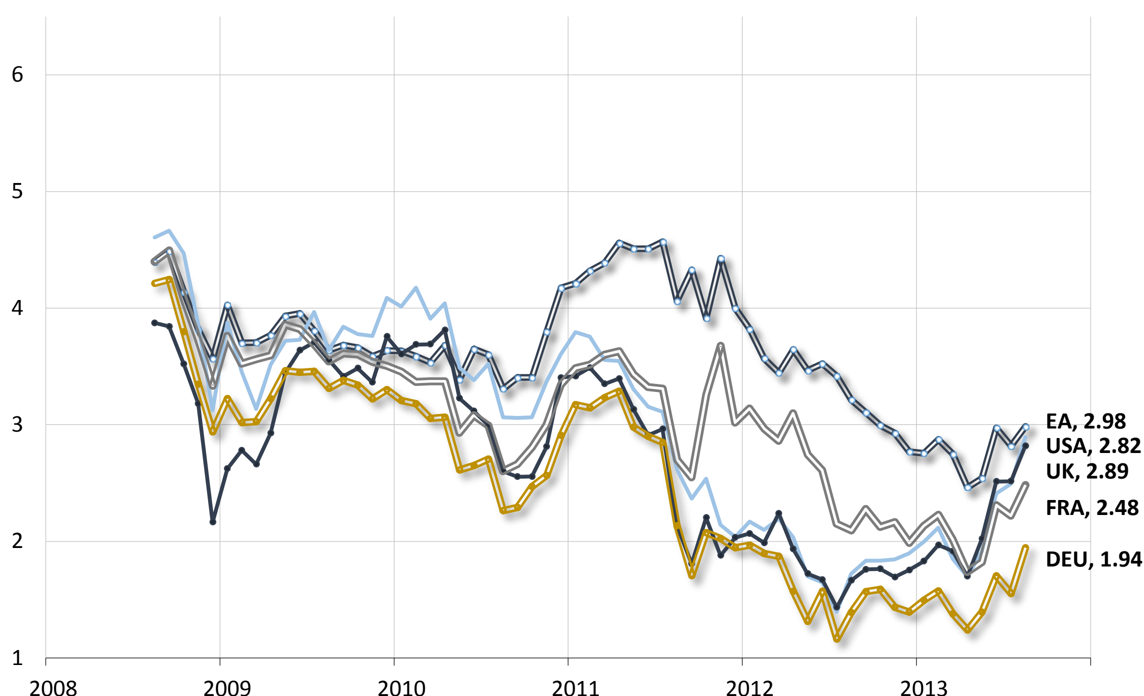
2. The current situation of the eurozone

The following figures summarize the situation of the Eurozone from the financial markets point of view. The Euro area average sovereign bond rate (the price at which a government can borrow), is today near the USA or UK ones, after 2 years of very large divergence (up to 200 basis points). The exchange rate trend or volatility can contribute to the spread, but the liquidity trap situation after the deepening of the crisis in 2011 has led to lower rates for "safe" sovereign bonds and an increase of rates for unsafe bonds (or at least perceived as unsafe). On average, Euro Area

(EA) , bonds rates have been far superior than rates of the UK or US during the euro area debt crisis, despite very low rates for some countries (German rates have been negative in real terms).

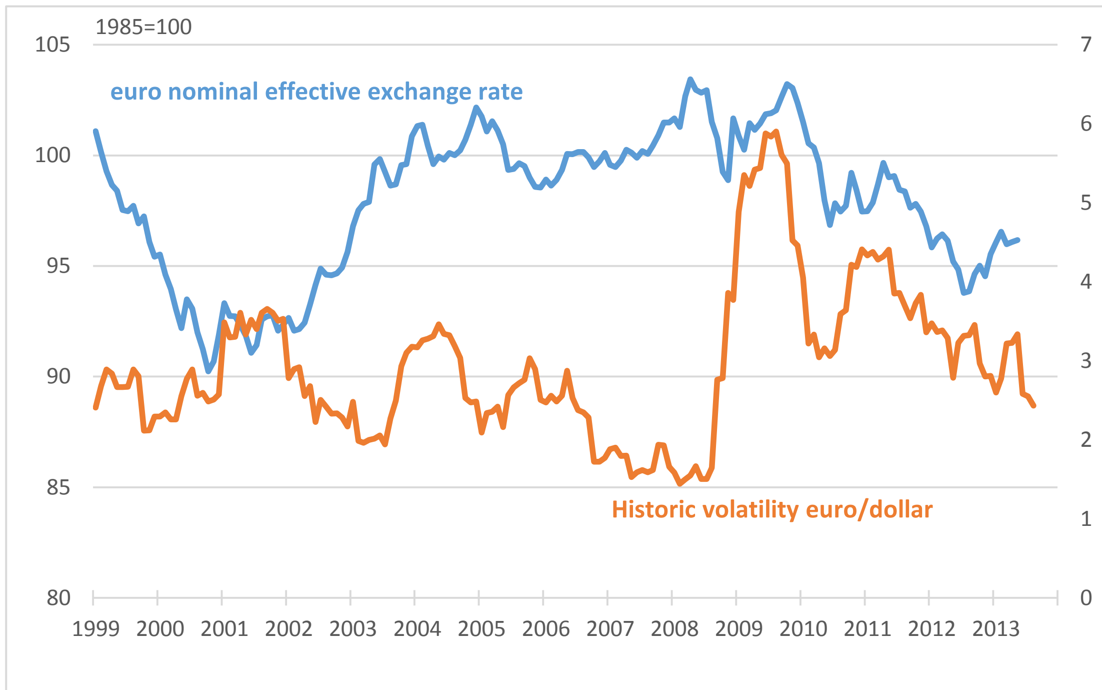
Inside the euro area, spreads have been very high. In July 2012, Italian and Spanish bond rates were respectively 500 and 600 basis points higher than German rates. Lately those spreads have been reduced to around 250 basis point, showing a progressive normalization of the situation even if not a return to zero spreads as experienced before the crisis. This concur to show a renewed trust in the euro. Commitment toward the continuation of euro without any exclusion of any country, including Greece, is now seen as credible. The effective exchange rate of the euro (exchange rate weighted by trade flows) has been regaining some strength in the past months and volatility of the exchange rate, an important factor for the conduct of business strategies, is low again.

Figure 1. 10 years sovereign bonds yields



Source: Eurostat, and National Central Banks, author calculations. Average rate for euro area is the average rate for each member state weighted by its debt in euro in 2010. Rates for Greece, Ireland and Portugal are non-market rates, set to 5% since resp. June 2010, November 2010, March 2011 and 3.5% since March 2011.

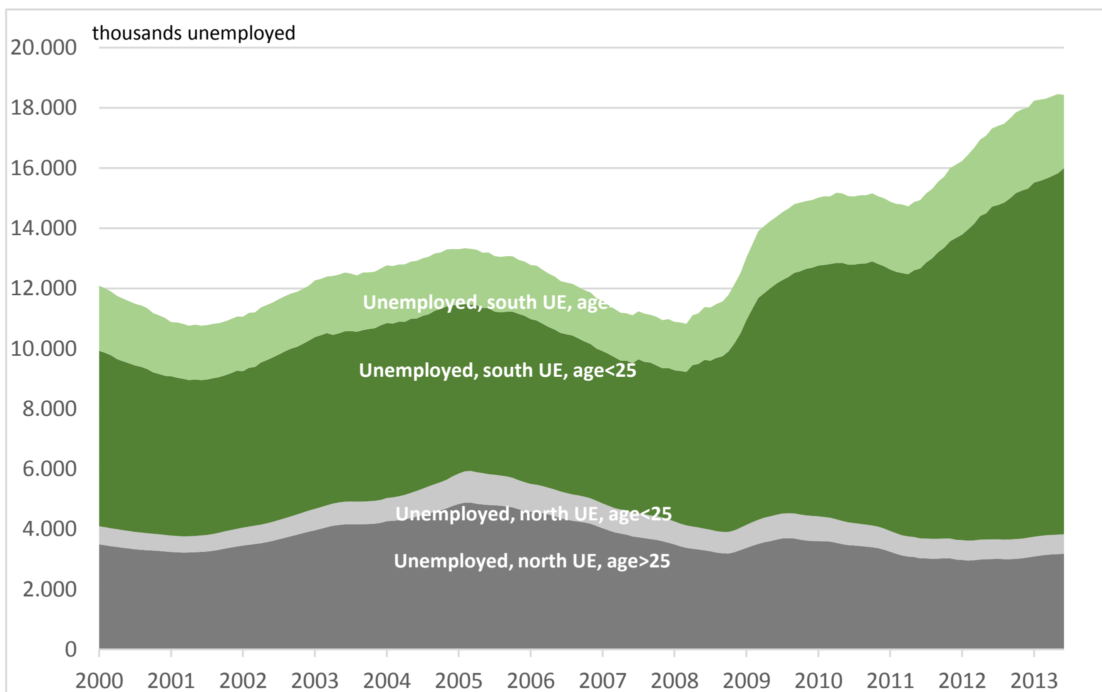
Figure 2. Euro effective exchange rate and euro-dollar volatility



Source: Nominal effective exchange rate from IMF, euro dollar exchange rate from ECB, author calculations. Volatility is a 1 year moving window standardized error.

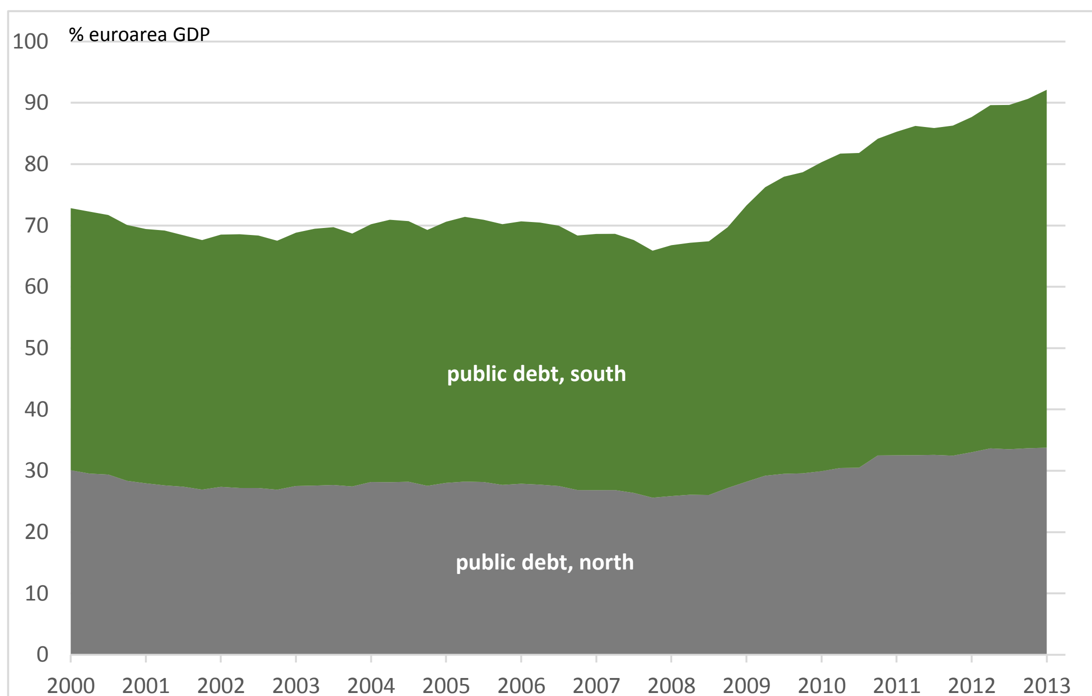
The figures below show unemployment and debt levels divided into "south" and "north" EU (see notes of figure 3 for a definition). Unemployment is, by far, the first issue of importance for people of the EU. Abnormally high levels of unemployment have strong social consequences on youth unemployment, long term unemployment, the poverty rate and social cohesion.

Figure 3. Unemployed, break down by age, south and north euro area



Source: Eurostat, quarterly labour force statistics. South is defined as France, Italy, Spain, Portugal, Greece, Slovenia, Cyprus, Malta, Slovakia. North is defined as Germany, the Netherlands, Austria, Belgium, Finland, Ireland, Luxembourg, Estonia.

Figure 4. Euro area public debt to GDP ratio



Source: Eurostat, quarterly government finance statistics. South is defined as France, Italy, Spain, Portugal, Greece, Slovenia, Cyprus, Malta, Slovakia. North is defined as Germany, the Netherlands, Austria, Belgium, Finland, Ireland, Luxembourg, Estonia

Public debt increased sharply due to the crisis. The fall in GDP induced a fall in tax and non-tax income for governments, automatic spending stabilizers and stabilization plans increased public deficits. In some countries, socialization of private debt (mainly through bank rescues) also contributed to increase public debt. Overall, the increase in the public debt to GDP ratio is more than 20% of GDP. It has reached more than 50 GDP points in Spain, Greece and Portugal. The increase of the debt-to-GDP ratio has been nearly 100% in Ireland (table 1).

Table 1. Euro area countries public debt to GDP ratio increase

	FR	SP	ITA	DEU	NLD	GRE	PRT	IRL	BEL	AUS
2013Q1 MINUS 2007	26.5	50.0	24.5	14.0	24.9	53.7	59.3	99.4	16.4	8.7

Source: Eurostat, quarterly government finance statistics.

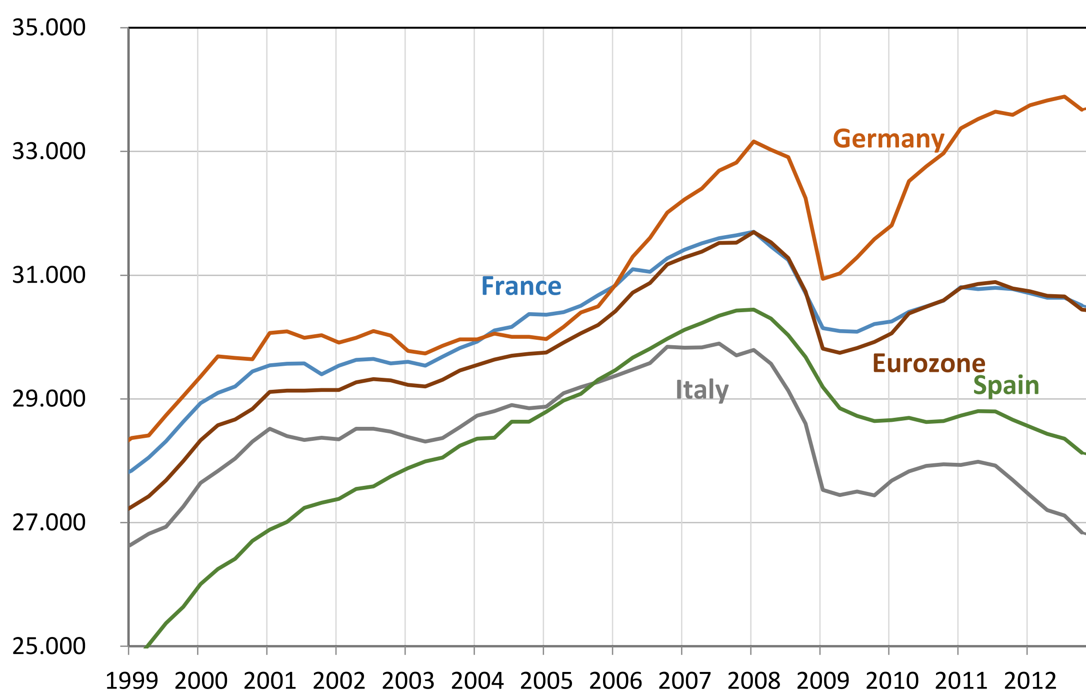
Moreover, the fall in real GDP per capita has been significant for euro citizens. The fall is spectacular for Spain and Italy. On the other hand, the recovery in Germany is nearly complete. Combining figures 1 to 5 shows a large gap between northern and southern countries. In the former, the economic and financial crisis of 2008 has led to a stagnation of GDP per head, no change in unemployment and a modest increase in public debt (slightly more than 10 percentage points of GDP). On the contrary, in southern countries, the level of activity has collapsed since 2009, with the consequence that unemployment and public debt are much larger. France is in-between South and North. The reduction in GDP per head is lower than in Italy or

Spain, the increase in public debt is more controlled than in most southern countries and sovereign bond rates, as in Germany, are kept at a low level.

Figure 5 shows an interesting pattern. After the initial fall in activity per head in late 2008 early 2009, Spain and Italy experienced a second collapse of activity per head, starting in 2011. This is what has been called the euro public debt crisis and one of the symptoms was a more difficult access to financial markets, as sovereign spreads with Germany indicate. But another factor explaining the reduction of GDP per capita is the increased structural effort to reduce public deficit. Table 2 reports structural deficit changes (see the note of table 2 for a definition).

In most countries, but specifically in southern ones, a huge effort has been undertaken in 2011 and in 2012 towards a deficit reduction. Never, since World War II consolidation plans of this size were voted and implemented. The latest approved finance laws indicate that the fiscal consolidation will go on during the year 2013. In some countries, the effort will be in the same magnitude as it was in 2011 and 2012, adding an extra year of huge consolidation. In Greece, Spain, France, Portugal, the Netherlands or Italy, voted (in 2012 or before) packages imply a structural effort that will largely go beyond 1 per cent of GDP. Income tax, VAT increases, public spending cuts, reduced social protection: every kind of measure has been triggered, leaving no room for more long-term and growth-friendly reforms to take place. Structural reforms usually don't produce positive results in the first stages of application and call for compensation of losers. For the euro area as a whole, consolidation will be lower in 2013 (1.1 % of GDP) than what has be done in 2012 (1.9% of GDP), but will exceed 1% of GDP.

Figure 5. GDP per capita, larger euro area countries



Source: volume GDP from Eurostat, population estimates from Eurostat, purchase power parity indexes for the year 2005 from World Bank. GDP per capita is GDP at constant 2005 prices, divided by ppp index, divided by population.

Stimulus packages were implemented in the first years of the economic and financial crisis and consolidation is, in a way, a reverse action after such stimulus. In a large number of euro area countries, however, cumulated 2008-2012 structural

deficit variation has been negative, showing since 2008 a negative fiscal stance. In some countries, the cumulated structural deficit reduction exceeds or is near 2% of GDP and could be even more important when consolidation for 2013 is included.

For some countries (mostly northern euro area: Germany, Belgium, Finland), the cumulated fiscal stance since the beginning of the crisis is neutral. So part of the divide between the South and the North is embedded in cumulated fiscal stance.

Table 2. Structural deficit variation

%GDP	**2008**	**2009**	**2010**	**2011**	**2012**	**2013 (f)**	**2008-12**	**2008-13**
Germany	0.1	0.6	1.4	-1.4	-1	0.1	-0.3	-0.2
Austria	-0.1	0.3	0.7	-1.5	-0.3	-0.6	-0.9	-1.5
Belgium	0.6	1.9	-0.1	0	-1.5	-0.5	0.9	0.4
Spain	2.4	2	-1.4	-1.5	-3.4	-2	-1.9	-3.9
Finland	-0.8	0.4	1.3	-0.9	0	-0.8	0	-0.8
France	-0.6	2.3	-0.6	-1.9	-1.3	-1.8	-2.1	-3.9
Greece	3	3.2	-7.6	-5.5	-3.9	-3.9	-10.8	-14.7
Ireland	4.9	2.2	-4.2	-1.5	-1.8	-1.9	-0.4	-2.3
Italy	-0.5	0.9	-0.6	-0.2	-3.1	-1.4	-3.5	-4.9
Netherlands	-0.4	4	-1.1	-0.4	-1.4	-1.7	0.7	-1
Portugal	-0.1	5	-0.3	-3.7	-3	-2.1	-2.1	-4.2
EA 11	**0.2**	**1.6**	**-0.3**	**-1.3**	**-1.9**	**-1.1**	**-1.7**	**-2.8**
USA	3	3.5	-1.1	-1.1	-0.9	-1.6	3.4	1.8
UK	1.7	4	-2.2	-3.3	-0.9	-1	-0.7	-1.7
Japan	-0.9	4.8	0.5	0.2	0.6	1.9	5.2	7.1

Source:Eurostat, National Accounts, OFCE estimates of potential growth. Structural deficit variation (aka cyclically adjusted public deficit) is the deficit variation that would have occured, given output gap would have not varied. Elasticity of public deficit to output gap is supposed to be 0.5.

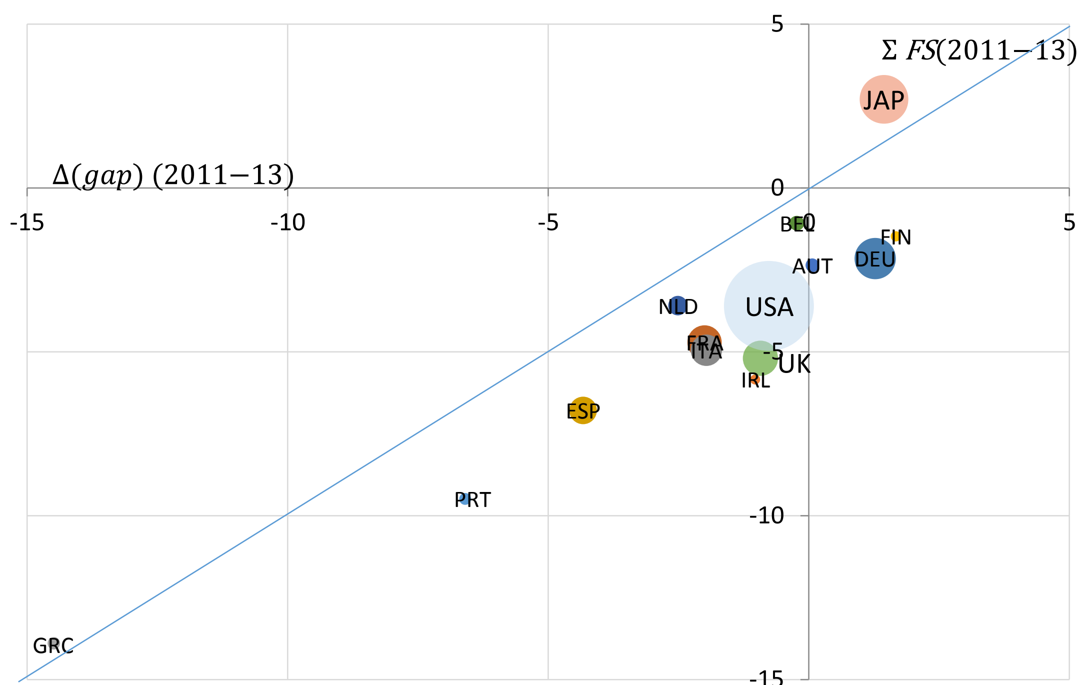
There has been a vivid debate on the link between the fiscal stance and economic activity. This debate refers on the one hand to the fiscal multiplier debate and on the other hand to the consequences of a high debt to GDP ratio and the possibility of loss of access to financial markets to roll over public debt.

On the first matter, the quotation from Blanchard and Leigh ((Blanchard & Leigh, 2013) is enlightening: "*We find that, in advanced economies, stronger planned fiscal, consolidation has been associated with lower growth than expected (…). A natural interpretation is that fiscal multipliers were substantially higher than implicitly assumed by forecasters. The weaker relation in more recent years may reflect in part learning by forecasters and in part smaller multipliers than in the early years of the crisis.*" The intuition is that, although fiscal multipliers are close to zero in normal times (at least when one considers a large enough period of time), they are possibly non-zero in crisis time (some estimate them to be larger than 1.5). The main explanations are loss of access to financial tools for a growing number of economic agents (who cannot smooth consumption or investment), zero lower bound for interest rates (referring to the liquidity trap definition by Paul Krugman (see (Krugman, Dominquez, & Rogoff, 1998)) or expectations in a framework of multiple equilibria (see (Creel, Heyer, & Plane, 2011; Heyer, 2012) for a recent review of literature on fiscal multipliers).

Figure 6 illustrates that intuition: there is a clear link between the change in the output gap (a way to measure the extent of the recession) and the fiscal stance

(cumulated from 2011 to 2013 on the graph, to get rid of non-fiscal policies induced reduction in activity that occurred in the first steps of the crisis).

Figure 6. Fiscal stance and output gaps



Source: OECD, Economic outlook n°92. Author calculation. Output gap is the ratio of GDP to potential GDP minus 1. X axis uses variation of output gap (as measured by OECD) between 2011 and 2013 (so gap(2013)-gap(2010). Fiscal stance is the structural deficit variation (cyclically adjusted public deficit). Y axis uses cumulated fiscal stance for the years 2011 to 2013. It is thus the variation of structural deficit from 2010 to 2013. A positive fiscal stance indicate an expansionary fiscal policy.

The issue of market access is a difficult one. Loss of access to financial markets, as Greece, Portugal or Ireland have experienced, leaves no room for anything. As huge amounts of debt are to be rolled over, if one cannot take up new loans, then there is no other solution than to cut spending, force taxation and accept a profound recession. In that sense, a fiscal consolidation aimed at keeping access to financial markets is a way to avoid a deep crisis and, when defined in relation with this counterfactual, one can say that the fiscal multiplier is largely *negative.* In that sense, fiscal consolidation undertaken in 2011 and 2012 and prolonged in 2013 is a way to insure that financial markets are confident enough to continue lending to heavily indebted states and has been a success so far, because trust is back in financial market as was stated earlier in this briefing paper.

But, this analysis relies on a very specific counterfactual. Mutualisation of public debt is an answer to loss of access to financial markets by some countries. It is highly unlikely that all countries lose access to financial markets, because savings, denominated in euro, are in need of securities to be invested in. However, inside Euro savings can flow to any euro area country. If savers or investors don't want to hold Greek bonds, then the financial system (and probably the central banks) has to compensate for that and finance Greek government or the Greek banking system.

In a situation of liquidity trap, flight to security (the premium one is ready to accept in exchange for absolute security) directs the flow of savings on safe bonds. A way to make public bonds safe is the central bank guarantee on such public bonds. Up to September 2012, the euro area was a very peculiar institutional framework because

investors (holding euros and wanting euro denominated assets) were in position to make arbitrage between different bonds of euro denominated public debt. They could choose to hold either German bonds or Greek bonds. This led to a beauty contest between public bonds which was not far from causing the end of the euro. One of the consequences was higher borrowing costs for Spain or Italy, imposing market discipline in the hard way on those countries, and lower borrowing costs for Germany, France or Austria. Virtue was granted that way, but euro continuation was (and still is) a cost to some countries while it brings interest payments reduction in others. It may seem natural that market mechanisms are used to allocate funds between more or less risky assets, even when those assets are public bonds. The euro debt crisis has shown that that kind of mechanism could lead to the collapse of a country, as illustrated by Greece. Another risk is the incentive to silently go out of the euro area, by restraining the free movement of savings. As a matter of fact, that solution was implemented during the Cyprus crisis, forbidding internal savings to leave the Cyprian banking system. That kind of scenario is plausible for countries like Spain or Italy and is a threat to the continuation of the euro, as it would conflict with the principle of free movement of capital inside the monetary union.

Public debt in the USA or in UK is not subject to such arbitrage possibilities and appears as the safest asset available on the market. Germany was thus able to enjoy lower rates than USA, up to 50 bp. Moreover, even when US public debt is considered as more risky (US sovereign credit rating was downgraded in August 2011), the price on the debt can decrease. The reason is that it is relatively to other assets less risky when the economic situation is worsening.

When there are no more possibilities of arbitrage between euro denominated public bonds, then, the probability of market access loss is radically different and fiscal multipliers follow the course indicated in the first point.

Table 3 displays simulation conducted with the model (see Model for euro area medium term projections) developed for the iAGS report (see http://www.iags-project.org for more information and (Andersen et al., 2012)). The present fiscal path is evaluated based on projected fiscal consolidation and based on an evaluation of fiscal multipliers that are high when unemployment is high and are zero when unemployment is at the equilibrium level. For the years to come, fiscal multipliers are supposed to be high because the rate of unemployment is high in 2012 and will not decrease rapidly (the speed of reduction is linked to rate of growth of GDP). More details are available in (Cochard & Schweisguth, 2013). The alternative fiscal path is built on a neutral fiscal stance in most countries, except the ones with a very large deficit (mainly Spain, Greece and Portugal). In those countries a mild fiscal consolidation is conducted up to 2017. The simulation is based on a non increase of sovereign interest rate. In fact, the hypothesis is one of a “normalization” of interest rates, that is to say a reduction in the spread and a global increase toward a real rate of 2%.

Table 3. alternative fiscal stance for the euro area 2013-2017

PRESENT FISCAL PATH	2012	2013	2014	2015	2016	2017	debt peak
GVT BALANCE	-3,7%	-3,4%	-2,9%	-2,0%	-1,5%	-0,9%	
GVT DEBT TO GDP	93,3%	95,7%	96,1%	95,9%	95,1%	93,7%	2014
FISCAL STANCE	-	-0,7%	-0,5%	-0,5%	-0,4%	-0,4%	
ALTERNATIVE FISCAL PATH	**2012**	**2013**	**2014**	**2015**	**2016**	**2017**	**debt peak**
GVT BALANCE	-3,7%	-3,4%	-3,0%	-2,2%	-1,7%	-1,3%	
GVT DEBT TO GDP	93,3%	95,7%	96,0%	95,5%	94,5%	93,3%	2014
FISCAL STANCE	-	-0,9%	-0,2%	-0,2%	-0,2%	-0,2%	

	GDP GROWTH		INFLATION RATE		UNEMPLOYMENT RATE	
	2013-2017	**2013-2017**	**2012**	**2013**	**2014**	**2017**
PRESENT FISCAL PATH	1,0%	1,3%	11,4%	12,3%	12,1%	11,7%
ALTERNATIVE FISCAL PATH	1,3%	1,4%	11,4%	12,4%	12,0%	10,8%

Source: iAGS model simulations, Cochard and Schweisguth 2013.

The simulations show that when fiscal multipliers are high, the implicit cost in term of unemployment of a small reduction in public deficit is high. For a reduction of a public deficit from 1.3% to 0.9% in 2017 and of a public debt by 0.4% of GDP, one needs to accept a 1 percentage point increase in the euro area unemployment rate. In some countries the difference in unemployment rate between the two scenarios can be huge (2 points for France, see Cochard and Schweisguth (2013)).

3. **Assessment of the 2013 CSRs**

The European Council adopted in July 2013 Country Specific Recommendations (CSRs) which are supposed to address the macro economic challenges at stake. This section is devoted to comment those CSRs and to provide with an opinion about their adequacy to the current euro area situation. The comment will focus on the largest countries (Germany, France, Italy, Spain and the Netherlands) and will neglect countries under an Economic Adjustment Program (Greece, Portugal, Ireland and Cyprus). Even if the 2013 CSRs deal with more structural issues and attempt to broaden the scope of economic policies, fiscal consolidation appears to me as a central point, so the first subsection develops this analysis. The second subsection will deal with the banking union and financial stability. The third subsection quickly addresses the social consequences of the crisis and the fourth subsection is about deflation risks. The last subsection concludes on more political questions.

Fiscal consolidation

The analysis presented in the first part of this briefing insists on the impact of fiscal policy on economic activity. Some observers have mentioned that underestimating fiscal multipliers may have led to engage to quic k (front loaded) consolidation paths after the first stage of the economic crisis was over. Moreover, as was mentioned earlier, setting targets of public deficit in terms of actual deficits and not structural

efforts was even amplifying the front loading of consolidation, deepening the crisis and fostering doubt about the sustainability of public debt for largely indebted countries.

The 2013 CSRs are falling into the same trap, even though a reference is made systematically to Medium Term Objectives (MTO), which set an objective as a structural deficit (a balance between +1 and -1 for cyclically adjusted deficit). The following table recalls for the main countries what are the 2013 CSRs:

Table 4. CSRs for deficits and medium terms objectives

	EDP EXIT	MTO	PUBLIC DEFICIT			CYCLICALLY ADJUSTED DEFICIT		
			2012	2013	2014	2012	2013	2014
GERMANY	.	.	0.2	-0.2	0	-1.2	0.2	0.4
FRANCE	2015	2016	-4.8	-3.9	-4.2	-4.5	-3.5	-2.1
ITALY	2013	2014	-3	-2.9	-2.5	-2.9	-1.3	-0.7
SPAIN	2016	2018	-10.6	-6.5	-7	-7.5	-8.4	-4.3
THE NETHERLANDS	2014	2015	-4.1	-3.6	-3.6	-3.7	-2.6	-1.8
BELGIUM	2013	2016	-3.9	-2.9	-3.1	-3.7	-3.4	-1.9

Source: 2013 CSRs, European Commission evaluations of cyclically adjusted deficit, spring 2013, retrieved on http://ec.europa.eu/economy_finance/db_indicators/gen_gov_data/documents/2013/ccab_spring_en.pdf. EDP stands for Excessive Deficit Procedure, MTO stands for Medium Term Objective.

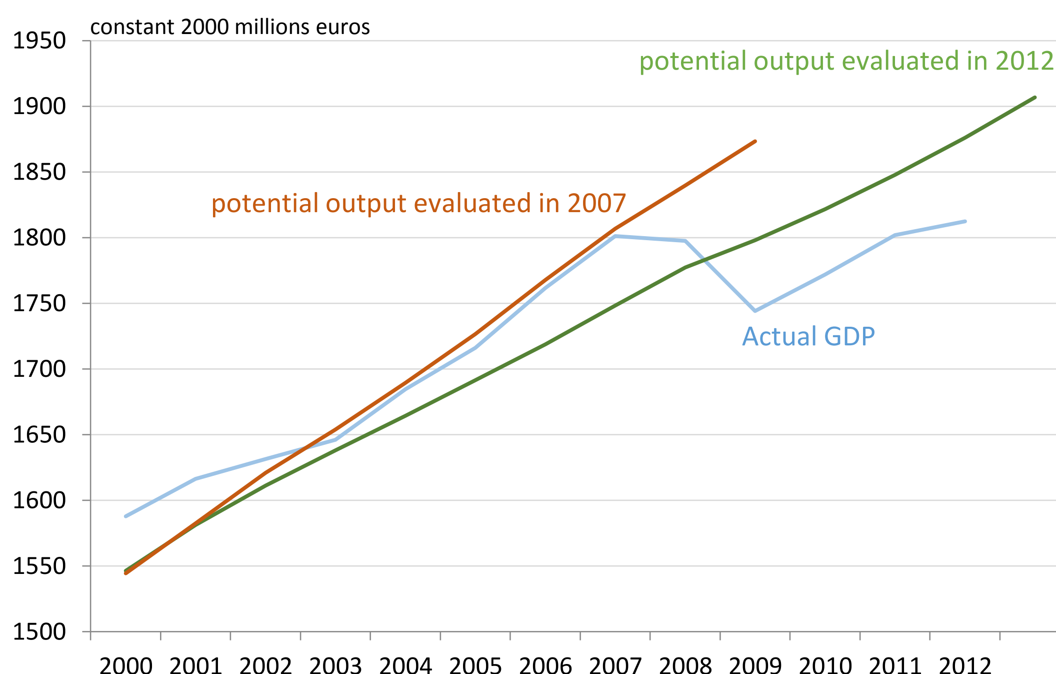
Countries need to pursue two targets, the first one being getting below 3% actual deficit before a certain date. For France, this implies a continued effort in reduction of the deficit in 2014 and 2015. Besides, as this is a nominal target (and not a structural one), higher multipliers than expected would imply a much larger *structural* effort than estimated currently by European Commission (EC). Simulations based on the iAGS model and reported in table 3 suggest that the structural effort for France should be of 1.3 % of GDP in 2013, 0.8 both in 2014 and 2015, in order to reach the 3% target, based a larger and probably more reasonable estimation of fiscal multipliers (1.0). This is less stringent than reaching the 3% target by 2013, as was agreed in the stability program for France voted in November 2012. This indicates an easing and an adaption of fiscal policy to the current situation as the Council has decided. Nevertheless, there is again a risk of not reaching the target by the year 2015. Neglecting the impact of fiscal multipliers, adverse shocks may then fuel doubt whereas France apply a voluntary path toward consolidation. On the opposite, if growth was higher than expected, and despite explicit notification of the opposite, unexpected windfall gains would probably not be affected to deficit reduction.

The same line of reasoning applies to Spain, The Netherlands and Belgium. The case for Spain is potentially even more dramatic as (1.) the current public deficit is larger for Spain, (2.) the risks of an unexpected increase in public deficit or debt are higher. For Spain, and for the next few years, the fiscal consolidation path should have been set as a structural effort with a more reasonable pace (1% of GDP of annual reduction of structural deficit for Spain, 0.5% of GDP for countries with lower debt and deficit).

Simulations conducted with the iAGS model, based on values of fiscal multipliers depending of the output gap, in the range of 1 to 1.5, show that this alternative fiscal stance would allow for a quicker reduction of unemployment rate and would end in close (but superior) ratios of debt to GDP.

Regarding MTO, the CSRs are setting precise years for the fulfilment of objectives. Those target years are different from one country to another, applying the Council specification that the fiscal consolidation path should be different for each country. It may seem that a structural target avoids the pitfalls of having an actual (or nominal) deficit target and thus prevent the potentially amplifying effect of wrongly estimated fiscal multipliers or of adverse shocks to the economy. Nevertheless, one should keep in mind that structural deficit evaluation relies on potential growth evaluation and that a memory effect is polluting those evaluations. It appears that evaluations of past potential growth are dependent on the present state of the economy. If multipliers are under estimated, then, growth is lower than expected and that is interpreted as a reduction in potential growth. For instance, potential growth estimates have been largely revised since 2007 and potential growth series display a large and unexplainable time variance. Figure 7 displays the evaluation of potential growth by OECD in 2007 and in 2012. Structural deficit revision for the year 2007 was from equilibrium (0% of GDP) as evaluated in December 2007 to a deficit of 1.6 % of GDP evaluated today. Such a revision illustrates the dependency of structural evaluation to the current state of affairs.

Figure 7. evaluations of potential output by OECD for France



Source: OECD economic outlook n°91 and 82

As a consequence, a less than expected growth for the years to come, up to the MTO fulfilment target, due for instance to higher than expected multipliers would induce a downward revision of potential growth and structural balances and would imply an extra effort to fulfil MTO.

There is no easy solution to this question, but it would be wrong to consider that adding the word structural to an objective for two or three years from now suffices to get rid of nominal targeting danger. In that sense, 2013 CSRs are not a fully satisfying answer.

Banking union and financial stability

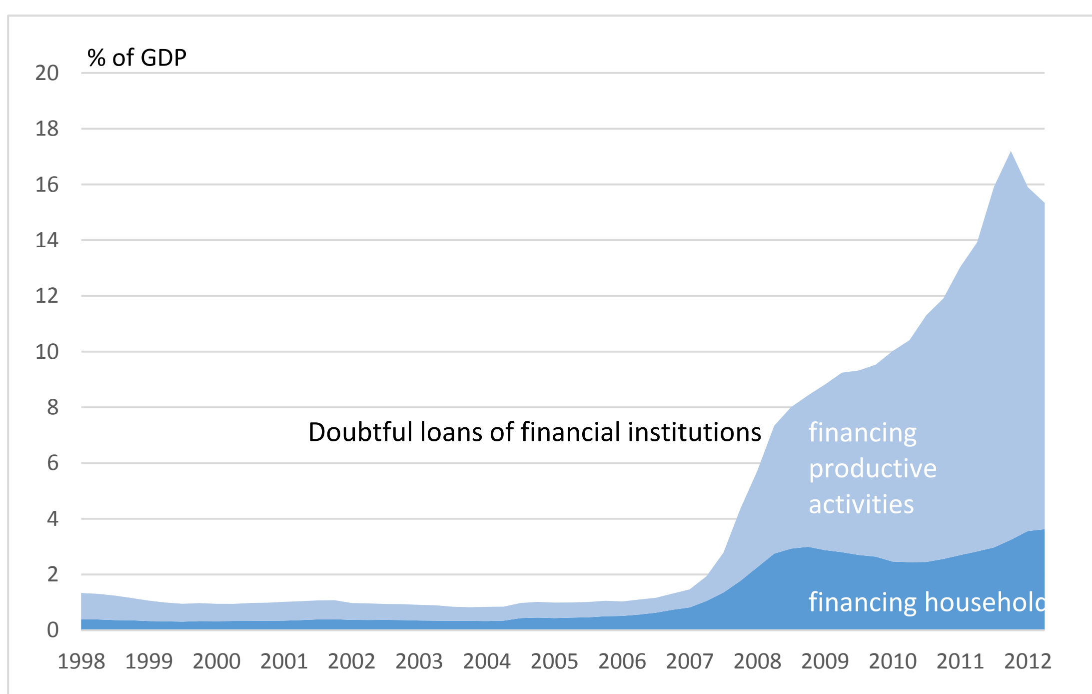
Banks were a weak point of the economies in 2008. Insufficient capital requirements and insufficient regulations are usually considered as factors of the economic crisis of 2008. Implementation of more stringent regulations seems legitimate based on that analysis. But 2 more points are to be made.

Firstly, monitoring of banks and contingency plans for banks failures, ability to reallocate assets and liabilities of failing banks are an alternative to large bailing out schemes which present the default of generating moral hazard risk. Being able to bail in a bank without any systemic transmission appears as a necessary device in a modern economy. That implies also that regulation, monitoring and bank crisis scheme have to be conducted at the eurozone level.

Secondly, there may be still bad debt located in Eurozone banks. Spanish banks are exposed to such dangers especially if unemployment rate stay high and if interest rates increase. A large share of Spanish households is indebted with variable rate loans. The liquidity trap situation and the lower benchmark rates used for calculating variable rates means that interest payment have been minimized, but a normalization of such rates could induce a surge in the default rate on private debt. That would foster stress on banks and could end in more public debt. A functioning banking union is a way to mutualize this debt and therefore avoid its concentration on the already high and untrusted Spanish debt. Wage deflation (see below) could be another factor triggering an increase in the default rate of Spanish households.

Figure 8 shows the magnitude of the problem in Spain. Doubtful loans account for more than 15% of GDP. Recent restructuration in banks assets and productive sector liabilities has allowed a significant reduction in the amount of doubtful loans, but a lot remains and casts a shadow on the banking sector. Moreover, household bad loans have not been addressed and are rising, increasing by more than 0.5% of GDP over the last semester.

Figure 8: Doubtful loans for Spain banking sector



Source: Bank of Spain, INE

Addressing the social consequences of the crisis

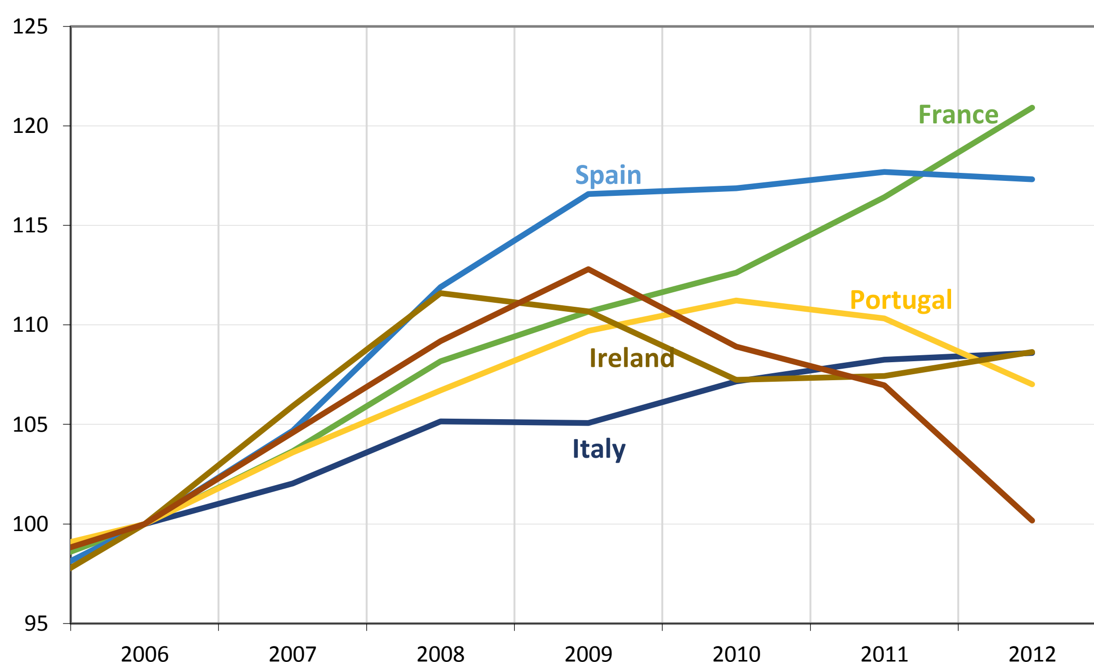
It is largely pointed out in the 2013 CSRs and in the euro area recommendations that the social consequences of the crisis are to be addressed, especially in southern countries. The social and political risk is high, and the Eurobarometer is showing a growing discontentment among populations exposed to the crisis. Moreover, long term consequences of the crisis will be shaped by loss of human capital, hysteresis on labour markets, unfairness in fiscal and social systems, and lower public investment.

However, CSRs may neglect one point. As mentioned when discussing fiscal multipliers, there is an arbitrage between reducing public deficit and debt and addressing the social consequences of the crisis. The CSRs rely implicitly on a prioritization of conflicting targets whereas the right way would be a balanced approach. Some measures can be taken with no fiscal impact to soften the social crisis. Reordering queuing line in job access, by reducing labour market segmentation, is one. But it is more a way of sharing misery over more people (making it more bearable) than a way to solve the problem. Pension reforms can also be analysed in that way, being a way to put the fiscal burden on older generations, limiting the direct consequences on working population. Such policies go very deep in questioning the social contract of each member states and should not be presented as inevitable solutions to the crisis.

Deflation risks

High unemployment in southern euro area is bringing wage deflation. Wage deflation is now a measurable phenomenon at the macro level as Spain, Greece or Portugal are showing (see figure 9). This wage deflation is going to bring competitiveness to those countries, which they presently lack. It could be considered as a normal and plain adjustment of macro imbalances in the euro area.

Figure 9. Wages per head in euro area



Source : Eurostat, Nominal wages per worker, all economy, 100 in 2006

Past episodes of wage deflation show that it is not an effective adjustment. Nominal decreases in wage income induce debt deflation à la Fisher, as households debt contract are usually non inflation neutral. The rat race between open economies for competitiveness leads to further deflation and in the end no competitiveness gain (the aim of the single currency was to promote price stability as a factor facilitating the fair quest for competitiveness). Wage deflation threatens social acceptance of inequalities (often seen as one of the initial factors of the economic crisis of 2008) and asks for more adjustment (in minimum wage, in pension or social income level, in fiscal system). Wage deflation moreover favours the owner over the worker.

The IMF Chief economist (Blanchard, Dell'Ariccia, & Mauro, 2010) and coauthors were recently pleading for more inflation as a way to get out of the crisis. That alone should be enough to understand the dangers of wage deflation

2013 CSRs for several countries point that labour market reforms, desindexation of wages or of social protection schemes and active unemployment policies are to be undertaken, considering the unemployment level and lack of competitiveness. Increased competition in the services sector may also have an indirect impact on wages, labour market participation or unemployment. Even though it is quite consensual that such reforms have positive long term impacts and that they are important to reduce labour market duality and rigidities, in the short term such reforms may increase the downward pressure on wages. There is, in my opinion, some danger to insist for the years to come on such reforms as their impact is not the same in an economy with a low rate of unemployment and in one with a high one.

Table 5: Labour market recommendations, 2013 CSRs

	DIRECT	INDIRECT	TAXATION
BELGIUM	Wage setting system, reduce disincentives to work	Competition in Service sector	Tax burden from labour to other basis
SPAIN	Continue 2012 reform, reskilling, monitoring of job seekers	Law on market Unity	
FRANCE	Professional agreement on competitiveness, target active policies to most disadvantaged, labour market segmentation, reform of benefit system	Enhance competition in services	
ITALY	Wage setting, increase labour market participation	Market opening in services	Tax burden from labour and capital to consumption, property and environment
THE NETHERLANDS	Participation on labour market	Labour market rigidities	reduce taxation of second earner
AUSTRIA	labour market participation	Federal competition authority	Tax burden from low work income to other basis
GERMANY	Wage growth (lower social contributions and high taxes), second earner participation	Competition in Service sector	

Source: 2013 CSRs

Moreover, as a recent report from International Labour Organization points out ((ILO, 2013)) labour markets after the crisis have been weakened by high unemployment and consolidation efforts. In that context, labour markets reforms should by no mean increase the pressure of competition or the incentives to find a job when unemployed. When unemployment is far from equilibrium level, such measures can indeed weaken even more the position of workers and unemployed.

A point can be made in proposals aiming at shifting tax burden from work (either overall or low income workers). Such reforms of course tend to increase employment through capital substitution and labour intensive consumption substitution and through competitiveness improvement. But, this is the point, competitiveness improvements are made at the expense of trading partners, who are still mainly euro area partners. By fiscal devaluation, as this process is usually understood, pressure on the same kind of policy or on wage deflation increases. Once again, the window of opportunity for such policy may be doubtful.

A political statement

In my opinion, CSRs may be largely improved by insisting on coordination of policies among euro area Member States. More than coordination, the feeling that a collective project in motion and that policies in each Member State are adding up to build that path is important. Several times in CSRs, mention is made of “growth friendly policies”. This expression lacks precise content and directions. Moreover, growth is of course a central outcome of economic policy, but low carbon economy, low unemployment, high social cohesion are also important goals for people. Part of such goals are included into the so called “Lisbon strategy” and it seems to me that CSRs should be articulated on such goals.

One example may help to understand the potential benefit from such an approach: many CSRs include service sector reforms in order to increase competition and openness. Transportation (road, train), electricity or energy distribution are the sectors concerned by opening and liberalization. But those sectors are also strategic sectors for the transition to a low carbon economy. They are also sectors where coordination among Member States is critical: interconnection of distribution network, interconnection of transportation network. So one way to move on those subject is to implement large scale projects, having as a target low carbon economy and as a tool market opening, instead of making market opening a goal, hard to understand and to accept as such by a lot of people.

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