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The argument for a Eurobond

A coordinated strategy for emerging from the crisis

By Frederic BONNEVAY

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THE AUTHOR

Frederic Bonnevay began his career with JPMorgan and Morgan Stanley in London. He currently advises financial institutions in Europe and the Middle East. He is an economist, an associate expert of the Institut Montaigne and a member of the *Cercle des fiscalistes* (Tax ExpertsôCircle). He has taught at Sciences Po and ENSAE. He is a graduate of the Ecole Polytechnique, Stanford University and HEC.

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FOREWORD

Almost all the advances made in the construction of Europe in the past 50 years have involved the partnership between France and Germany. At the time of the 12th Franco-German Council of Ministers held on 4 February 2010, Paris and Berlin reaffirmed their determination to achieve a strong and lasting rapprochement between the two countries by presenting the eighty proposals in the îFranco-German Agenda 2020ò.

The Institut Montaigne, through its constant commitment to the Franco-German locomotive, has itself contributed to this tendency through its many specific proposals contained in various publications. Recently, its work on the financial crisis (*Rebuilding the financial system in order to kick-start the economy* in March 2009, and *Between the "G2" and the G 20: Europe and the financial crisis* in September 2009) placed the accent on the necessary revival of Europe through reinforced co-operation between France and Germany.

The *Policy Paper* published in February 2010 goes a step further along the same path. The Institut Montaigne is in fact proposing that Germany and France implement a common fiscal strategy by creating a joint debt instrument in the form of a Eurobond. This would contribute to the renewal of the economic pact binding all the countries in the eurozone and would be a powerful instrument for emerging from the crisis on a high note, as Europe has always managed to do in the most difficult moments of its existence.

This being said, the beginning of 2010 finds all eyes turned towards Greece. Urgency rules: the speculative attacks against the euro are threatening European monetary construction as a whole. The governments of the Union are clear about this. They have to stand shoulder to shoulder. The proposal for a joint bond issue is not new, being at least as old as the single currency. But the context has changed radically. As for the mechanism proposed, it would have been possible to avoid such a setback if the Eurobond had already been in existence. It would have tightened the fiscal links among the European capitals by ruling out attacks on the securities of Greece or Portugal or Spain. It would have contributed to a convergence of financing, if only vis-à-vis the outside world.

Admittedly, when the bathtub is overflowing it is premature to be worrying about changing the plumbing ï the first thing to be done is to turn off the tap. Even so, this first indispensable move does not rule out giving consideration as soon as possible to the remedy to be put in place in order to avoid another catastrophe. This is precisely the proposal reached in the conclusion of this *Policy Paper.*

François Rachline
CEO of the Institut Montaigne
Professor at Sciences Po

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EXECUTIVE SUMMARY

1. The financial crisis of 2008, by abruptly worsening the latent imbalances between the European economies, revealed the considerable **fragility of the monetary union**. The Stability and Growth Pact showed its limitations, highlighting the need **for designing a new instrument for fiscal coordination, notably between France and Germany**. The object of this *Policy Paper* is to propose a coupling of French and German fiscal policies through the creation of a **Eurobond. This European debt instrument** would guarantee coordinated and transparent fiscal strategies and would make the common monetary policy once more fully effective.

2. **The single currency**, a powerful political symbol, was intended **to support economic growth by accelerating the integration** of the Common Market. (p. 12)

3. By establishing **criteria for fiscal convergence** between Member States with very heterogeneous economies, the Stability and Growth Pact aimed to limit the divergence of the national economies, this being the precondition for an effective common monetary policy. (p. 13)

4. **The Franco-German tandem** occupies a strategic place within the eurozone. The far-reaching interdependence of these two economies, coupled with their borrower quality, makes this pairing the cornerstone of monetary union. (p. 14)

5. In ten years, the euro has made it possible **to control inflation** and to invigorate intra-EC trade. The economic complementarity of the sixteen countries lies at the origin of a certain symbiosis between Member States, comparable to the Chinamerican tandem. (p. 15)

6. Another result is a certain **concentration of financial risk** around the Franco-German pole, which is supposed to guarantee the commitments entered into by all the Member States. (p. 19)

7. **The stimulus packages introduced following the financial shock of 2008**, blending **monetary activism** and **fiscal interventionism**, has resulted in a deterioration of public accounts throughout the western world. (p. 22)

8. The financing of this effort leaves countries facing a ñ**wall of debt**ò that is all the more threatening because of severe **tensions on capital markets** ï the result of disturbances linked to the interplay between supply and demand for sovereign paper. (p. 25)

9. **The French response** was orchestrated in two stages, around the stimulus package, short-term support for consumption and employment, and a National Loan, intended to promote long-term growth. (p. 34)

10. **The German public authorities,** on the other hand, were anxious to preserve their immediate room for manoeuvre, committing only a small amount of

expenditure and demonstrating their determination to contain their debt. (p. 36)

11. **The recent initiatives taken by Paris and Berlin** provide tangible but fragile guarantees of rapprochement. A lasting divergence between the fiscal orientations of France and Germany would constitute a **major threat** to recovery in the eurozone and would call into question the appropriateness of monetary union. (p. 39)

12. In order to restore the full effectiveness of the common monetary policy, a **fiscal coupling between France and Germany** must be founded on **reactive**, **coordinated** and **credible** public action. (p. 41)

13. In a first stage, **strategic investments common** to France and Germany will be undertaken. (p. 46)

14. Paris and Berlin, gradually joined by all the eurozone members, will agree on a **multi-annual financing strategy** and on the evolution of their debt policy. (p. 46)

15. **The creation of a Eurobond, a joint debt instrument,** initially Franco-German and then gradually extended to the other countries of the Eurogroup, will make it possible to maintain a competitive budgetary financing cost while removing any risk of moral hazard. (p. 47)

16. **The new device will replace the Stability and Growth Pact**. Eurobond auctions will be carried out by a **specially created agency** that will allocate the issuance volume in accordance with a precise calendar. (p. 48)

17. By obliging Member States to respect their commitments, this new instrument will make public action within the eurozone more credible and reactive. In the long term, **the Eurobond will replace national sovereign paper entirely**. (p. 48)

INTRODUCTION

At a time when the international community is recovering from a massive economic crisis, there are serious concerns regarding the viability of the rebound in the eurozone[1]. The strains that appeared on capital markets at the end of 2009 concerning the solvency of Greece, the probable relapse of a Spanish economy that is historically highly dependent on foreign direct investment flows that have now dried up, the commercial handicap of a then overvalued euro-dollar exchange rate (on a purchasing power parity basis), and the prospect of lasting weak growth are leading some analysts and a section of public opinion to wonder about the real benefits of monetary union[2].

The impossibility of competitive devaluation, the maladjustment to widely varied national economic circumstances of the interest rates set by the European Central Bank (ECB), the rigidity of the fiscal norms imposed by Maastricht, the reduction of the single currency to an adjustment variable on foreign exchange markets ï there is certainly no lack of criticisms. The virtuous momentum observed until the mid-2000s seems to have run down. Is this the effect of the economic turnaround in 2008 or of structural dysfunctioning of the eurozone institutions?

The monetary union, since its beginnings, has been intended to support the economic integration of the Common Market. The mutualisation of growth goes hand in hand with the concentration of financial risks: the link between the Franco-German tandem and other eurozone members is an incentive for the latter to apply a lax fiscal policy[3] that is incompatible with the stability goals pursued by the ECB. The scale of the 2008 crisis and the consequent national stimulus packages have distinctly worsened this situation by exposing the heterogeneity of European public finances.

Any divergence between the French and German fiscal orientations in answer to the crisis could threaten the permanency of the eurozone. The uncoupling of the two countries' public finances would necessarily lead to opposite reactions in the two countries vis-à-vis coming economic shocks. Such divergences would call into question the effectiveness and appropriateness of a common monetary policy. On this assumption, the euro would soon lose its hard-won status of structural advantage and instead become a real handicap.

The recent initiatives taken in Paris and Berlin offer a tangible but fragile guarantee of rapprochement. Only a constraining mechanism for fiscal coupling will be capable of soundly and lastingly reinvigorating growth. The Eurobond, as a supra-national debt instrument and a tool for Franco-German coordination as described in this *Policy Paper*, whose aim is to breathe new life into a project that goes back at least as far as that of the single currency[4], will restore to the Eurogroup's economic policies the credibility and reactivity that are now severely restricted. Launched initially by France

[1] Austria, Belgium, Cyprus, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Malta, the Netherlands, Portugal, Slovenia, Slovakia and Spain.

[2] In 2008, 78% of the citizens of the Member States of the eurozone thought that the single currency had had an inflationary effect, according to a Eurobarometer study (*Public attitudes and perceptions in the euro area*) published in September 2008.

[3] The term fiscal policy refers to the public expenditure programmes undertaken by a government, and to the corresponding resources raised for their financing.

[4] See, in particular, the work of the European Primary Dealers Association (2009).

and Germany to finance common investments, the Eurobond will be gradually adopted by all Member States, which will in this way come to agree on the evolution of their debt policies. Such a solution, credible for being coordinated, will facilitate the restoration of public finances and enhance the effectiveness of the eurozoneôs monetary policy.

Sovereign debt: definition and perimeter

ñSovereign debtò, in the present *Policy Paper,* refers to the aggregate financial liabilities taken on by a State, directly or via an agency, in the form of tradeable securities (ñsovereign paperò), loans or guarantees. The sovereign debt held by residents is called *domestic debt* (***ñ****external debt*ò in the contrary case).

The term ñsovereign debtò is used in this *Policy Paper* in a restrictive sense, indicating the debt of central government and excluding the debt of local authorities or the accumulated social security deficit. This choice is dictated by two considerations:

- Local authority financing depends essentially on the organisation of the individual States and the policy choices made by governments, and this limits the relevance of an independent analysis or an international comparison;
- The evaluation of social commitments remains difficult, because of the evolutions in retirement pension schemes, demographic developments, contributions and benefits.

The developed economies: a few comparisons

	France	Spain	Germany	Greece	Italy	Japan	United States	United Kingdom	Portugal
GDP 2008 (in ú) (GDPs for 2009 have not yet been finalised)*	1,948.6	1,095.7	2,494.9	243.7	1,566.1	3,353	9,701.5	1,806.5	165.8
Source: World Bank									
Net debt burden 2009 (% of GDP)	75.80	47	70.30	120	112.80	104.60	58.20	62.10	81.80
Source: IMF-WEO/Eurostat									
Inflation (CPI) 2009 (annualised data)	1	0.10	0.80	1.30	1.10	-1.90	2.70	2.90	-0.10
Source: Bloomberg LP									
Issues of sovereign paper 2007-2008-2009 (billions of local currency)	2007: 100 2008: 88.8 2009: 285.5	2007: 27.5 2008: 58 2009: 160.9	2007: 94 2008: 147 2009: 233	2007: 46.5 2008: 34.2 2009: 68.5	2007: 172 2008: 181 2009: 314	*Thousand billions* 2007: 81 2008: 82 2009: 224	2007: 513 2008: 1290 2009: 3950	2007: 110 2008: 93 2009: 164	2007: 6.1 2008: 13 2009: 30
Source: Bloomberg LP									
Standard & Poor's rating 2010 for the domestic currency** (long term)	AAA	AA+	AAA	BBB+	A+	AA	AAA	AAA	A+
Source: Standard & Poor's/Bloomberg LP									

*The average USD/EUR at exchange rate in 2008 is 0.683.
Ratings are structured in decreasing order: **AAA is the highest grade and **D** the lowest (equivalent to default).
An issue that is rated **BBB** or higher is said to be "investment grade". An issue rated **BB** or below is said to be "non-investment grade", "speculative" or even "junk".

PART I

THE EUROZONE TEN YEARS AFTER ITS CREATION

CHAPTER I

SINGLE CURRENCY AND CONVERGENCE CRITERIA

A single currency at the service of the Common Market

The creation of a European monetary union, provided for in the Maastricht Treaty of 1992, had a triple ambition: to encourage trade within the Common Market, to absorb shocks in crisis periods, and, in the long term, to share the ñexorbitant privilegeò then exclusively enjoyed by the dollar, the worldøs principal reserve currency. As a powerful political symbol of a pacified and unified continent, the euro was the result of a long process that started in Basel in 1972 with the launching of the European monetary ñsnakeò, continued in Copenhagen and then in Bremen in 1978, through the inauguration of a European Monetary System, on the joint proposal of President Giscard d'Estaing and Chancellor Schmidt.

The conclusion reached by the founding fathers was simple: monetary rapprochement would catalyse economic integration within the Common Market and would make it possible to underpin growth while avoiding further currency crises, then a permanent threat and an obvious curb on the development of the countries with the lowest incomes[5].

The contrasted but complementary profiles of the European economies, like the relative diversity of their business cycles, clearly argued in favour of a privileged commercial partnership, with the domestic demand of one country compensating for that of another, under the influence of *cyclical swings**[6].

As a barrier against exchange-rate fluctuations and an accelerator of growth, the euro was clearly a necessity.

An ambitious but risky bet

The bet involved in the single currency could, however, appear risky. As a corollary of their complementarity, the wide diversity of the economies meant that they did not *a priori* form a perfectly coherent grouping. Furthermore, the conduct of a single monolithic monetary policy appeared to suffer from an obvious handicap: how could the same interest rates be applied to two economies as different as those of Germany and Spain, for example? [7]

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[5] Because of persistent inflationary tensions or loss of competitiveness.
[6] All the words marked with an asterisk are defined in ñDefinitionsò (p.50).
[7] Germany has a substantial current-account surplus and robust domestic savings (7.5% and 25.9% of GDP respectively in 2007), and stable inflation (2.27% in 2007 and 2.75% in 2008), whereas the Spanish economy, dominated by imports (as indicated by a substantial current-account deficit equal to 10% of GDP in 2007), is prone to much more volatile inflation (rising from 2.8% in 2007 to 4.1% in 2008).

A view often heard is that the policy of the ECB since the bursting of the stock exchange bubble in 2001 is unsuited to such diverse economic needs. With interest rates historically low (held at 2% for almost three years, after reaching a maximum of 4.75% at the turn of 2001), the policy of the ECB was at the same time too strict for a German economy that was running out of steam (actually contracting for the year 2003, and then stagnating until 2006) and too accommodating for a Spanish economic situation that seemed to be set fair (able to post GDP growth rates of almost 3% for this same period) but was excessively dependent on the real estate market[8]. A compromise monetary policy that was too rigorous for certain members and too lax for others ultimately benefited none of the group.

The theory of optimal currency areas, defined by Robert Mundell in 1961, sets out the conditions for the effectiveness of a single currency as consisting of satisfying four main criteria: *labour mobility, capital mobility, price and wage flexibility and existence of an automatic internal fiscal transfer mechanism (to compensate for the distortions induced by the first three criteria).**

Obviously, the territory covered by the founding countries failed, *ex ante*, to constitute such a zone, for lack of the translation into practice of the freedom of movement granted to the factors of production, but above all for lack of a mechanism for a common fiscal and tax policy. There was still hope, however: if the eurozone failed to meet the above optimality criteria at the time it was founded, the introduction of the single currency was expected to impose these criteria retroactively, by aligning the responses of individual Member States subjected to the same shock.

The cornerstone of this theory, i.e. the capacity of the European economies to absorb *asymmetric shocks** ï differing effects within the zone of the same economic phenomenon ï thus made a rebalancing indispensable. This rebalancing, without which a common monetary policy would inevitably be ineffective, could take two forms: the implementation of tax transfers between Member States ï going beyond mere *factor mobility** ï or the reduction of the asymmetries. The first solution, synonymous with a ñcommon European budgetò, being politically unrealistic, it was logically the second that was adopted.

It was with this aim that the Maastricht Treaty (which came into force on 7 February 1992) was drawn up, requiring Member States to respect a series of criteria known as ñconvergence criteriaò in order to enter the Eurogroup: *inflation rate and *long rates**[9] under control[10], public deficits below 3% of GDP and net debt of less than 60% of GDP at the end of the year preceding membership.**

The purpose of the Stability and Growth Pact was to extend the range of these constraints ï other than in exceptional circumstances ï once entry had become effective. Equipped with such a tool for coordination, the founding members hoped to see their economies converge in a fast and targeted manner: economies subjected to

[8] The spectacular appreciation of the Spanish real estate market reflected a flagrant excess of liquidity.
[9] Maintenance of the benchmark rates on long-dated sovereign paper below a level equal at most, to the average of the three lowest *inflation rates** among those of the other members raised by 2 points.
[10] Equal, at most, to the average of the three lowest rates among those of the other members raised by 1.5 of a point.

strict but still flexible budgetary constraints would have the advantage of protecting the Common Market's intrinsic diversity, and let it benefit from alternating economic cycles, this degree of diversity being nonetheless limited, so as to reduce the risks of renewed strongly *asymmetrical shocks**.

The central position of the Franco-German pillar in the monetary union

The economic weight of the Franco-German pillar within the Eurogroup, representing nearly 48% of the total GDP of the eurozone in 2008 and more than 35% of the GDP of the European Union, is obviously considerable.

But the central position of France and Germany is above all strategic, and is best explained by the mechanics of the eurozone's growth engine: strong demand from the Mediterranean and Eastern countries met by the Rhineland pole provides a stimulus for German and French exports. Not only is Germany France's principal trading partner but it also has France as its principal export destination. The euro, one of whose most important functions is to reinforce the trade within the European Common Market, constitutes the keystone of Franco-German commercial relations.

The financing of the deficits within the eurozone is ensured – directly and indirectly – by France and Germany thanks to the relative stability of foreign exchange markets (and of inflation) ensured by the single currency. Moreover, the French and German borrower quality, extended to their partners, appreciably reduces the cost of capital for these other Member States. Also, the paper of France and Germany's European partners is mainly held by domestic investors – national or in most cases Franco-German – while Paris and Berlin place a large share of the French *OATs** and the German *Bunds** with international investors.

Apart from their strong economic and financial interdependence, these two countries, because of their complementarity, form a coherent grouping in the cultural, historic and political fields. The introduction of a single currency had as its role above all to consolidate, by its symbolic importance, a European Union driven since its origin by the political will of France and Germany – from the signature of the Rome Treaties in 1957 through to the joint initiatives of President Sarkozy and Chancellor Merkel in the immediate wake of the 2008 crisis.

CHAPTER II

THE VIRTUOUS MECHANICS OF ECONOMIC INTEGRATION AND THE RISKS OF FINANCIAL CONCENTRATION

Reinforcement of economic integration

Ten years after the introduction of the euro, have the ambitions of the founding fathers and of the Maastricht Treaty been realised? The fact that inflation is now safely under control seems to be the most obvious benefit of the single currency (see graph 1). On the other hand, the general stabilisation of the *budget balance** below the 3% threshold provided for in the Stability and Growth Pact, remains very relative ï Germany excepted (see graph 2).

The impact of the euro on growth appears to be even more differentiated: the annual growth of the high-income economies has weakened, in compensation for a reduced dispersion, while it has progressed marginally in the Eurogroup countries with the lowest incomes. As illustration, Germany has recorded a decline of almost 0.6 of a point between its average growth in the years 1980-1999 and 1999-2008, compared with an approximately stable situation for France and a net gain of more than 0.7 of a point for Spain (see graph 3).

It is still too early to reach a definitive conclusion concerning the effects of the introduction of the single currency on trade flows within the internal market[11]. Early empirical studies seem however to indicate a fairly distinctly positive impact[12]. The acceleration of trade within the euro area was accompanied by a polarisation of trade balances, accentuating the natural inclinations of the Member States, i.e. reinforcing German (and to a certain extent Italian) exporting power, but also fuelling Spanish and Greek imports (see graph 4). The strong demand from these last countries would thus seem to have provided support for German industrial production, mitigating the deficiencies of traditionally weak German domestic demand, while also generating important tax revenues for Berlin.

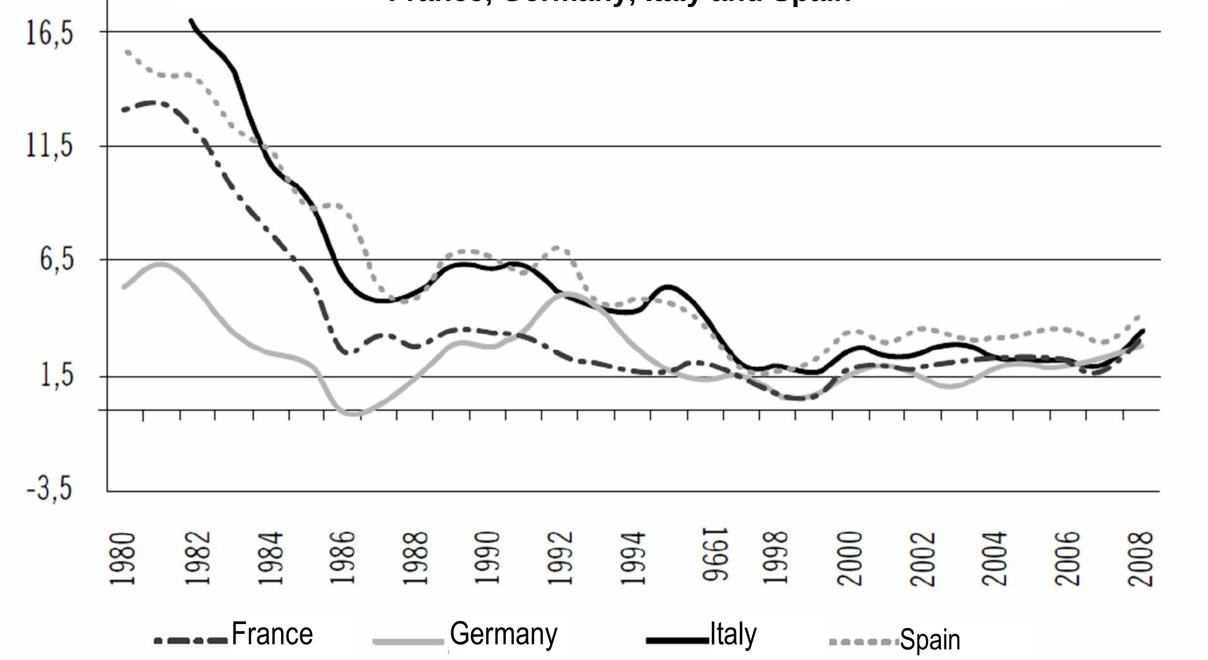
This architecture, roughly comparable (on a very reduced scale, obviously) to that of the Chinamerican tandem, can thus be seen as supporting the growth and surpluses of one set of countries by means of the demand and deficits of the others. A reverse transfer, moreover, ensures the financing of demand by means of surpluses. The

[11] Known as ñthe Rose effectò.

[12] A net gain of five to ten points would thus have been recorded between 2002 and 2006 on the figures for trade between Member States (Source: P. Mongelli, J.L. Vega, *What effect is EMU having on the euro area and its member countries? Year Overview*, European Central Bank, Working Paper Series, No 599, March 2006).

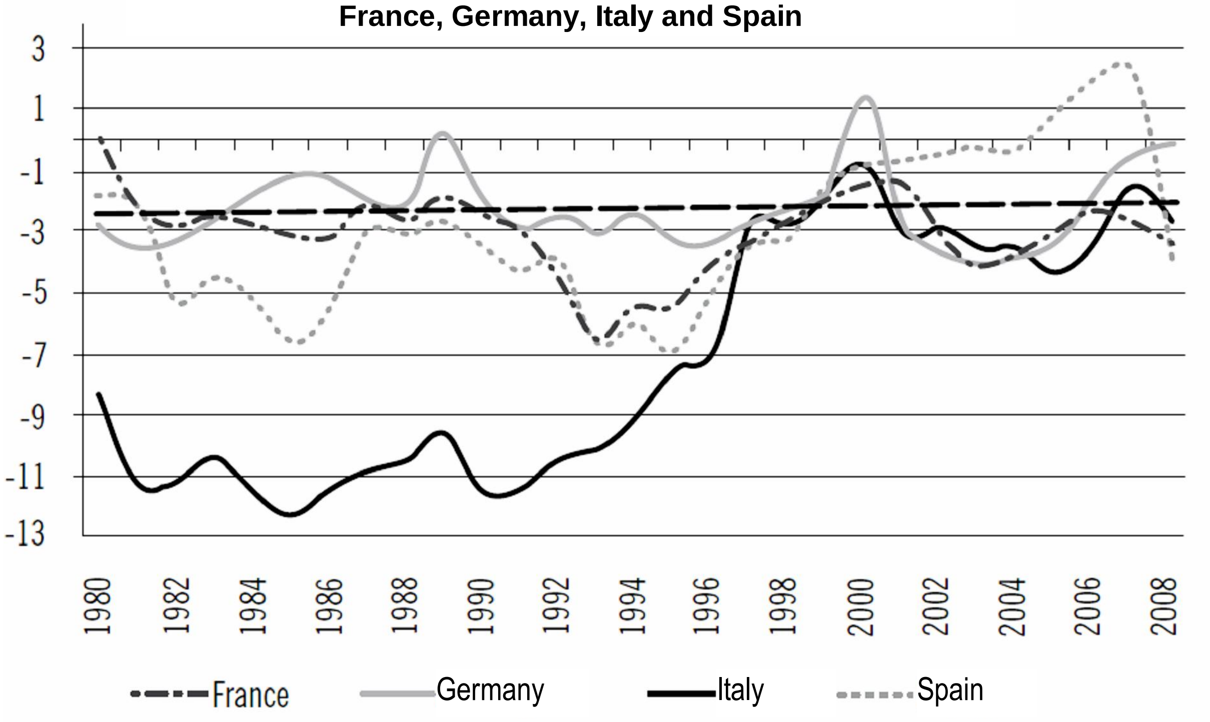
growth mode of the eurozone thus rests mainly on robust internal trade, thanks to a mix of economic catch-up and well-sustained industrial production. Unlike China, however, the surpluses achieved are not large enough to ensure that the EMU operates in closed circuit and the countries concerned are forced to take on more debt. The solidity of the entire edifice thus depends on their borrower quality. Economic integration and the commercial coupling are thus accompanied by a concentration of the financial risk on the Franco-German pillar.

1. Inflation (%), 1980 ï 2008
France, Germany, Italy and Spain



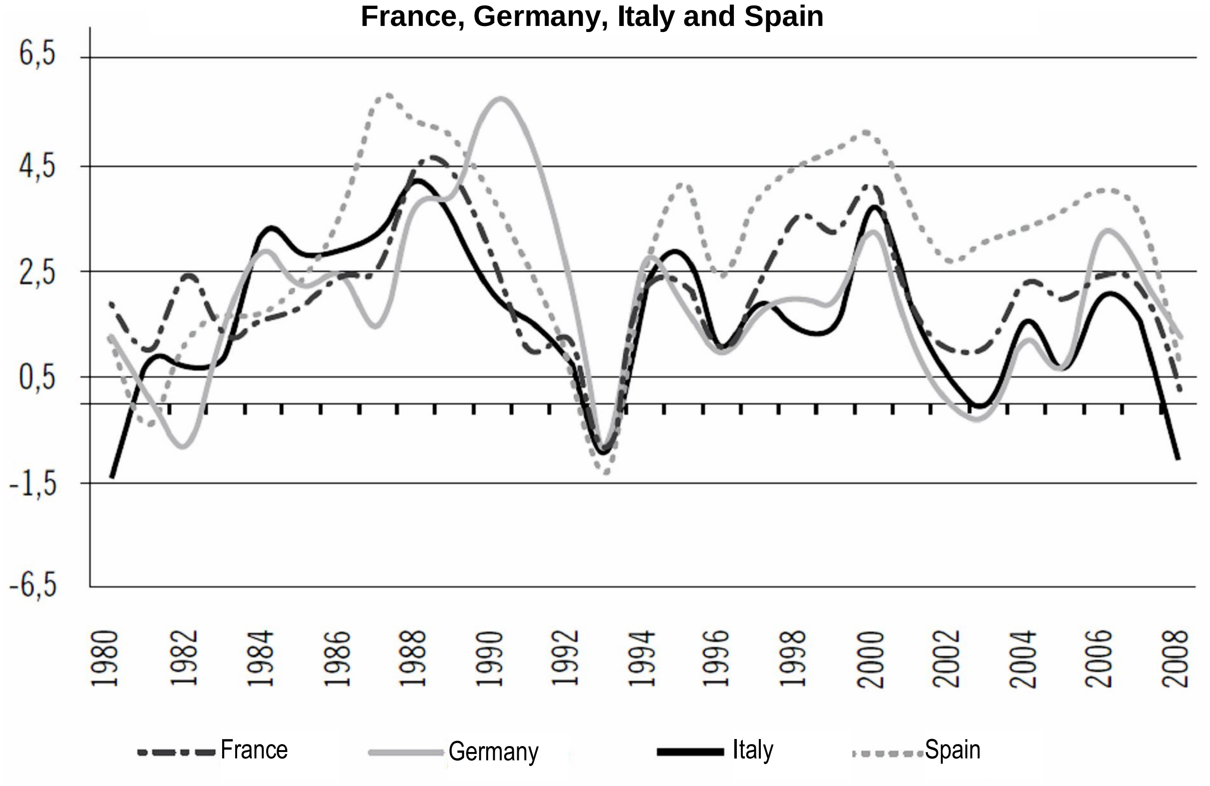
Source: International Monetary Fund, *World Economic Outlook*, October 2009

2. Budget balances (% of GDP), 1980 ï 2008
France, Germany, Italy and Spain



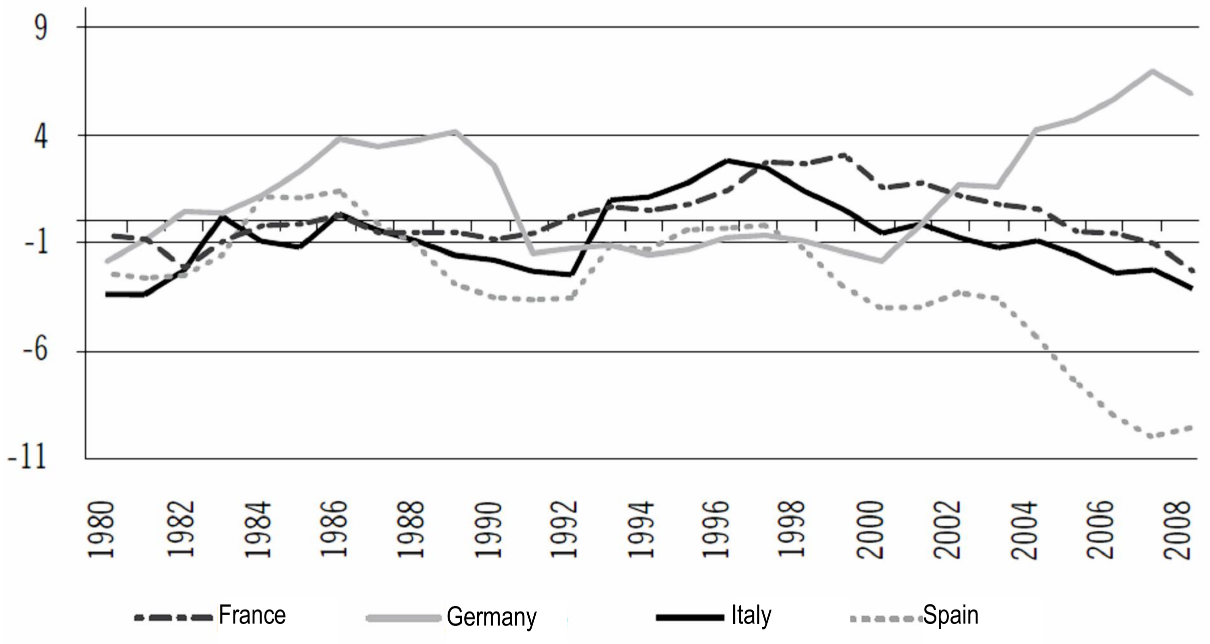
Source: International Monetary Fund, *World Economic Outlook*, October 2009

3. GDP growth (%), 1980 ï 2008
France, Germany, Italy and Spain



Source: International Monetary Fund, *World Economic Outlook*, October 2009

4. Current-account balance (% of GDP), 1980 ï 2008
France, Germany, Italy and Spain



Source: International Monetary Fund, *World Economic Outlook*, October 2009

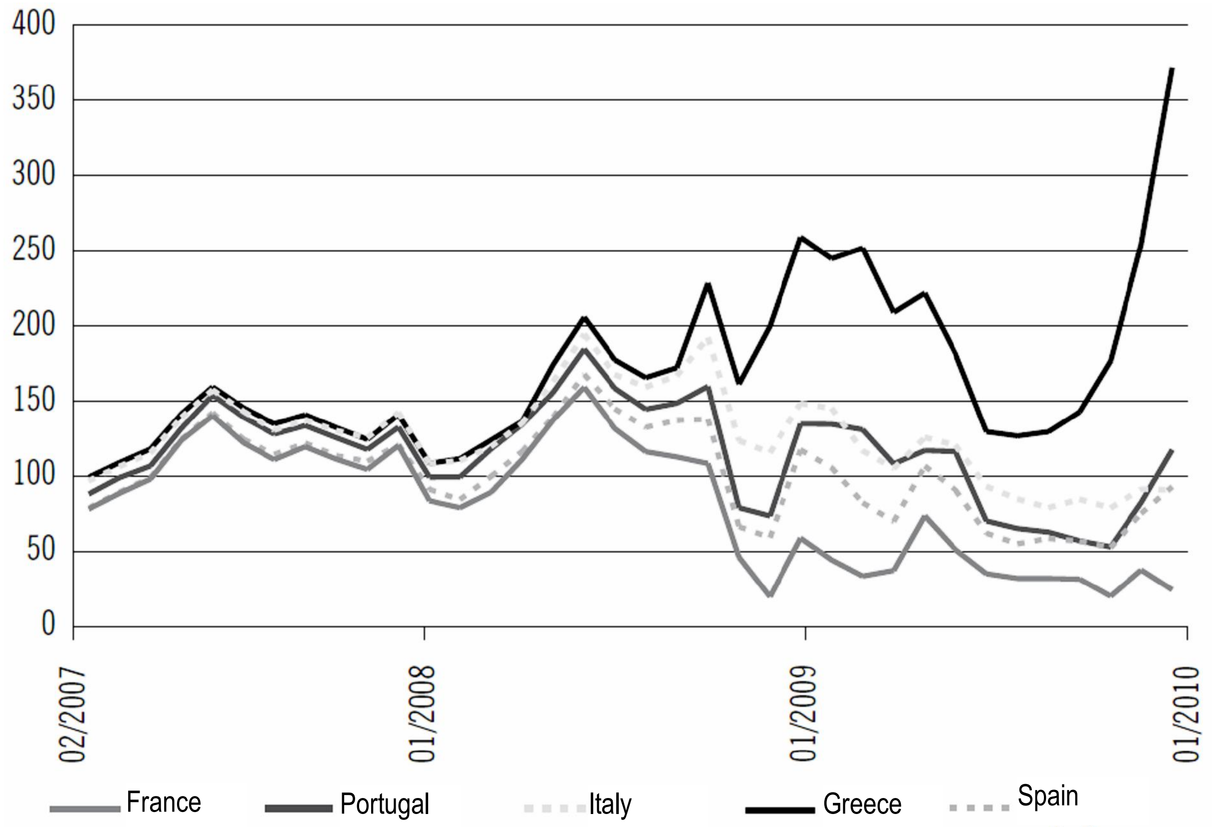
5. EUR/USD exchange rate, 1998 ï 2010

Source: Bloomberg LP, January 2010

Concentration of financial risk

The introduction of a common currency and the formulation of criteria setting limits on deficits have been the springboard for a virtuous dynamic process that is highly beneficial for the lowest-income countries, which now enjoy the benefits of a stable currency for their debt and a borrower quality that is a great improvement on what their individual intrinsic creditworthiness would theoretically have deserved. From an external point of view, everything is in place for the debt securities of the Member States to be more closely assimilated to the German *Bund**, a benchmark on capital markets (and to a lesser extent, to the French *OAT**): a European central bank established in Frankfurt, in the immediate vicinity of the *Bundesbank*, and chaired by a Frenchman, is a further symbol of this rapprochement. On the whole, the operation has been a success: the confidence that investors traditionally grant to Germany and France seems to have naturally been extended to the other Eurogroup members ï as clearly shown by the substantial narrowing of sovereign debt *spreads** over the past 10 years (see graph 6).

6. Spreads on 10-year sovereign bonds versus the German equivalent (basis points), 2007 ï 2010, Greece, Spain, Portugal, France and Italy



Source: Bloomberg LP, January 2010

This clear improvement in financing conditions is obviously not an incentive to apply fiscal discipline, since the markets appear to have given up on penalising the governments with large deficits. A supposedly infinitely elastic debt absorption capacity encourages "zero-gravity" financial management: the chronic failure since 2001 to respect the 3% threshold imposed by the Maastricht criteria probably owes as much to this incentive to laxity as it does to the bursting of the Internet bubble.

The creation of the eurozone has encouraged a stronger integration of the member economies by supporting internal trade. Generally controlled inflation and a growth redistribution, particularly favourable to the financially most fragile countries, were above all accompanied by a commercial symbiosis between exporting countries with healthy public accounts ï led by Germany ï and importing countries with *budget balances that were often more volatile. The Franco-German pillar, a factor for the stabilisation of the euro and a *de facto* ñcredit insurerò for the sovereign borrowing of the sixteen, facilitated the financing of these countries, while giving them access to capital markets on particularly advantageous conditions.**

Another result has been substantial imbalances, with higher growth rates in the deficit countries accompanied by increasing dependence on the Franco-German "guarantee": the financial crisis of 2008, by abruptly increasing the scale of these imbalances, constitutes a definite challenge for the eurozone.

PART II

FINANCIAL CRISIS AND BUDGETARY STRAINS: A THREAT TO THE EUROZONE

CHAPTER I

THE WORLD FINANCIAL CRISIS AND THE STIMULUS PACKAGES

The financial crisis of 2008 and the effects of the unprecedented stimulus efforts have shattered this fragile balance. The parallel that is often drawn between the initial stages of the ñGreat Depressionò of the 1930s and the present ñGreat Recessionò is astonishingly accurate. The response of the public authorities, on the other hand, has been completely different: whereas they reacted to the 1929 shock with austerity measures, governments and central banks have since the last quarter of 2008 deployed the entire expansionary monetary and fiscal arsenal at their disposal ï with the risk of finding themselves helpless, should these tools fail to achieve their intended aims.

The abrupt widening of the deficits within the eurozone and the resulting marked increase in public debt could have particularly dramatic consequences: any divergence of the fiscal stances within the Franco-German pillar would threaten the cohesion of the monetary union.

A prolonged uncoupling of the fiscal policies of France and Germany would curb the growth model of the sixteen and dangerously restrict the effectiveness of the ECB: in the long term, it is the appropriateness of the European project that is at stake.

Monetary activism

The means implemented were, in all respects, proportionate to the seriousness of the problems. Central banks throughout the world initially cut rates drastically ï even in some cases applying a "zero interest rate" policy (or ZIRP) in reaction to inflation figures that were in free fall.

Moreover, in order to divert financial institutionsô investment flows away from the sovereign debt markets ï largely considered then as the only refuge in a storm ï the central banks undertook to compress the returns on this asset class. The massive buyback of public claims (see graph 7), pushing up their prices and consequently reducing their returns, re-directed bank resources towards lending to the comparatively more lucrative private sector[13].

[13] These somewhat unorthodox initiatives, now better known as *quantitative easing**, have spread rapidly, despite the many doubts concerning their long-term consequences.

Fiscal interventionism

Vigorous monetary policies, applied with firmness by central banks not particularly concerned with orthodoxy, thus made it possible to restore an acceptable liquidity regime on capital markets, stabilising lending to the private sector, stemming the fall in stock market prices and unfreezing credit channels.

These monetary successes would have been incomplete and probably only temporary, however, had they not been accompanied by a determined fiscal stimulus.

The recovery plans, drawn up mainly at national level, mark a theoretical turning-point by associating initiatives of openly monetarist inspiration with others having an avowedly Keynesian heritage. The goals of these two sets of policies are distinct: once the financial markets had been stabilised thanks to a substantial liquidity inflow, there would still remain a need to return to ñrealò growth and to resume the trend growth rates of the years of prosperity, thanks to a courageous fiscal intervention having two main levers:

- One in favour of households and companies,
- The other in favour of the banking system.

A collapse of industrial production, consequent on that of world trade and the deterioration of domestic demand, a sharp rise in corporate bankruptcies[14] and a distressed labour market in the period to March 2009 clearly called for a public commitment on all fronts. Large tax breaks were introduced and measures to support consumption (such as the car scrapping premia or the reinforcement of social benefits) were undertaken, benefiting especially lower-income households. Targeted industrial support programmes and massive public investment schemes (in particular, by building stakes in companies belonging to sectors deemed ñstrategicò) also constituted the backbone of the stimulus packages.

At the interface between monetary activism and fiscal intervention, the protection of a banking sector suffering huge write-downs in book values following the sub-primes crisis justified fresh public commitments. From vast guarantees on portfolios of ñtoxic assetsò to the opening of additional credit lines, through straight recapitalisation (with occasional assistance from private investors) and possibly extended to a *de facto* nationalisation[15], all solutions were considered and many of them applied.

[14] Estimated, in France, at 64,000 between January 2009 and January 2010, increasing by 11% over the year, compared with a total of 48,000 over twelve months four years earlier.

[15] As was the case in the United Kingdom, in particular.

7. Central bank balance sheets and holdings of Treasury bills in December 2009

	Volume of assets in balance sheet (billion dollars)	**Purchases of Treasury bills (billion dollars)**
Federal Reserve	2,210	780
Bank of England	390	310
Bank of Japan	1,360	800
European Central Bank	1,760	_

Sources: Federal Reserve, Bank of England, Bank of Japan, European Central Bank

CHAPTER II

PUBLIC DEFICITS, "WALL OF DEBT" AND *STRUCTURAL BALANCES**

Financing of the stimulus packages and widening of the public deficits

The stimulus packages all resulted in a visible and lasting deterioration of public finances throughout the world ï particularly in the United States, the United Kingdom and the eurozone. Paradoxically, the extent of the deterioration could be of much less importance than its nature. While an easily reversible short-term measure, having little or no long-term impact on the budget, is essentially benign, support on a smaller scale but more difficult to retract leads to a deterioration in the *structural balance*,* by compromising the restoration of the public accounts and restricting the capacity for growth.

The situations of the countries of the eurozone, in a distinctly gloomier world landscape, show wide variations:

- Germany ï badly hit by the fall in its exports ï rebounded strongly in the spring of 2009 and this enabled it to hold the federal deficit down to around 5% of GDP (compared with virtual equilibrium for the *budget balance** in 2007), and probably return to surplus in 2014, according to IMF estimates. The public deficit announced for 2010 amounts to ú85.8 billion (to which has to be added an additional ú14.5 billion resulting from the stimulus measures enacted by the previous administration).
- Greece, at the other end of the European spectrum, has had to revise its public statistics and is now having to cope with a deficit of approximately 12.7% of GDP for the year 2009. This has led to a bout of fever on capital markets and justified a downgrading of Greek debt by rating agencies.
- France, finally, is thought to have stomached a deficit of approximately 8% of GDP in 2009. The deficit announced for 2010 is 149.2 billion euros.

Heading for a "wall of debt"

These deficits, widened still further by a marked decline in tax revenues, have been largely financed by borrowing ï a phenomenon further aggravated by the transfer of private claims to public balance sheets. Countries of the ñeconomic Northò are now facing a ñwall of debtó. The hangover from 2008 and 2009 has exacerbated problems that were previously considered to be important for the long run, but yet secondary. The abrupt acceleration in the debt build-up evokes worrying geographical and historical comparisons.

The United States, according to IMF estimates, was likely to be labouring under a debt burden of close to 58.2% of GDP at the end of the year 2009, compared with roughly sixteen points less two years earlier, and the figure could approach 85% by 2014. The deterioration in the United Kingdom's economic prospects ï the result of a ruinous increase in expenditure decided in 2004 by Gordon Brown when he was Chancellor of the Exchequer ï is more worrying still, since the net public debt, calculated to be approximately 38% of GDP in 2007, is put at 62% today ï a rise of almost 24 points in as many months ï and could breach the 90% level in 2014. The Japanese debt, a *cause célèbre* on capital markets since the 1980s, and long regarded as setting a ceiling for the G20 countries, is expected to rise from a little over 80% of GDP to nearly 105% in 2009, and could reach 143% in 2014.

The countries of the eurozone, by comparison, show considerable contrasts:

- Germany's debt burden is still moderate, at close to 70% of GDP for 2009 ï a reasonable figure, albeit still more than thirteen points higher than in 2007.
- Italy, for its part, is in a much more delicate situation, with net debt of almost 113% of GDP, having already exceeded 100% in 2007[16].
- France, by comparison, has performed comparatively well with debt of no more than approximately 77% of GDP for 2009, according to IMF estimates. This puts it in a rather enviable position compared with the majority of its European peers, in spite of an expected trajectory that is probably less flattering, since this figure is expected to rise by more than seven points by 2014.

The public-debt equation depends also on another unknown factor that is at least as significant as the burden on central government, namely the social insurance deficit, especially through the management of the retirement pension systems. The lack of clarity of certain national systems could foreshadow a painful awakening:

- The sharp decline of the financial markets will unquestionably have an impact on the asset-to-liability adequacy of the retirement schemes based on capitalisation. The recent erosion of the assets set aside to cover future liabilities places most pension funds with a particularly delicate choice between raising the bar of needed returns on investment[17] and a simple reduction in the benefits offered.
- Pension schemes based on distribution will most probably not be spared, either. Unfavourable long-term demographic trends, a sluggish labour market and a contraction in the total wage bill will weigh heavily on these regimes. The application of often unrealistic discount rates, on the one hand, and reliance on an improbable demographic dividend, on the other, constitute an addition to the current debt stock whose overall volume and whose financial and social costs are as yet difficult to measure. Reduced benefits or a rise in the contributions imposed on future generations would depress consumption and growth. The clarity of the German system of distribution (based on unit points accumulated over a taxpayerôs professional life) is an advantage not enjoyed, in their majority, by the fifteen other Eurogroup members.

The dominant topic of the year 2010, namely the problem of sovereign debt, is not new and for most countries the crisis will merely have brought it into the open. The

[16] More moderate deficits nevertheless reduce the urgency of the Italian situation.
[17] Leading to more aggressive risk-taking.

Pébereau report[18] stressed that by 2005 the central government debt had increased fivefold since 1980. At the end of 2008, with the outbreak of the financial crisis, the situation had further deteriorated.

Far from having been the instrument of a prompt exit from the crisis in 2008, the costly national stimulus packages, by strongly increasing the world debt stock, could on the contrary ñhave permitted a disorder to persist in order to avoid a [depression]ò, to paraphrase Machiavelli: it is perfectly possible that the governments, instead of ñavoidingò the worst, merely ñdelayed it to their disadvantageò.

Severe strains on capital markets

The crisis that erupted in September 2008 inflicted a simultaneous shock on all countries. The destruction of value consequent on the collapse of market quotations and the erosion of credit helped to worsen world imbalances. While budget surplus countries on average experienced a slowdown in their growth and in the rise of their reserves, the deficit governments, for their part, found themselves having to cope with a full-fledged recession followed by a fragile recovery ï sometimes solid, but more often weak ï and with a large rise in their financial requirements. Difficulties should be expected to result from ever-increasing strains on capital markets: the already fragile interplay between supply and demand is clearly at risk, as a lasting supply of sovereign paper will find it difficult to attract a matching demand.

Overall, total public borrowing in 2009 is expected to rise to the colossal amount of $12,000 billion in the OECD countries, compared with less than $10,000 billion in 2007[19]. The additional net borrowing requirements of OECD countries accordingly rose by 61.5% (in nominal, absolute value) in the space of 12 months (the figures for the United States and the eurozone countries being 46.1% and almost 85%, respectively).

The resulting inevitable competition between borrowers/issuers could lead to a generalised increase in the cost of financing and to a penalisation of the most fragile among them. The possible crowding-out of private paper could also dry up a source of capital on which firms are still heavily dependent[20].
While seeking to increase the liquidity available in the economy by the massive buyback of sovereign paper (ñ*quantitative easing**ò), the central banks have

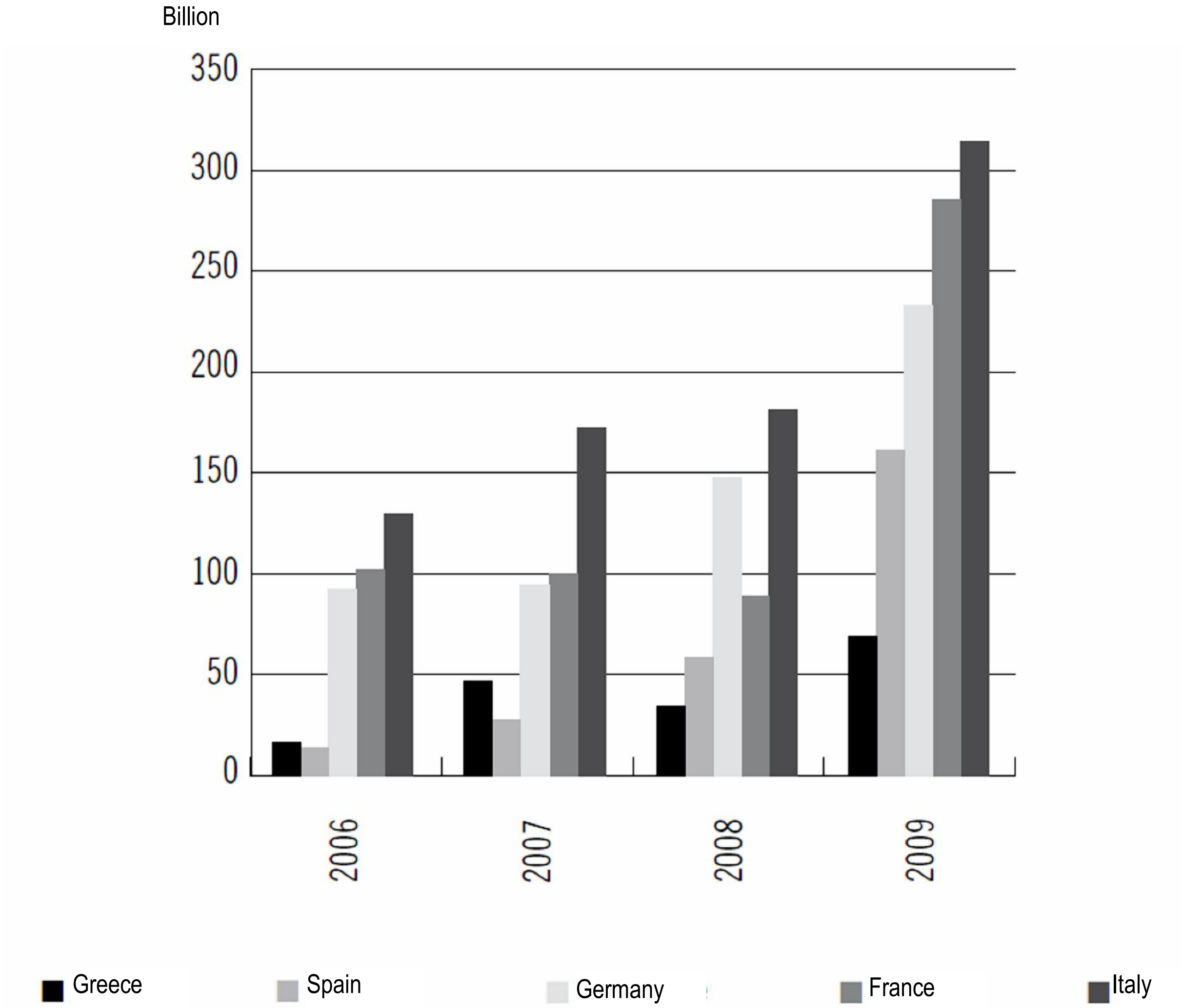
[18] Michel Pébereau, *Rompre avec la facilité de la dette publique. Pour des finances publiques au service de notre croissance économique et de notre cohésion sociale* (ñBreaking away from the facility of public debt. The need for public finances serving our economic growth and our social cohesionò), December 2005.

[19] The volume of bond issues on the capital markets is thought to have shown a distinct increase in the OECD countries, to almost 2,620 billion dollars compared with only 1,620 billion in 2008. It is important to stress that American paper represents the bulk of these amounts, at 1.890 billion dollars compared with barely 308 billion in the eurozone. The figures corresponding to the gross issues are more eloquent still, since the United States then accounts for 64% of the total compared with 18.5% for the eurozone ï figures that have also been rising, the corresponding figures for 2007 being 60.7% and 17.9% respectively.

[20] A total of 1,400 billion dollars of investment-grade debt was issued in 2009, a record figure that testifies to the concern of private borrowers wanting to raise capital with a view to possible future tensions.

organised the financing of the budget by newly-created money (see graph 8). These programmes, with their inevitable inflationary effects, are meant to be temporary: only the announcement of their ending and their possible reversal (by sales on the market of the previously acquired securities) will reveal the true gravity of the situation.

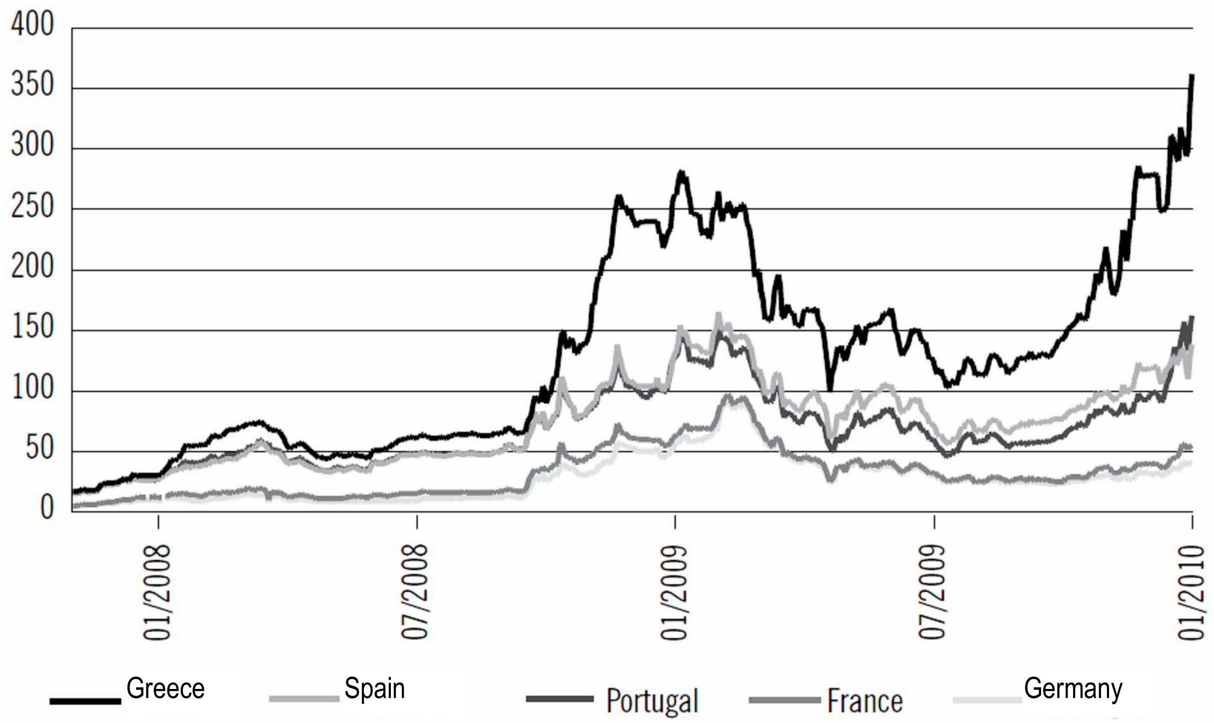
8. Issues (EUR), 2006 ï 2009
Greece, Spain, Germany, France and Italy



Source: Bloomberg LP, January 2010

The worst may therefore be yet to come: a differentiation between issuers/borrowers according to their financial robustness has already halted the convergence momentum generated by the introduction of the euro. With the crisis, a sharp rise in risk premia has caught the least virtuous pupils of the European class by surprise, and punished *a posteriori* their past ñmisdemeanoursò, as shown by the wide variations in returns on sovereign paper of the same maturity or the widening of the *spreads** on the corresponding credit derivatives (ñCredit Default Swapsò) (see graphs 9 and 10).

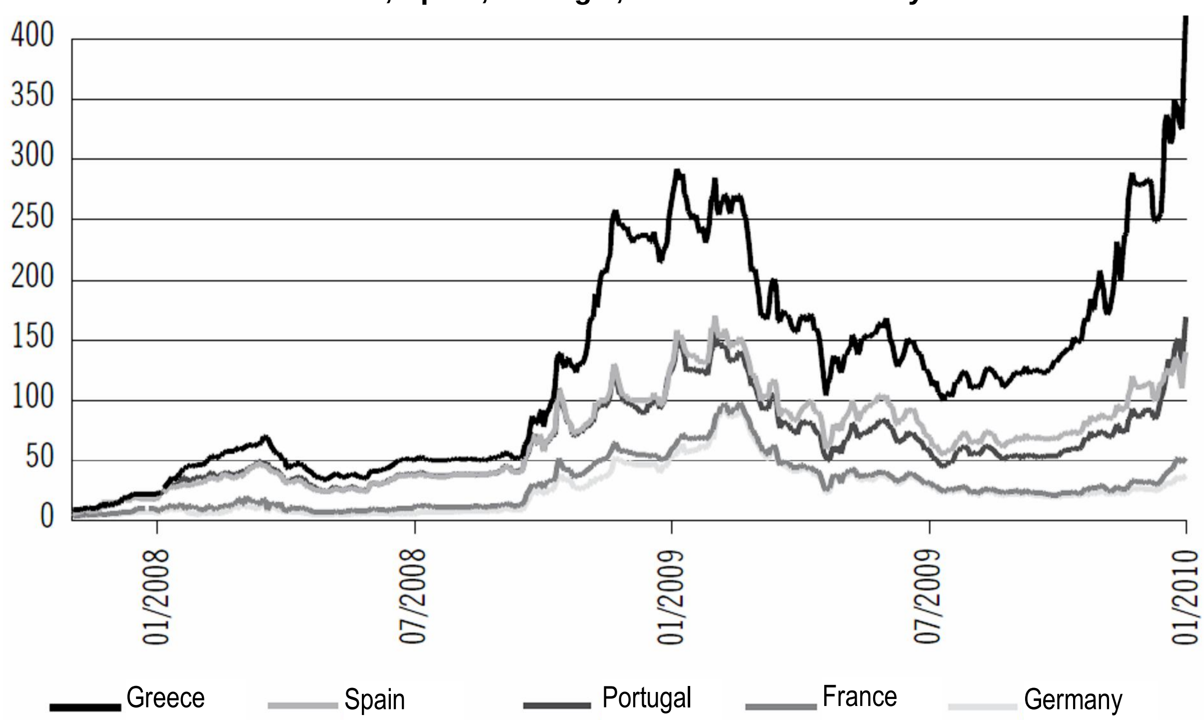
9. CDS* spreads (basis points) on 10-year sovereign bonds, 2006 ï 2010, Greece, Spain, Portugal, France and Germany



* Credit Default Swaps

Source: Bloomberg LP, January 2010

10. CDS* spreads (basis points) on 5-year sovereign bonds, 2006 ï 2010, Greece, Spain, Portugal, France and Germany



* Credit Default Swaps

Source: Bloomberg LP, January 2010

*Deficit dynamics and structural balances**

A strictly quantitative analysis is inadequate to give a true picture of a country's economic health and of the appropriateness of its fiscal policy measures. While the scale of public deficits ï and, correlatively, of the net debt already accumulated ï give a first idea of the room for manoeuvre available to governments, it is not sufficient as an analytical instrument.

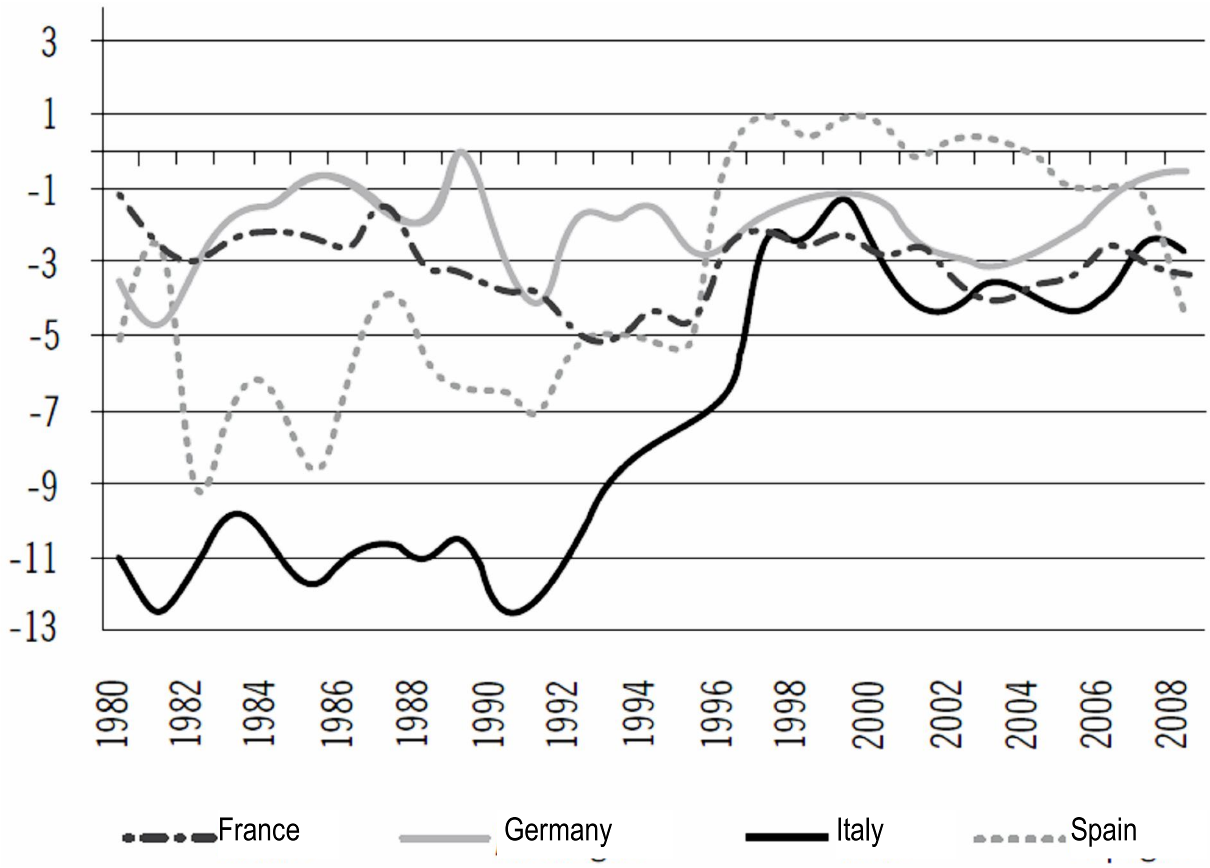
There are ñgoodò deficits, just as there are ñbadò surpluses: the source and the total volume of the resources invested by the government cannot be assessed without being related to the use made of them. Furthermore, a negative tax balance is not necessarily to be condemned, provided that the proceeds of the debts contracted today, invested with discernment, sow the seeds of increased future productivity and competitiveness, generating additional tax revenue in the long run.

There exists, moreover, another difference between cyclical and structural deficits. A budget position is said to be cyclical if it is proportionate to the growth rate, whereas a structural budget position does not depend on the prevailing economic climate but rather on factors such as an over-expensive administrative apparatus or excessively burdensome debt service. *A pro-cyclical* budget balance** ï which may lead to sometimes important short-term deficits ï can paradoxically be a sign of vitality and flexibility of the economic fabric. A deficit is thus regarded as structural if the weight of public expenditure exceeds the resources which the government can expect to generate ï in other words, when the country ñis living beyond its meansò.

The share of the structural impact in relation to the national public accounts at the time of emergence from the crisis is variable[21] and the countries of the eurozone show substantial divergences on this point as well (see graph 11).

[21] The American budget deficit, for example, adjusted for cyclical variations, is still showing a distinct deterioration over the past two years, rising from 1.4% of (potential) GDP in 2007 to approximately 5% in 2009, bringing to nearly seven points the impact (strictly cyclical) of the financial crisis. The UK situation is, in this respect, more worrying, since the difference between the *structural balance** and the actual balance is barely more than 1½ points, with the former having widened considerably since the beginning of the decade, reaching -9.0% in 2009 and set to remain decidedly negative, according to IMF estimates, in coming years. In the case of Japan, similarly, three points of the public deficit is estimated to be due exclusively to the economic crisis, with the *structural balance** coming out at approximately -7.5%.

11. Structural budget balance (% of potential GDP), 1980 ï 2008
France, Germany, Italy and Spain



Source: International Monetary Fund, *World Economic Outlook*, October 2009

- The deficit in the Spanish *structural balance** rocketed between 2007 and 2009, to reach 8.7% of GDP in the latter year, contributing to an expected deficit of about 12.3% ï giving a cyclical impact of a little more than four points.
- Germany, on the contrary, has maintained this difference at less than two points, with an initially expected deficit of 4% (later reduced by one point in December) and a *structural balance** estimated at -2% in 2009.
- France, for its part, is in an intermediate position in this respect, with a deficit of 8% reducing the *structural balance** by approximately four points, according to IMF estimates[22].

A budget deficit due mainly to an unfavourable economic environment ï leaving the *structural balance** close to equilibrium ï can therefore naturally be expected to be rectified with the return of growth. Injudicious policy options or a prolonged crisis can easily have dangerous secondary consequences, such as a too heavy-handed stimulus programme of Keynesian inspiration, installing public support for demand that will be difficult to retract at a later stage. In the same way, a simple increase in

[22] However, the majority of the forecasting institutes put it rather at approximately 5%.

the level of a country's debt ï and the resulting inevitable increase in interest charges (both in absolute value and at the margin) ï illustrate how easily a cyclical shock can be transformed into a structural burden.

A ratio between *structural balance** and deficit that is initially under control in the immediate aftermath of a crisis will tend to deteriorate in the event of prolongation of the economic storm and/or in the absence of a sufficiently tough policy. In this respect, the observed (and expected) evolutions in the *structural balances** reveal even more profound splits within the eurozone: the Italian balance is likely to slide further, with the deficit exceeding 5% in 2014 according to IMF estimates, signalling a chronic incapacity to contain public expenditure, while the German *structural balance**, today in slight deficit, (by average international standards), should return to balance in less than five years.

At a time when a global crisis with very similar effects from one country to another within the eurozone and when stimulus packages based on the same principles were supposed to synchronise the cycles within these economies and to set public accounts on parallel trajectories, how is one to explain such divergent structural impacts?

CHAPTER III

A MAJOR RISK: DIVERGENCE BETWEEN FRENCH AND GERMAN POLICIES

Comparison of budget positions and public policies

France's and Germany's neighbours are generally more heavily indebted, have less robust *budget balances*,* and are prone to inflation dynamics that are marginally more volatile. Their fate is conditioned on the architecture of the monetary union and the solidity of the tandem formed by Paris and Berlin. The disparity of budget positions within the eurozone is misleading, since the responses of governments to the financial crisis and the evolutions of their public finances depend on their positioning vis-à-vis the Rhineland pillar.

The promotion of a lasting recovery on the continent and the revival of the European project thus necessarily require a reinforcement of the central Franco-German pillar (as a recent *Briefing Paper* from the Institut Montaigne pointed out[23]). Getting the eurozone countries into phase with this pillar through the stabilisation of the Mediterranean area (and, to a small extent, that of the East) can only be achieved on the basis of a solid cornerstone. **A lasting divergence, however small, between German and French economic policies could halt the recovery within the Eurogroup, thus posing the question of its *raison d'être*[24].**

Despite the overall alignment of French and German positions since the G-20 summit held in London (March 2009) and later in Pittsburgh (September 2009), the initiatives taken by the two countries did not systematically work towards a lasting rapprochement between the two economies. Quite apart from the variations in the lifelines thrown to the financial sector and in the support for demand, a fiscal decoupling could further separate France and Germany. Stimulus packages with potentially asymmetric impacts could widen the gap between the *structural balances*,* badly damaging the driving force behind the single currency.

[23] Institut Montaigne, *Between the "G2" and the G20: Europe and the Financial Crisis*, September 2009.

[24] See "*Diverging deficits could fracture the eurozone*", Wolfgang Münchau, *Financial Times*, 4 October 2009; "*Franco-German marriage of convenience*", Wolfgang Münchau, *Financial Times*, 18 November 2009.

Between stimulus package and National Loan: a French programme in two stages

The French response is articulated on two main thrusts, consisting, on the one hand, of the stimulus package, the short-term support for consumption and employment announced as early as December 2008 for a maximum of ú26 billion, and, on the other, of the investment of the proceeds of the "National Loan" amounting to ú35 billion and intended to promote long-term growth through research and innovation.

It is generally considered that one initial element of this highly structured action programme seems already to have borne fruit, inasmuch as a strengthening of the *automatic stabilisers** has considerably cushioned the economic and social impact of the financial crisis. A series of closely-targeted initiatives benefiting mainly the less-well-off households has prevented the subsidies allocated in this way from being saved (in order to maximise the *multiplier effect**) and has sustained domestic demand on drip-feed at a time when everywhere else in Europe consumption was collapsing. A 15-point rise in part-time unemployment benefit (and a reduction in the minimum contribution period), the creation of a "*prime de solidarité activeö*[25] as a prelude to the RSA[26] and substantial reductions in income tax have pumped additional strength into the French economy.

Furthermore, the exonerations from social contributions and steps to improve companies' cash situations have ï directly and indirectly ï benefited a labour market that has been badly hit, although probably without being able to prevent the unemployment rate reaching 10% of the labour force in 2010.

The "National Loan", for its part, is aimed at restoring priority to long-term growth and bringing renewed vigour to an eroded French growth potential[27]. The proceeds of ú22 billion, to which will be added ú13 billion in bank loan repayments, will be invested mainly in research and innovation in certain strategic priority areas (higher education and training, research, industry, sustainable development and digital technology) ï priorities whose precise boundaries could evolve over time. Its practical modalities, defined by a Commission of experts, also comprise a reshaping of the architecture of the higher education system and the constitution of endowment funds to be allocated to teaching and research institutions ï though managed by the Finance Ministry ï and the financing of innovative SMEs, and the implementation of a major urbanisation project[28].

The effectiveness of the programmes initiated in this way will depend mainly on the quality of the investments made. Even so, the combination of a defensive programme

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[25] Active Solidarity Bonus.

[26] Revenu de solidarité active (Active Solidarity Income), introduced in June 2009.

[27] As shown by the decline in hourly labour productivity since the 1980s (from an average of 3.1% between 1980 and 1990 to 1.2% between 2003 and 2007). Source: õ*Priorities financed by the National Loan*ö, 14 December, 2009, Presidency of the Republic.

[28] The budget of the National Loan will be managed according to a logic of concentration of resources without burdening the public accounts, the proceeds being deployed in the form of loans, acquisition of shareholdings and contributions to foundations, and with the interest due on the ú22 billion raised on the capital markets financed by a reduction in government current expenditure.

of support for growth and a longer-range capital spending programme intended to enhance competitiveness is perfectly coherent and has every chance of turning out to be very effective.

These programmes, however good their performances (achieved or expected), nevertheless have a material cost that will weigh on the French budget in years to come. The net increase in the national debt, in the absence of scrupulous management of administrative expenditure, could call into question the commitments entered into by the State vis-à-vis its Eurogroup partners, its creditors and its taxpayers.

Any new worries on the part of the French governmentôs creditors could result in a sell-off on the markets, a rise in benchmark rates and an increase in the cost of financing French debt at the time of the next auctions. If doubts were to persist, France could thus be penalised by its usual lenders. More serious still, the taxpayers themselves could suddenly become more mistrustful, setting aside the resources temporarily placed at their disposal by tax breaks, thereby increasing precautionary savings in order to deal with what they would view as a looming rise in taxes and social contributions. Such behaviour (known by economists as the *Ricardo effect** after the 19th-century English economist David Ricardo) probably constitutes the greatest risk at the present time. Any overambitious fiscal measures could then be useless, while still burdening the public balance sheet.

Fortunately, the French government has for the time being managed to preserve intact its capital of credibility with investors. The reduction of the deficit amounting to five GDP points in three years announced by the Finance Ministry ï equivalent to a total sum of ú100 billion ï gives the measure of the government's ambitions. The possibility that the French authorities might become locked into a vicious circle of debt repayment remains highly theoretical, to say the least. However, certain indicators show that such a risk could become definitely more tangible in the relatively short term, should the extreme nervousness of the markets last. The National Loan, whose announcement had initially been greeted by the markets with a certain anxiety[29], has finally succeeded in convincing observers by the clarity of its ambitions and the rigour of its forthcoming implementation. More worrying are recent developments in the mood of taxpayers: a survey carried out by the British institute Harris Interactive for the *Financial Times* (28 December 2009) reveals that the French, of all the populations questioned ï American, British, German, Italian, Spanish ï are at the same time the most anxious regarding their material future in the decade now starting and the least satisfied with the evolution of their standard of living during the past ten years. A total of 44% of the national population said they were ñpessimisticò concerning the near future, a result which speaks volumes about French confidence in a lasting recovery.

[29] Cf. the note published by Moody's on 17 November 2009.

12. Stimulus package and National Loan: consolidation

	Billion euros	% of GDP (2008)
Stimulus package	**38.7**	**1.98%**
Public Investment	11.7	
Firms and employment	19.4	
Social measures, housing	4.6	
Strategic investment fund	3	
National Loan	**35**	**1.79%**
Higher education and training	11	
Research	8	
Industry and SMEs	6.5	
Sustainable development	5	
Digital technology	4.5	

Source: DGTPE (Treasury and Economic Policy General Directorate); Ministry for the Budget, Public Accounts, the Civil Service and State Reform

Dynamic stability and pro-cyclicality in Germany - a renovated federal budget*

The German situation is quite different. While the German and French initiatives are indeed of comparable nature, their methods diverge. **On the whole, the German authorities have shown themselves above all anxious to preserve their future room for manoeuvre, committing only very little net expenditure that is irreversible in the short term and giving priority to announcement effects and the management of expectations[30].**

Germany, whose growth is highly dependent on its exports of capital goods, has been particularly penalised by the slowdown in world trade and by the precipitous fall in industrial output as a result of an abrupt de-stocking movement. The very weak growth in tax revenue (only 3% in 2008), coupled with a very big rise in public expenditure due mainly to layoffs, sent signals which the federal authorities met with pragmatism but caution. A relatively small immediate response ï equivalent to about 1.5% of GDP ï mainly favouring the key export sector and endowed with an

[30] The German economy profits very substantially from the stimulus packages of its Eurogroup trade partners. This considerably reduces the incentive for Berlin to implement an expensive stimulus package of its own.

extraordinary budget envelope of ú82 billion and new lines of public credit amounting to ú100 billion was accordingly voted[31].

To this first raft of measures were soon added initiatives intended to counter the deliquescence of bank balance sheets. German banks were distinctly more exposed to the American mortgage market and to the so-called "toxic" structured products than most of their European counterparts, notably the French banks[32]. The hurried creation of the SoFFin (*Sonderfonds Finanzmarktstabilisierung*), a structure for ñsmoothingò the book losses suffered by the German institutions[33], was the subject of some criticism. If this entity had, like the French SFEF (*Société de financement de lõéconomie française*), a clear mandate to offer an alternative to systematic stake acquisition (the British solution), often resulting in majority ownership[34], it was not intended to play a direct role in the financing. Given that estimates by the IMF and the ECB had already highlighted the particularly sensitive situation of German credit institutions, the incomprehension of analysts and the general public regarding such conservative measures was legitimate.

But it is the small scale, especially, of the tax measures and the direct support for domestic demand (limited to ú50 billion in January 2009), traditionally regarded as being the Achillesô heel of the German economy, that was subject of the harshest judgments. The recent upward revision by the ECB of the write-downs by European banks between 2008 and 2010, whose total is now put at over ú550 billion, may have given reason to these criticisms.

It is true that the Merkel administration, on the eve of a general election (in September 2009), was then faced with an acute dilemma, squeezed between ñfacilityò ï in the shape of a bloated and popular stimulus package, but one that was also far more expensive in the long term ï and ñdiscouragementò ï the opposing and no less manifest risk of introducing measures insufficient to heal the wounds inflicted on the nation's economy. The implementation of the modest new tax cuts promised during the campaign, to the tune of ú8.5 billion[35], was welcomed with relief at a time when industrial production, despite having moved upwards since the first quarter, was giving fresh signs of weakness[36].

Much criticised for its lack of reactivity to a historic crisis throughout the first half of 2009, could Germany be on the way to falling indulgently into overreaction? On the contrary, there is tangible evidence that the adjustment of German fiscal policy was

[31] The precautionary character of the committed policies is due less to the amounts invested or guaranteed than to the weakness of the tax stimulus and of the support for demand.
[32] This is a particularly significant problem for the regional institutions (*Landesbanken*) for which the withdrawal ï imposed by Brussels ï of any official support could often have been fatal, because of an imbalance between the returns on the assets held in their portfolios, on the one hand, and their financing costs on the other.
[33] By subtraction of the most heavily discounted assets on a mark-to-market basis, charging the aforementioned losses to the government only temporarily.
[34]Contrary to what was sometimes done in extreme cases such as those of Bayern LB or West LB, which were re-capitalised in haste and provided with substantial guarantees by their respective Länder.
[35] This measure is due to be accompanied, from 2010 on, by income tax exemptions of about ú19 billion.
[36] New orders fell by roughly 2.1% between September and October 2009 ï a signal rather than a fact having lasting consequences, as the growth since February has remained at 17%.

well timed, remaining rigorous but without excluding a certain opportunism. Preliminary work on the 2010 budget, presented in December 2009 by
Wolfgang Schäuble, Federal Finance Minister, announced a drastic rise in taxes, over the long term, in order to contain a public deficit that was still expected to exceed ú85 billion, but to which had to be added an exceptional charge of ú14.5 billion due to the Federal governmentõs most recent interventions. The plan for an uninterrupted reduction in public spending until 2016 has forced the government to improve the public accounts by ú10 billion annually until that date. Recourse to "extraordinary" measures is likely to be necessary in the near future.

But it is another initiative, taken by the preceding coalition government ï and prompting curiously little comment outside Germany ï that lies at the heart of Berlin's strategy. Namely, the decision in June 2009 to write into the Constitution a cap of 0.35% of GDP on the federal deficits starting in 2016 ï except in "exceptional circumstances" ï and then from 2020 on a complete ban on budget deficits at regional level. The aim appears to be twofold:

- On the one hand, to anchor investors' expectations with immediate effect, as a rampart protecting Germany's ñsignatureò (borrower quality);
- On the other, to build up a *pro-cyclical** fiscal momentum to coincide the start of the process of improving the *structural balance** with that of debt reduction, on the back of the recovery[37].

The IMF ï whose recent forecasts expect Germany to run a balanced budget starting in 2014 ï seems to be expressing its confidence in this latter scenario.

Even so, this initiative carries substantial risks ï for the Federal Republic but also for the Eurogroup as a whole. In the event that growth were to run out of steam (an eventuality that numerous research institutes have still not discarded), the government would be forced to respect this self-imposed rule, inflicting deep budget cuts that would be all the more painful in that they would also have to compensate the cyclical loss of tax revenue. Anaemic growth, probably coupled with deflationary pressures, would in this case threaten to plunge Germany into a crisis that would be more severe than that seen in recent months. This decision could represent a new turning-point for the eurozone economy[38].

[37] The increase in government financial requirements for the States caused a shortening of average maturities of the public debt. To launch stimulus, governments had to raise short-term capital. Whereas the short-term foreign debt (repayable in under twelve months) of the Federal government accounted for only 4.8% of the total stock in 2007, this figure had risen to nearly 10% in Q2 2009. The corresponding figures for France were 9.1% and 16% respectively. The refinancing of such a stock of debt implies a higher frequency of issues, as the return to budget surpluses in Germany will allow only a very gradual reduction in debt.

[38] The conclusions of the working group charged by the French presidential office with examining the appropriateness of a rule regarding equilibrium in the public finances will decide the orientation to be adopted by France ï conforming to the German model or preferring to retain greater leeway.

13. Franco-German comparison of general government revenue, expenditure and debt in 2008

	France	Germany
General government revenue (% of state budget)	49.3%	43.9%
General government expenditure (% of state budget)	52.7%	43.8%
General government debt (% of GDP)	68.1%	65.9%
The S2 sustainability indicator (*)	3	1.3

Source: DGTPE (Treasury and Economic Policy General Directorate);
Ministry for the Budget, Public Accounts, the Civil Service and State Reform

(*): This quantifies the immediate and lasting improvement needed to meet the financing requirement without increasing debt. S2 therefore depends on the initial budget position and the scale of possible future increases in expenditure (population ageing, for example). The higher S2, the greater the necessary fiscal improvement.

An explicit risk for the eurozone

If the re-starting of the eurozone growth engine depends on a prompt recovery of the French and German economies, the cohesion of monetary union depends, for its part, on maintaining a strong fiscal coupling between Paris and Berlin.

In the immediate aftermath of the financial crisis, France opted for a deliberately *contra-cyclical** short-term policy, counting on the strengthening of its *automatic stabilisers**, whereas Germany seems to have followed the opposite path of pro-cyclicality.

In the longer term, however, there is an obvious desire for convergence, as demonstrated by the announcement from the French Finance Ministry of substantial spending cuts and by the possibilities opened up by the conference organised at the Elysée Palace on 28 January, 2010, which could lead to the implementation of a Merkel-style cap on deficits. But protecting the Eurogroup's future requires far more solid guarantees between France and Germany.

A new persistent fiscal divergence between the two partners of the Rhineland pole could increase the *asymmetric character of future shocks, depriving the Member States of an adequate common monetary policy and calling into question the *raison d'être* of European economic construction.**

PART III

THE ARGUMENT FOR A FRANCO-GERMAN FISCAL COUPLING THROUGH THE CREATION OF A EUROBOND

CHAPTER I

THE NEED FOR AN EFFECTIVE COUPLING OF FRENCH AND GERMAN POLICIES

Ambitions

Beyond the similarities between the levers actuated by France and Germany in response to the financial crisis of 2008, the threat of divergent fiscal orientations remains. Uncoupled public finances, resting for Germany on a *pro-cyclical** programme of *budget balance** and debt reduction and in the case of France on *contra-cyclical* automatic stabilisers**, will necessarily produce opposite reactions in the two economies in dealing with future economic shocks. This development, while not necessarily harmful to the trade complementarity of the two partners, nevertheless directly calls into question the *raison d'être* of the eurozone.

The Institut Montaigne has already for many years pleaded for an economic, political and cultural rapprochement between Germany and France. The cracks which are gradually opening up in the walls of the European edifice are incompatible with this vision. This *Policy Paper* intends to set out a series of proposals intended, first, to restore a coupling between French and German economic policies (necessary for the proper functioning of the Eurogroup) and later to overhaul the institutional arrangements in force between Member States by tracing out the contours of innovative mechanisms for managing public debt.

Reactivity, coordination and credibility: three pillars for a Rhineland fiscal policy

Recent turmoil affecting Greece's sovereign debt have highlighted the key role played by expectations regarding public debt management and the external financing of deficits. It is the reputation – the signature, the "credit" – a borrower enjoys that will determine the facility with which it will be able to contract new loans and at what cost[39].

The credit accorded by markets to a sovereign borrower is therefore above all a matter of expectations. These may just as easily depend on an impeccable record, involving zero default, as on adopting a convincing set of measures that investors regard as well suited to mitigate credit risk. The case of the Eurogroup is very

[39] This being the sum of a supposedly risk-free interest rate and a premium specific to the borrower, remunerating the possibility of a default.

particular in this respect. This being a unified monetary area backed by an economic and political union, the functioning of expectations involves an additional degree of complexity. The existence of a common central bank and a common currency makes the consequences of a default extremely problematic, with a credit crisis inevitably leading to a currency crisis - in this case partly ñunjustifiedò in that the financial health of the other Member States is theoretically not directly affected. The consequences of a sovereign default within the eurozone would plunge the entire group ï and more broadly, the continent as a whole ï into far too deep water. In all likelihood, therefore, everything will be done to prevent such a scenario.

Three vectors make it possible to steer the fiscal action plan in the eurozone and to establish a virtuous circle: reactivity, coordination and credibility. The following paragraphs aim to clarify and illustrate each of these terms.

Reactivity

As the first part of this *Policy Paper* has highlighted, one of the principal differences between the Great Depression of the 1930s and the ñGreat Recessionò from which the world is struggling to emerge in the early part of 2010, is the determination shown by public authorities. A fiscal policy can be effective only if it is truly preventive: *pro-cyclical** in an effort to increase tax revenues in upswing phases and to reduce public debt; *contra-cyclical** in downswings in order to foil the perverse effects of an erosion of growth, consumption and employment. The restoration of the *structural balances** has no other objective than to leave governments the room for manoeuvre needed for a possible change of orientation to cushion the effects of an unfavourable economic situation.

Within the eurozone and more particularly at the Franco-German level, it is urgent to achieve greater fiscal flexibility. While the rapid reaction of the governments at the time of the last crisis, particularly on the French side, was decisive, the initial decoupling of the policies implemented on the two sides of the Rhine could have made the rebound less easy. Each new economic jolt threatens to produce a common monetary response to which each country has to adapt through national fiscal measures that are temporarily useful but could turn out to be counter-productive in the long run. The reactivity of the fiscal policies can thus be preserved only at the cost of a reduction in the structural deficit ï which requires closer coordination between the governments.

Coordination

The coordination of French and German fiscal policies ï and, at a second stage, all eurozone fiscal policies ï can start with the coordinated management of public assets and/or liabilities. An asset-led coordination is a well-known solution, although it still awaits tangible implementation: the launching of joint industrial projects, the construction of trans-border infrastructure in the fields of energy, transport and communication, for example, could advantageously take place with this goal in mind[40].

But this coordination can just as easily be led from the liability side of the public balance sheet. The method previously described implicitly relied on the assumption that ñthe expenditure creates the resourcesò ï meaning that projects common to France and Germany, by synchronising the financial needs of the two countries, would sooner or later lead to a sharing of resources, or at least to a greater alignment of receipts. Liability-led management, reversing this reasoning, is based on the view that common resources (and repayment schedules) are an incentive sooner or later to align spending and to syndicate investments.

A further look at the Greek case illustrates the shortcomings of the current system and indicates an initial reform agenda. The comments by the President of the *Bundesbank*, Axel Weber, by the President of Eurogroup, Jean-Claude Juncker, and by Fredrik Reinfeldt, the Prime Minister of Sweden (a country that is not a member of the eurozone), have underlined the primarily domestic nature of the Greek crisis, and have more or less explicitly ruled out any intervention by a Member State[41]. This has merely intensified the anguish of the markets and helped to widen the differential between the Greek and German benchmark rates by almost one and a half points in the space of barely a few days. Incidentally, and despite the normalisation of Greek yields brought about by the possibility of an explicit collective guarantee ï which would be just as unsatisfactory ï from other Member States, it is possible that Athens has already been in technical default for several months, to judge by the pharmaceutical companiesôclaims that the Greek government has neglected to pay approximately ú7 billion owed to them[42].

The solution by default of a collective guarantee by Member States, supposedly conditional on the offending borrower's putting its public finances in order, is obviously too asymmetrically restrictive to be convincing. The government benefiting from the guarantee has nothing to gain (especially in the run-up to an election) from a cure of austerity which it does not feel obliged to implement to the letter. Conversely, the guarantors have everything to lose from a default on the part of the beneficiary of the guarantee, so that their threat of abandonment is not credible. The distinct decline of the euro on the foreign exchange market since the start of the Greek crisis illustrates this clearly. A collective guarantee from Member States is thus not an effective mechanism, since it encourages the governments to lead a fiscal policy according to strictly domestic motivations, counting on an intervention of the other Community Members in the event of difficulties: in the long term, this would put the finances of all the Member States at risk.

[40] The *Briefing Paper* by the Institut Montaigne *Between the "G2" and the G20: Europe and the Financial Crisis* published in September 2009 gives a list of concrete projects whose implementation awaits only the approval of the public authorities.

[41] A position that was later rejected on 28 January 2010 by European Commission President Barroso ï probably to limit the risk of contagion, at a time when Portuguese solvency is also being called into question.

[42] According to a report published on 31 October 2009 by the Greek pharmaceutical companies' association (*A Report on Public Hospitals' Debt Towards SFEE's Member Companies, HAPC*), a sum of 3.5 billion euros was unpaid by the Greek hospitals in October 2009, with the corresponding figure for the whole of the public healthcare sector at the end of 2009 reaching ú7 billion, according to the *Financial Times* of 16 December 2009.

The maintenance of the Stability and Growth Pact in its current form, supplemented by a collective guarantee of national debts, can lead the Eurogroup in the direction of two different types of equilibrium:

- An increasingly heterogeneous, unjust and ineffective coupling, with the absence of strict fiscal management on the part of some countries resulting in increased dependence on the discipline of the others;
- A progressive separation of the most virtuous Member States, wanting to preserve their signature, from the others, even to the point of withdrawal.

Obviously, neither of these two options is acceptable: reform of the Stability and Growth Pact and of the guarantee mechanisms is thus both necessary and urgent.

The creation of a debt instrument, initially common to France and Germany and then gradually extended to the whole of the eurozone, would have many advantages. Such an initiative would above all facilitate the coordination of fiscal policies thanks to a reinforcement of their individual credibility.

Credibility

A fiscal policy can be effective only if it is credible at both domestic and international level. Indeed, the multiplication of stimulus packages with objectives considered too vague, too remote or with too uncertain a chance of success is likely to encourage households and firms to give preference to saving over investment and consumption ï necessarily curbing (because of erosion of the *money multiplier**) the effect sought by the initiative in question ï an initiative whose cost will nevertheless weigh on the public accounts. Symmetrically, a loss of confidence on the part of international investors holding sovereign bonds would lead to a service cost increase for the borrower and raise the probability of default.

The policy of a Member State will be credible in two cases:

- A first possibility is that all the members individually remain virtuous in the management of their public finances, reducing their own structural deficits: this solution remains clearly imperfect (and widely unrealistic), because of the pro-cyclicality that will be bound to govern the adjustment phase and because of the ambivalent impact of a common monetary policy, a source of potentially destabilising shocks;
- A second solution, at the same time more realistic and more effective, sees the Stability and Growth Pact replaced by a constraining mechanism for planning and coordination, satisfying the third criterion of optimality defined by Mundell (the existence of a fiscal transfer mechanism).

A supranational debt instrument combined with a system of redistribution will maintain the advantages enjoyed by the members of the Eurogroup before the financial crisis ï essentially, a lower financing cost ï while reducing the risk of moral hazard relating to the least rigorous Member States. The necessarily constraining character of this instrument guarantees its reliability: any individual deviation by a Member State behaving in ñfree riderò fashion would automatically be corrected by the dual effect of a deprivation of fresh capital and an inevitable rectification of the domestic fiscal balance[43]. An austerity programme on a sufficient scale to ensure the repayment of the advances granted ï but possibly spread over time to avoid stifling growth ï would then be drawn up with the European partners of the country concerned. The Eurobond would constitute a double rampart against an individual default and against the application of too harsh a policy, with disastrous effects on short-and long-term growth to satisfy anxious international creditors.

Such a solution, credible for being coordinated, would have a clearly virtuous effect on public finances in the whole of the eurozone while leaving the borrowers ample room for manoeuvre ï a first step towards reactive and credible fiscal policies.

[43] An increase in tax pressure and a reduction in expenditure then being the only recourse available to the government to finance its budget.

CHAPTER II

PRACTICAL METHODS OF IMPLEMENTATION

Asset-side fiscal coordination

The first approach considered is based on a coordination of fiscal policies from the asset side through the launching of common investments.

Investments common to France and Germany can be carried out and continued in many strategic domains: space industry, transport and energy distribution, motorway transport, armament research and manufacture, information technology, pharmaceutical industry, media and communication, etc.

Beyond this first set of measures, a coupling of the two countriesôtax policies could also be launched. While a strict alignment of the French and German tax systems cannot work for the time being because of too large differences in specific needs and asymmetries which the taxes help to rectify, certain segments, on the other hand, would lend themselves perfectly to such an exercise. While corporation tax can constitute a first field of application, a broader effort to harmonise tax bases (rather than tax rates, initially at least) would undoubtedly contribute effectively to a Franco-German economic rapprochement. The tax reforms being considered in both countries should provide the governments with the ideal occasion to carry out these changes.

Liability-side fiscal coordination: a ñEurobondò issuance

The keystone of the new institutional device outlined in this *Policy Paper*, which would be introduced to replace (progressively) the Stability and Growth Pact, comprises two simple elements linked by an explicit contract.

France and Germany (and later, in a second phase, all the Eurogroup members) will agree first of all on a strategy of multi-annual financing of their budgets and on the planned evolution of their debt policy. Once the amount of the additional resources needed has been mutually approved, an auction of ñEurobondsò will be undertaken by an agency created for the purpose.

Each financial year would see the capital raised in this way transferred to the national Treasuries according to a predetermined issuance timetable. In the same way, the required share of the domestic tax revenues of each country would be distributed to the agency for the purpose of ensuring the payment of the interest and the reimbursement of the capital due from the agency to its creditors. In the event of non-observance of this agreement by a Member State, its partners would stand surety for its share ï at the same time retaining the right to subtract this ñcash advanceò from the sums to be redistributed to it at a later date.
Such a mechanism would have immense advantages. The Eurobond would, from a technical point of view, be particularly beneficial to the sovereign bond market. While giving the highest-graded Member States the benefit of perfect liquidity ï probably

better than their own paper would enjoy, as can be easily shown by the two failed German auctions in Q1 2009 (see graphs in the Annexes) ï and ensuring the other less solid countries preferential financing, at the same rate as their more virtuous peers ï without, even so, harming the effectiveness or the credibility of the instrument.

The syndication of sovereign issuances within the Eurogroup would also prevent the Member States from engaging in fratricidal competition to corner the (necessarily limited) demand from investors, a competition that would undoubtedly lead to a general rise in interest rates and increasingly systematic recourse to inflation-indexed paper[44]. It is thus a question of carrying out bond issues in common so as to make the financing of the Member States as effective and inexpensive as possible[45].

The Eurobond project is not intended to bring about a merging of national liabilities ï and hence of sovereign debts ï since each country would retain, in normal times, its full financial sovereignty. **The recourse to a common debt instrument and the collateralising of a newly-issued security on the tax revenues of the participants, by forcing the States to respect their commitments, would reinforce the credibility of public action and would stimulate a form of fiscal coordination essential to the effectiveness of the single currency and the construction of the European economic edifice.**

The conditions for success

The creation of the Eurobond will obviously not be free of difficulty. The risks likely to surface at the time of its introduction are numerous. An ill-defined hierarchy between sovereign paper and the Eurobond could result in a confusion on the markets that would be highly prejudicial in the event of tensions, accelerating a retreat towards German paper. A more thorough but insufficiently structured financial integration could lead to a clear increase in systemic risk and to an increased risk of contagion: for example, a Greek quasi-bankruptcy would no longer lead to merely a widening of the yield spread between Greek paper and the German *Bund*,* but to variation of yield on the Eurobond.

However, the benefits of this instrument greatly outweigh the possible costs to be borne because of these risks ï provided that its introduction is carried out with precaution and rigour.

[44] Such indexing is dangerous in the aftermath of strong injections of liquidity.

[45] Yet again, the Greek case is a mine of information: the critical situation facing the government at the end of January 2010 would have constrained Athens to turn to the Chinese authorities ï holding reserves estimated at 1,400 billion dollars ï to ensure the refinancing of the debt and to calm the fears of the market. The wide variations in the return on Greek paper and the marked erosion of the euro on the announcement of this news clearly shows its importance: the possible substitution of China for Greece's European partners but also for the IMF as lender of last resort (and as a ñmonoline insurerò) is revealing of a profound change in the international monetary order. The need for Europe to show a united front thanks to the Eurobond would avoid one of the sixteen becoming too dependent on Beijing ï with the Chinese appetite for sovereign paper influencing the other investors and dictating the cost of refinancing ï while facilitating the diversification of Asian reserves in favour of the euro.

A first phase, strictly Franco-German, will begin with the establishment of a list of common long-term investment projects (in the fields of transport and energy infrastructure and also that of research and innovation). The selection of these projects will be accompanied by a common investment schedule, explicitly and jointly backed by the tax revenues of the two countries in proportions that correspond to the expected gains (or to the amounts actually invested by the two countries). The precedence given to the Eurobond over sovereign domestic paper and the creation of a supranational issuance and management agency will enable the first auctions to take place smoothly, with *OATs**, *Bunds*,* and Eurobonds coexisting on capital markets. The pre-eminence of Eurobonds over the national securities ï whose residual volume would be reduced year by year ï should fully convince markets. Defensive measures can also be considered: recourse to private placement with sovereign investors seeking diversification, even to underwriting[46], at the time of the first auctions, accelerated replacement of certain types of national paper through an exchange of securities for Eurobonds, etc.

The second phase, still Franco-German, will see a progressive extension of the budgetary perimeter for the financing of Eurobonds: this will involve associating with the common investment projects the most relevant items of current budgetary expenditure ï the most comparable and most capable of providing identical responses to economic shocks. Satisfactory progress with this critical phase will presuppose a certain prior consultation regarding, and mutual approval of the budgetary agendas, as the basis for a degree of coordination that will be rounded off by the joint financing instrument.

In the long term, the drawing up of coordinated budgets will make it possible to replace domestic sovereign paper entirely. A parallel widening of the geographical boundaries of the Eurobond, through the participation of other members of the eurozone, will be possible at the conclusion of this second phase.

The financial crisis and the widespread national over-indebtedness can provide the occasion for restarting European construction, after several years of stagnation. By meeting the criteria of coordination and redistribution necessary for the transformation of the European monetary union into an optimal currency area (which today are still not met), the creation of the Eurobond would guarantee the existence, between France and Germany, of a permanent fiscal coupling: with the disappearance of the threat of *asymmetrical shocks, the effectiveness of the choices made by the ECB would be immediately reinforced ï an effective common monetary policy remaining, as the founding fathers had so rightly observed, the best means of invigorating growth.**

[46] A procedure in which a financial intermediary carries out an issue of securities on behalf of a customer. An underwriting contract contains guarantees regarding the success of the operation, with the intermediary carrying the risks related to its placement.

ANNEXES

DEFINITIONS

Asymmetric shock: an exogenous macroeconomic phenomenon affecting different economies in different ways, depending on their specific characteristics.

Automatic stabilisers: contra-cyclical policy instruments tending to dampen fluctuations in consumption and employment, generally taking the form of major social programmes.

Budget balance: net balance of revenue and expenditure posted in the government budget. A negative budget balance will be met by borrowing.

Bund: the German *Bund,* a benchmark instrument on capital markets, is one of the debt securities offered by the Federal government. The following (non-exhaustive) list shows their names and maturities:

- Tagesanleihe (daily, indefinite);
- Finanzierungsschätze (one or two years);
- Bundesschatzanweisungen (two years);
- Bundesobligationen (five years);
- Bundesschatzbriefe (six years - type A - or seven years - type B);
- Bundesanleihen (ten years or thirty years).

Contra-cyclical: a phenomenon is said to be contra-cyclical if its effects are inversely proportional to the evolution in the economic situation. Contra-cyclical policy ï monetary or fiscal ï will therefore aim to reduce fluctuations in growth.

Cyclical swings: short-to-medium-term variations, generally relating to exogenous effects, independent of the structure of the economy being affected.

Factor mobility: the ease with which factors of production are allocated within a given territory. The mobility varies from one factor to another, with capital being traditionally more mobile than labour.

Fiscal redistribution: mechanism by which the tax levied on a given population finances spending carried out for the benefit of another. Fiscal redistribution, synonymous with social transfers at a national level, more generally designates any instrument for managing budgetary resources.

Inflation rate: marginal rate of increase in prices ï producer prices or consumer prices ï in wages or asset values observed in a given currency over a given period.

Money multiplier: the coefficient of circulation of money, equal to the inverse of the marginal saving propensity of a representative economic agent. The injection of one euro into the economy generates more or less substantial commercial flows (of degressive amounts). For example, a loan of one euro to individual A will generate an initial transaction ï still for one euro ï between A and B, followed by a second transaction for 80 cents, for example between B and C, and then a third for 64 cents between C and D, then a fourth for 51.2 cents, and so on. The marginal saving ratio is in this case 20% at each stage and the multiplier will be equal to 5.

OAT (*obligation assimilable du Trésor):* fungible debt instrument. The majority of French government debt takes the form of OATs. The following list gives a more complete picture of French debt instruments (and their maturities):

- Obligations assimilables du Trésor ï OAT (between seven and 50 years);
- Bons du Trésor à intérêt annuel ï BTAN (annual-interest) (between two and five years);
- Bons du Trésor à taux fixe et à intérêts préescomptés ï BTF (fixed-rate Treasury notes at pre-discounted interest) (less than one year).

Pro-cyclical: a phenomenon is said to be pro-cyclical if its effects are proportional to the evolution of the business cycle. A pro-cyclical policy ï monetary or fiscal ï aims at intensifying growth fluctuations.

Quantitative easing: "non-conventional" monetary policy tool by which a central bank increases the liquidity available in the economy to finance debt securities ï public or private ï in order to compress their yields. Banks would then divert their capital away from the latter, to finance private sector lending activities that have suddenly become more lucrative. Originally introduced by the Bank of Japan in the early 2000s, quantitative easing became increasingly widespread during the 2008 crisis. The powerful inflationary tensions that this policy exerts, and the strains that its withdrawal can create, make it effective but potentially dangerous.

Ricardo effect: a phenomenon highlighted by the English economist David Ricardo (1772-1823), according to which demand will in the end be unaffected by the fiscal policy applied to an economy, since the additional demand generated by deficits will be compensated by an increase in taxpayers' saving ratios, in anticipation of a rise in taxation. The Ricardo effect therefore refutes the hypothesis of short-sightedness on the part of the private sector and calls into question the long-term effectiveness of fiscal policy.

Spreads: difference between two rates or yields. Generally, the spread on sovereign paper is measured by the difference between the return on a given government security and that on a certain benchmark security ï usually American or German.

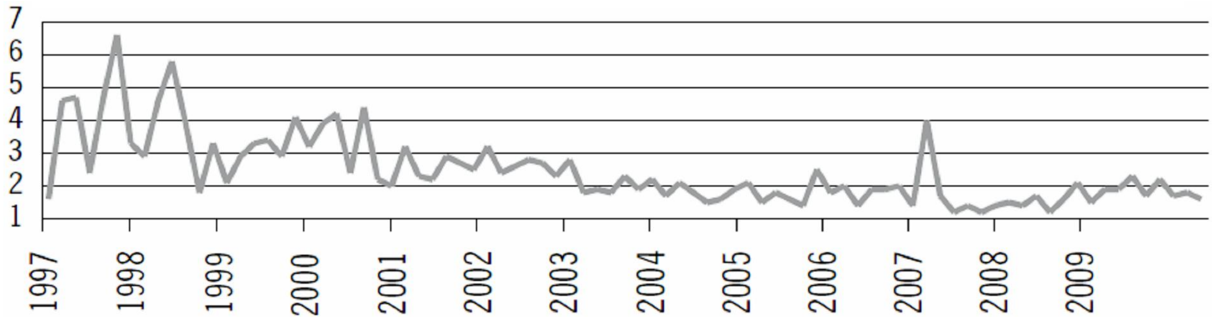
Structural balance: budget balance adjusted for cyclical effects, corresponding to equilibrium between revenue and expenditure.

Yield curve: a curve showing the cost of borrowing for different maturities at a given time. A normal curve has a positive slope, meaning that borrowing for a long period is marginally more costly than borrowing for a short period.
In the opposite case, the curve will be said to be "inverted" ï generally pointing to a worsening of the economic climate and growth expectations. An inverted yield curve, in addition, discourages the short-term refinancing of long-term debt as borrowers are then encouraged to default.

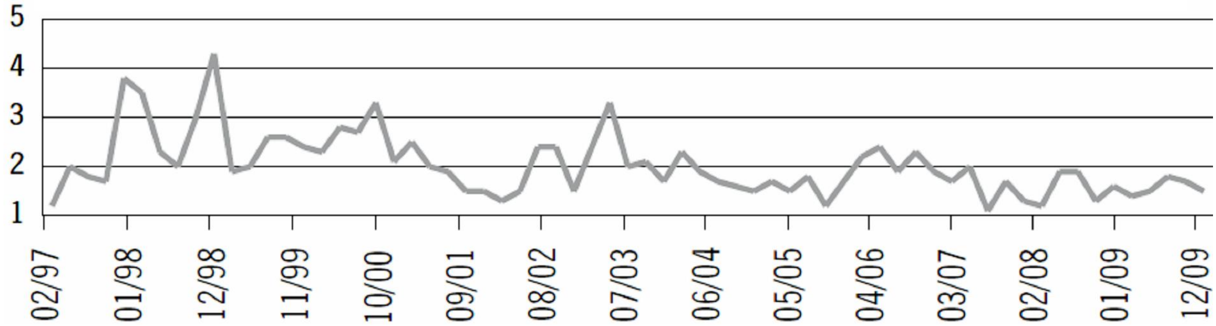
Gradual decline of liquidity on German bond auctions: evolution of the cover ratio (1997-2009)

The cover ratio of sovereign bond auctions, the ratio between bids received and the issue volume, is an indicator of investors' appetite. A ratio of less than 2 is regarded as low. The distinct decline in the cover ratio of German auctions since the creation of the eurozone is a by-product of the hypothetical guarantee that Berlin was assumed to provide its partners: for identical credit risk, the markets will in normal times prefer the paper with the highest yield. The cover ratio for an auction is equal to the ration between the number of bids received and the number of securities actually placed.

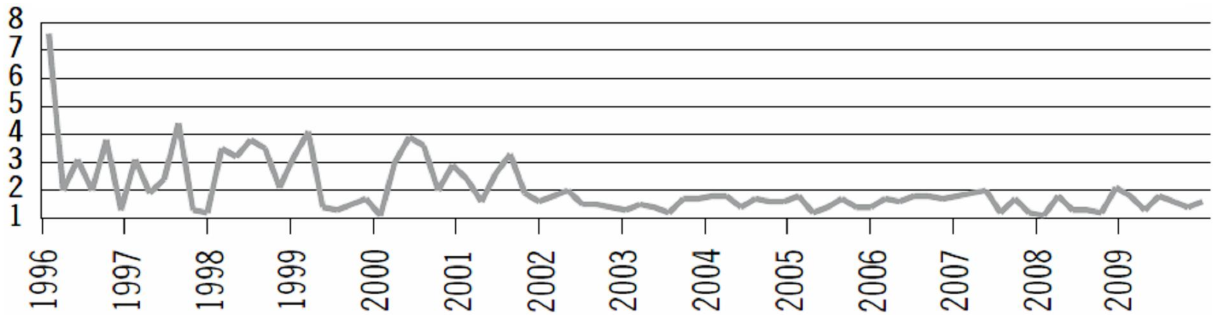
Cover ratios of German two-year bond auctions



Cover ratios of German five-year bond auctions



Cover ratios of German ten-year bond auctions



Source: Bloomberg LP, January 2010

Comparison of national gross external debt profiles, Q2 2009

Debt is said to be short-term if it arrives at maturity within one year.

	Long-term gross external debt/ Total gross external debt (central government)	Short-term gross external debt/Total gross external debt (central government)	Gross external bank debt/Total gross external debt (central government)
Germany	89.5%	10.5%	49.5%
France	81.0%	19.0%	46.9%
Spain	90.8%	9.2%	46.0%
Greece	96.8%	3.2%	28.3%
Portugal	86.6%	13.4%	50.4%
United States	74.9%	25.1%	20.0%
United Kingdom	87.3%	12.7%	64.7%
Japan	57.8%	42.2%	46.2%

Sources: World Bank, Bank for International Settlements

French general government expenditure in 2007

	Billion euros	Proportion of total expenditure
APUL	206.5	20.8%
Central government and ODAC	340.1	34.3%
ASSO	444.4	44.8%

French general government debt in 2007

	Billion euros	Proportion of total expenditure
Central government	930	75.0%
APUL	165.7	13.4%
ODAC	97.4	7.9%
ASSO	46.4	3.7%

Source: Ministry for the Budget, Public Accounts, the Civil Service and State Reform

APUL: Local authorities
ASSO: Social security funds
ODAC: Miscellaneous central government agencies

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