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Germany will have no other choice than to cooperate and accept rapid institutional reforms

Since the creation of the euro zone, Germany has accumulated very substantial assets in the other countries of the zone. This means that it cannot accept an option that involves a break-up of the euro zone, and this will force it to change its stance on two key points:

- ***in the short term, the troubled countries cannot reduce their fiscal deficits through their own policies without overall support provided by euro-zone growth; the current dynamics in these countries, where the drop in activity and the rise in unemployment are preventing a reduction in the fiscal deficit, makes no sense. A stimulation of euro-zone growth will require Germany's cooperation, in particular a fiscal stimulus in Germany, in addition to the use of the leeway available at the European level;***

- ***in the medium term, a currency area cannot weather a situation with a high level of heterogeneity among member countries in the absence of federalism. The countries with low exports would be forced to permanently maintain a low level of income and a high level of unemployment to succeed in balancing their current account. It will therefore be necessary to rapidly implement federalism, in one form or another.***

So we believe that rapid institutional reforms will be implemented in the euro zone, while it is usually believed that this process is very slow. Without rapid reforms, the probability of a break-up of the euro is significant.

ECONOMIC RESEARCH
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It is usually believed that institutions can change only very slowly in the euro zone

Common wisdom holds that institutions can change only very slowly in the euro zone:

- **Lack of coordination of fiscal policies, which are still decided at the national level** and which, moreover, in principle must **comply with the golden rule** in the future, i.e. a zero structural fiscal deficit **(Chart 1)**. Coordination assumes that the fiscal policies can be chosen in one country according to the economic situations of the other euro-zone countries; this seems to be incompatible with the sovereignty of parliaments, given the recent trend of returning to a balanced budget as soon as possible in each country **(Table 1)**.

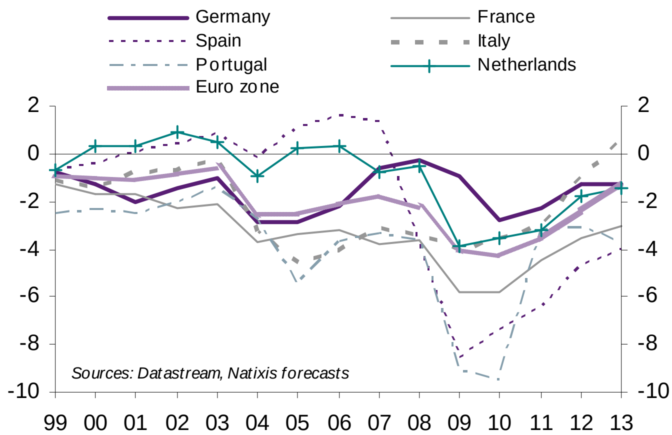
Table 1
Government forecasts of fiscal deficits (as % of GDP)

	2008	2009	2010	2011	2012	2013	2014	2015	2016
Germany	0.1	-3.3	-4.3	-1.0	-0.9	-0.6	-0.4	-0.2	-0.1
France	-3.3	-7.5	-7.0	-5.2	-4.5	-3.0	-2.0	-1.0	0.0
Spain	-4.2	-11.2	-9.3	-8.5	-5.3	-3.0	-	-	-
Italy	-2.7	-5.2	-5.0	-3.9	-1.7	-0.5	-0.1	-	-
Portugal	-3.5	-10.0	-9.1	-4.2	-4.5	-3.0	-1.8	-0.5	-
Greece	-7.7	-15.4	-10.6	-8.5	-6.5	-4.9	-2.6	-1.1	-
Ireland*	-7.3	-11.7	-11.8	-10.1	-8.6	-7.5	-5.0	-2.9	-
Netherlands	0.6	-5.4	-5.1	-4.2	-2.9	-	-	-	-
Austria	-0.9	-4.1	-4.5	-2.6	-3.2	-	-	-	-
Belgium	-1.3	-5.9	-4.1	-3.6	-2.8	-1.8	-0.8	-	-
Luxembourg	3.0	-0.9	-1.7	-1.0	-1.5	-1.2	-0.8	-	
Finland	4.2	-2.6	-2.8	-0.8	-0.6	-0.7	-0.9	-0.9	
Slovenia	-1.7	-6.0	-5.5	-5.5	-3.9	-2.9	-2.0	-	
Cyprus	0.9	-6.0	-7.1	-4.0	-2.6	-2.0	-1.6	-	
Estonia	-2.8	-1.7	-2.5	-0.4	-2.1	0. 1	0.5	1.0	
Malta	-4.8	-3.8	-4.3	-2.8	-2.1	-1.6	-1.0	-	
Euro zone as a whole	**-2.0**	**-6.3**	**-6.0**	**-4.0**	**-3.0**	**-1.7**	**-1.1**	**-0.5**	

(*) Excluding bank recapitalisation

Sources: National sources, Natixis

Chart 1
Structural fiscal deficit (as % of nominal GDP)



- **Increase in the size of investments made at the European level** (structural funds, investments by the EIB, **Tables 2A** and **B**). It is well known that the recent direction of policy has, on the contrary, consisted in limiting the size of the European Union budget.

Table 2A
EU structural funds (EUR bn by type)

Commitment appropriations	2012	2013
1. Sustainable growth	67.0	70.0
1a. Competitiveness for growth and employment	14.2	15.4
1b. Cohesion for growth and employment	52.8	54.5
2. Preservation and management of natural resources	60.8	61.3
o/w: Agriculture - market-related expenditure and direct payments	48.1	48.6
3. Citizenship, freedom, security and justice	2.1	2.4
3a. Freedom, security and justice	1.4	1.7
3b. Citizenship	0.7	0.7
4. EU as a global player	9.0	9.6
5. Administration	8.7	9.1
Total commitment appropriations	***147.5***	***152.3***

Payment appropriations	2012	2013
Total payment appropriations	***141.4***	***143.3***

Source: European Commission

Table 2B
Amounts issued by the EIB (in EUR bn)

	2009-2011	2010	2011	2012*
EUR	104.46	26.15	35.16	21.40
GBP	19.88	5.51	7.85	2.60
USD	68.37	24.00	23.84	7.70
Others	29.71	11.36	9.18	1.90
Total	222.43	76.02	67.02	33.60

Table 2B
Amounts of EIB loans to the European Union

	In EUR bn			As % of total loans		
Country	**2010**	**2011**	**2012***	**2010**	**2011**	**2012***
Austria	1.48	2.02	0.07	2.35	3.82	1.20
Belgium	1.69	1.33	0.10	2.69	2.52	1.72
Bulgaria	0.12	0.14	0.00	0.18	0.26	0.00
Cyprus	0.46	0.18	0.13	0.73	0.34	2.23
Czech Republic	1.65	1.25	0.02	2.63	2.36	0.34
Denmark	0.39	0.16	0.00	0.62	0.29	0.00
Estonia	0.08	0.18	0.01	0.12	0.35	0.10
Finland	1.00	1.40	0.06	1.59	2.66	1.11
France	4.86	4.95	1.26	7.73	9.38	21.69
Germany	7.06	6.11	0.00	11.24	11.57	0.00
Greece	3.15	0.86	0.03	5.01	1.63	0.51
Hungary	1.68	1.40	0.00	2.68	2.65	0.00
Ireland	0.26	0.48	0.00	0.41	0.90	0.00
Italy	8.83	8.29	1.00	14.05	15.69	17.09
Latvia	0.10	0.04	0.00	0.16	0.07	0.00
Lithuania	0.02	0.00	0.00	0.03	0.01	0.00
Luxembourg	0.06	0.11	0.26	0.10	0.20	4.53
Malta	0.10	0.00	0.00	0.16	0.00	0.00
Netherlands	1.56	0.86	0.10	2.48	1.63	1.72
Poland	5.47	5.15	0.38	8.71	9.75	6.57
Portugal	3.41	1.97	0.00	5.43	3.73	0.00
Romania	0.41	0.92	0.00	0.65	1.74	0.00
Slovakia	1.42	0.40	0.00	2.26	0.76	0.00
Slovenia	0.73	0.34	0.00	1.17	0.63	0.00
Spain	9.33	9.00	2.02	14.84	17.04	34.58
Sweden	2.61	0.71	0.00	4.15	1.34	0.04
United Kingdom	4.92	4.59	0.38	7.82	8.70	6.57
Total	**62.84**	**52.83**	**5.83**	**100.00**	**100.00**	**100.00**

(*) Early April 2012

Sources: EIB, Natixis

- **Federalism**, which can take **several forms**: organised government transfer payments from rich countries to poor countries and from countries that have external surpluses to countries with external deficits; pooling of certain taxes (for example VAT) or of certain parts of social welfare (e.g. unemployment benefits); common issuance by the member countries (eurobonds). **The consensus is that federalism** is unacceptable for some countries (Germany, Finland, Austria, etc.), requires changes in the countries' constitutions and in European treaties, and **can therefore only be a very long-term objective**.

A change in the euro zone's institutions is therefore normally seen as a very difficult and very slow process. We believe this process will unavoidably have to accelerate.

The first problem: Stopping the recession dynamics

It is becoming clear now that **the implementation of very restrictive fiscal policies simultaneously in all euro-zone countries, and without any measures to stimulate growth at the same time, leads to a depressive cycle that makes no sense**; all demand components are weakening **in France, Spain, Italy, the Netherlands and Portugal**: exports because of the weakness of the other economies **(Chart 2A)**, business investment because of the weakness of expected demand **(Chart 2B)**; consumption because of the rise in unemployment and the resulting decline in real wages (Spain, Italy, Portugal, Netherlands, **Charts 2C, D** and **E**).

Chart 2A
Exports in value terms (Y/Y as %)

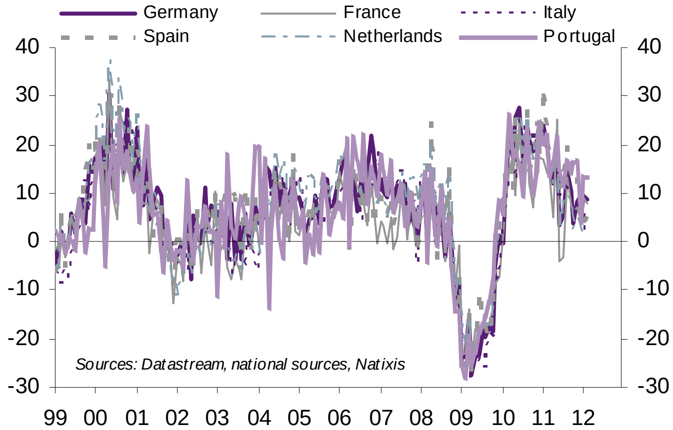


Chart 2B
Domestic demand in volume terms (1999:1 = 100)

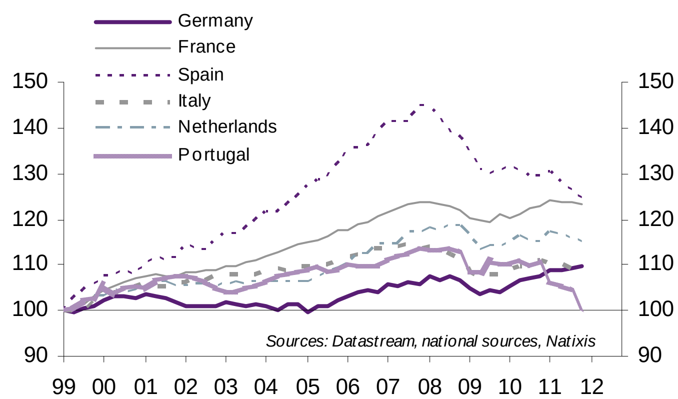


Chart 2C
Household consumption (in volume terms, 1999:1 = 100)

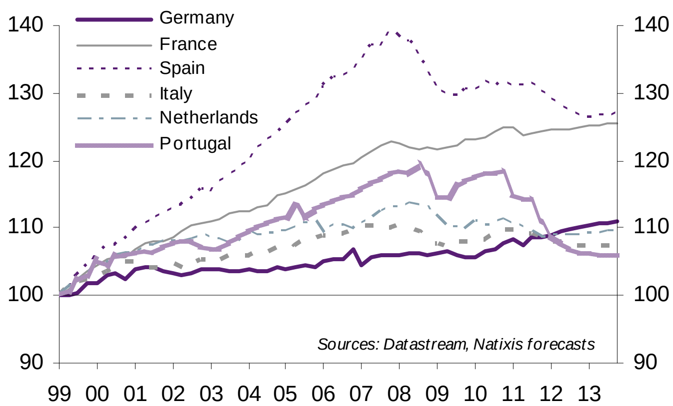


Chart 2D
Unemployment rate

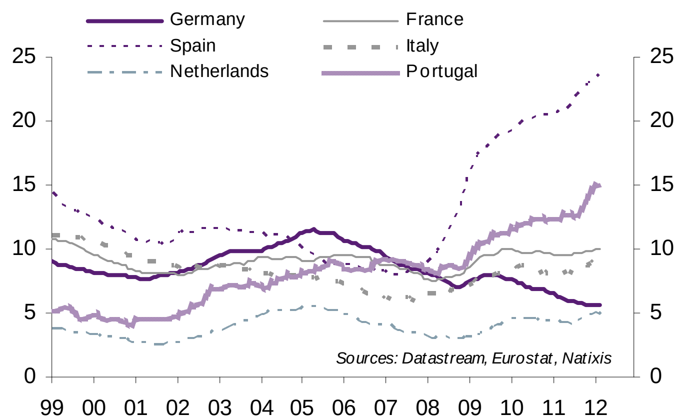
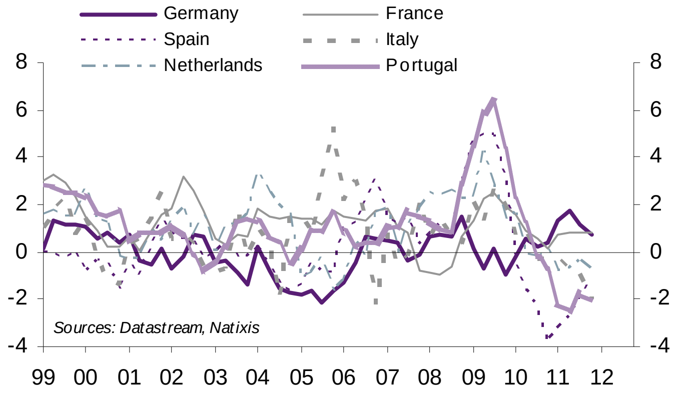


Chart 2E
Real per capita wage
(deflated by consumer price deflator, Y/Y as %)



In France, the real wage is not declining because of the usual low sensitivity of wage increases to the labour market situation; **in Germany**, the situation is different since, as the fiscal adjustment has already been carried out (**Chart 1** above), fiscal policy is not restrictive while full employment and the good financial situation of companies have paved the way for faster wage increases. Nevertheless, Germany is suffering from the slowdown in exports.

Spain, Italy, Portugal and even now the Netherlands are caught in a depressive cycle where activity is declining (Chart 3), preventing a reduction in the fiscal deficit despite the restrictive fiscal policies (Charts 4A, B, C, D and **E).**

Chart 3
Real GDP growth (Y/Y as %)

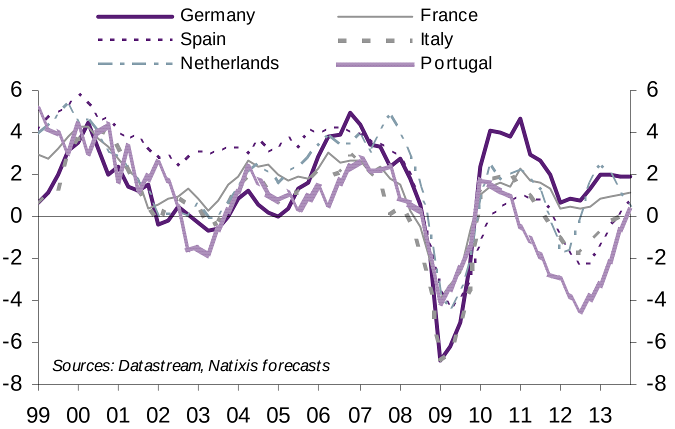


Chart 4A
France: Cumulative fiscal deficit (in EUR bn)

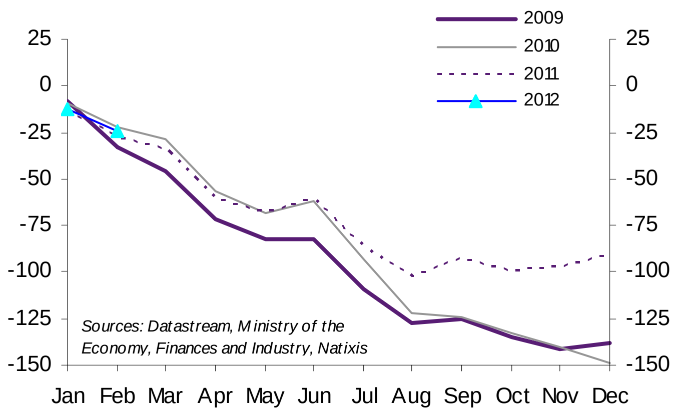


Chart 4B
Spain: Cumulative fiscal deficit (in EUR bn)

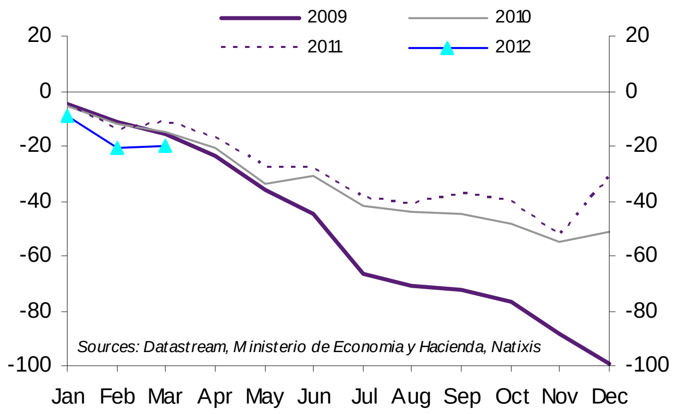


Chart 4C
Italy: Cumulative fiscal deficit (in EUR bn)

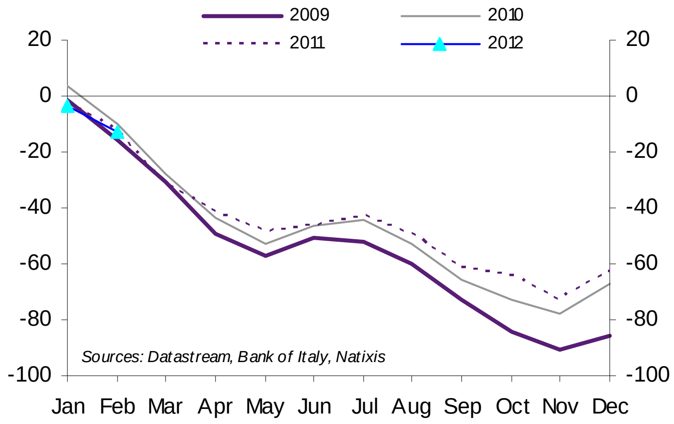


Chart 4D
Portugal: Cumulative fiscal deficit (in EUR bn)

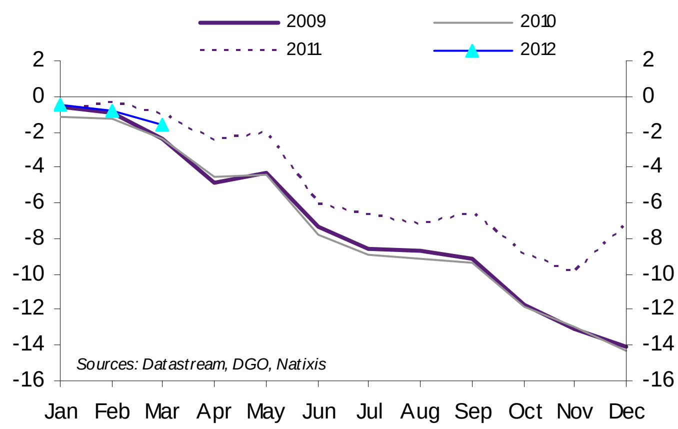
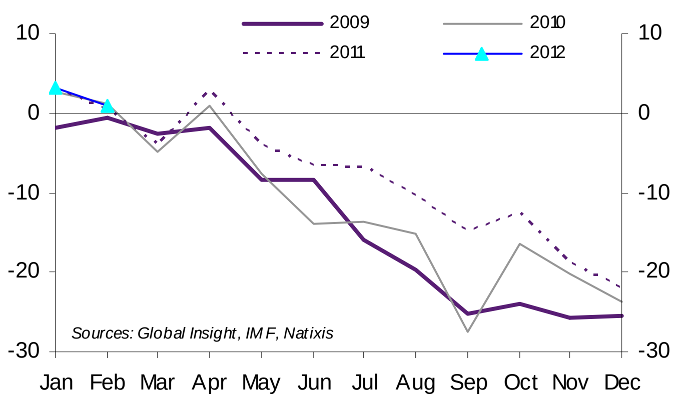


Chart 4E
Netherlands: Cumulative fiscal deficit (in EUR bn)



It then becomes impossible to understand why fiscal policy should be tightened further in these countries (Inset 1), if the result is a further fall in activity, practically without any improvement in the fiscal deficit *ex post*.

Public opinion will find the rise in unemployment (**Chart 2D** above) **unacceptable while the fiscal deficits will remain high.** This path of reducing purchasing power and demand is therefore leading to a deadlock and to the risk of a political and social crisis in the affected countries.

Inset 1

Portugal
Main fiscal consolidation measures in 2012

	EUR mn	% GDP
Total deficit target	**7,645**	**4.6**
Total spending cuts	**6,295**	**3.8**
Public payroll	3,000	1.8
Pensions	1,140	0.7
Healthcare	1,000	0.6
Education	380	0.2
Investment	200	0.1
Welfare transfers (other than pensions)	180	0.1
Transfers to local authorities	175	0.1
Administration reform	130	0.1
Transfers to other public entities and state-owned companies	90	0.1
Increase in receipts	**3,044**	**1.8**
Reform of VAT and tax collection	2,024	1.2
Income tax	265	0.2
Corporate tax	330	0.2
Special taxes (alcohol, tobacco, etc.)	200	0.1
Property tax reform	50	0.0
Fight against fraud	175	0.1
Total	**9,339**	**5.6**

Source: IMF, 3rd review, March 2012

Spain
Main fiscal consolidation measures in 2012

	EUR mn	% GDP
Spending cuts	**11,144**	**1.0**
Education	1,333	0.1
Healthcare	3,600	0.3
Justice	128	0.0
Welfare services	613	0.1
Redundancies	100	0.0
Investment	5,070	0.5
Current expenditure	300	0.0
Increase in receipts	**19,120**	**1.8**
Income tax	4,100	0.4
Corporate tax	5,300	0.5
Wealth tax	2,500	0.2
Tax amnesty	560	0.1
Tobacco and other taxes	360	0.0
Tax fraud	1,900	0.2
Taxes on earnings	900	0.1
Receipts from Autonomous Communities	3,500	0.3
Total	**30,264**	**2.8**

Sources: Ministry of the Economy

Netherlands
Budget cuts adopted for 2011.

To restore public finances, the government proposed a series of savings measures totalling EUR 18 billion. These budget cuts will take effect from 2011 to 2015.

Budget cuts

- EUR 6.1 billion in government operating expenditure. The largest cuts will be achieved by downsizing government and increasing efficiency. There will be fewer civil servants and less use by the government of external consultants, with fewer tasks and procedures.
- EUR 1.4 billion in government subsidies. For example, subsidies for culture and innovation will be reduced.
- EUR 1.9 billion in international spending. The government wishes to reduce its contribution to the European Union. Spending on cooperation in the areas of defence and development will also be capped. The number of embassies abroad will be reduced.
- EUR 3.9 billion in healthcare spending. Some treatments will be transferred from the standard medical care package to supplementary healthcare schemes.
- EUR 570 million in government assistance. The contribution to childcare costs will be capped. Costs have increased by EUR 2 billion in four years. Students who take longer to finish their studies will pay higher fees.
- EUR 4.28 billion in spending linked to the labour market and social welfare. On 1 January 2020, the retirement age for civil servants will increase to 66 years. The government will also punish welfare fraud more severely.

Tax increases

- Welfare taxes and contributions will be increased in some sectors; VAT on performing arts, art and collector's items will be increased, as will be tax on insurance. These measures could bring in EUR 1.3 billion by 2015.

Budget cuts apparently agreed for 2012

Another series of measures totalling EUR 14-16 billion was agreed on 27 April (but not yet put to the vote).

- Further increase in the retirement age to 67 years for civil servants
- 2 percentage point hike in VAT to 21%
- High taxes on alcohol
- Increase in taxes on tobacco

The government was dissolved on 23 April, with the hard-line right-wing parties (Freedom Party) leaving the coalition as a result of the government's inability to agree on the budget savings. Prime Minister Rutte (VVD) tendered his resignation to Queen Beatrix, who accepted it. The Queen asked Rutte to stay at the helm of an interim government until the elections in September. In this situation, the Prime Minister managed to gather a small majority (77 out of 150) for a coalition government bringing together five parties for another spending reduction plan of EUR 14-16 billion. It appears the interim government will thus succeed in pushing through the vote on the new raft of savings.

Italy
Additional fiscal deficit reduction measures

The Monti government's plan includes EUR 30 billion in savings and EUR 10 billion in spending to boost activity and employment for a net effect on the budget balance of EUR 20 billion in 2012.

With regard to receipts:

- hike in local rates	EUR 10.7 bn
- fuel tax	EUR 5.9 bn
- additional regional tax on personal incomes	EUR 2.2 bn
- stamp duties on securities and financial instruments and products	EUR 1.2 bn
- tax on regulated professions	EUR 1.5 bn
- increase in levies on artisans and traders	EUR 1.1 bn

With regards to spending, in early May the government launched a review of government expenditure with a view to saving an additional EUR 4.2 bn, which would forestall the 2 percentage point VAT hike initially scheduled for October this year. In addition, the main sources of savings for the time being are:

- de-indexation of pensions in excess of 3 times the minimum pension	EUR 2.5 bn
- spending cuts by territorial entities	EUR 2.8 bn

Germany cannot take the risk of a break-up of the euro

The euro-zone countries now have to understand that, in reality, Germany's bargaining position is very weak.

In the event of a break-up of the euro, **Germany would suffer considerably:**

- **not only because of the appreciation of its currency and the resulting loss of competitiveness,** as in 1992-1993 **(Charts 5A** and **B)**;

- but **above all because of the capital loss that would follow the depreciation of the exchange rate of the other euro-zone countries against Germany.** For Germany, with its external surpluses **(Charts 5A** and **B, 6A)** has accumulated **substantial external assets (Chart 6B)** whose value in Germany's currency would plummet in the event of a break-up of the euro.

Chart 5A
Germany: Trade balance and real trade-weighted exchange rate*

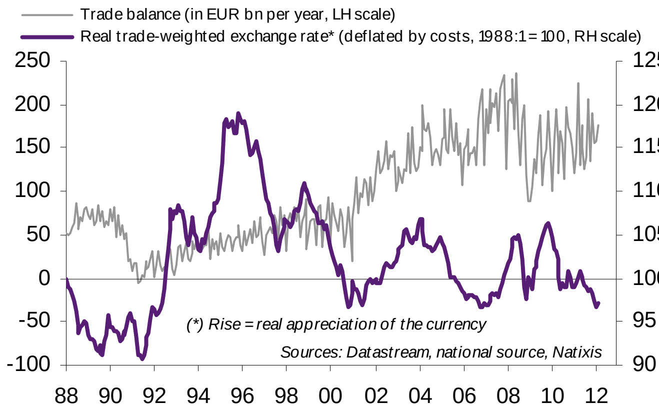


Chart 5B
Germany: GDP growth, exports and current-account balance

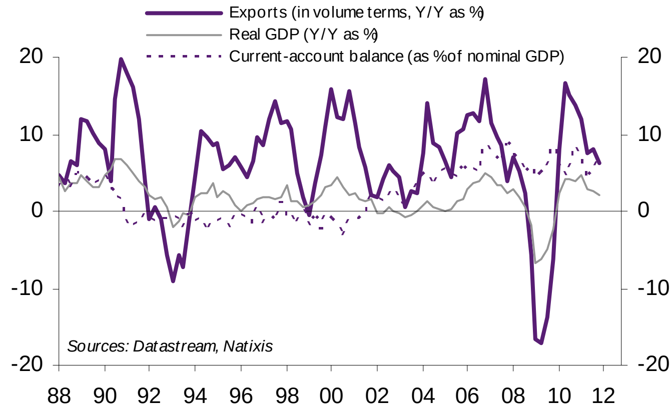


Chart 6A
Germany: Annualised trade balance with the euro zone (EUR bn)

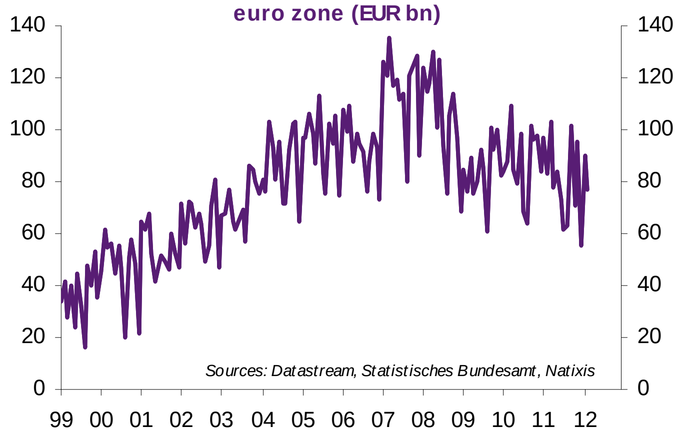
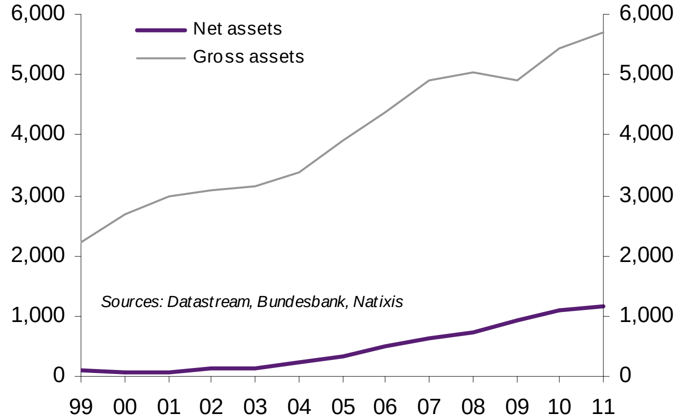


Chart 6B
Germany: External assets (in EUR bn)



It is impossible to imagine that Germany would seriously consider a loss of competitiveness of 30 or 40% and a wealth loss of EUR 1,800 to 2,400 billion.

Therefore, we believe that Germany will accept to participate in coordinated growth stimulus measures for the euro zone to pull it out of the depressive trap seen above. This can involve:

- **a coordination of fiscal policies, with a fiscal stimulus in Germany - which has the means to implement such measures** (**Chart 1** above) - **and an easing of the required pace of reduction in the fiscal deficits** (**Table 1** above);

- **an increase in European structural funds, and in investments by the EIB** (**Tables 2A** and **B** above).

The second problem: Heterogeneity of countries and federalism

The first problem, i.e. fiscal deficit reduction and growth, is arising now; **the second problem is the institutional organisation of the euro zone in the medium term,** given the countries' heterogeneity.

As is normal in a currency area, some countries have large exporting sectors (manufacturing industry, **Chart 7A**, tourism, **Chart 7B**, exportable services, **Chart 7C**) **and other countries small exporting sectors.**

The latter countries, with small exporting sectors (France, Spain, Greece, Portugal), **have current-account deficits, which is normal (Chart 8).**

Chart 7A
Value added in the manufacturing sector (in volume terms, as % of GDP)

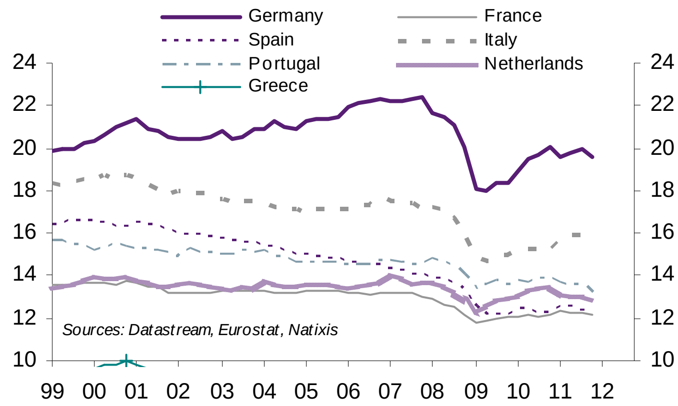


Chart 7B
Tourism trade balance (as % of GDP)

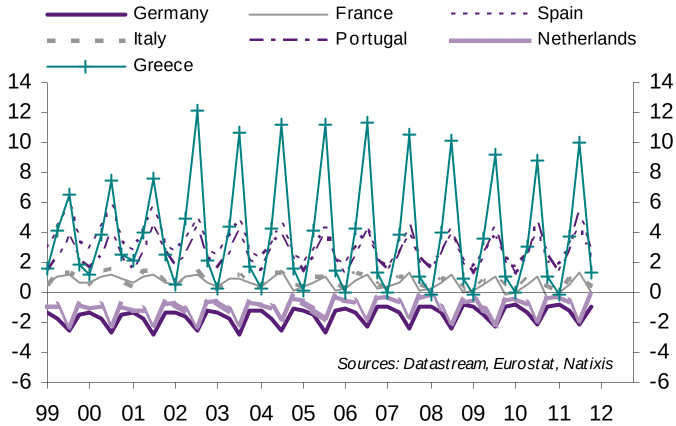


Chart 7C
Trade balance in services excl. tourism (as % of nominal GDP)

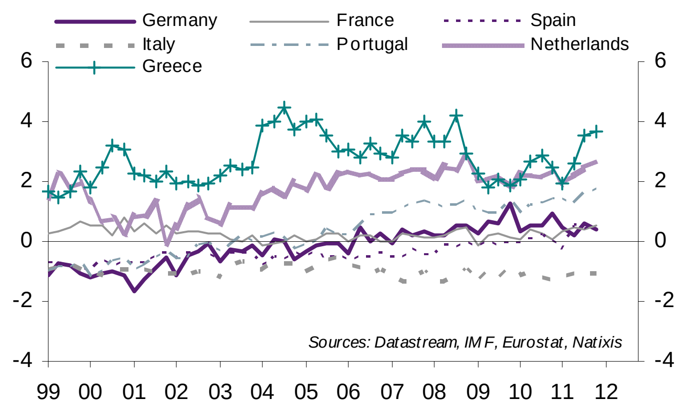
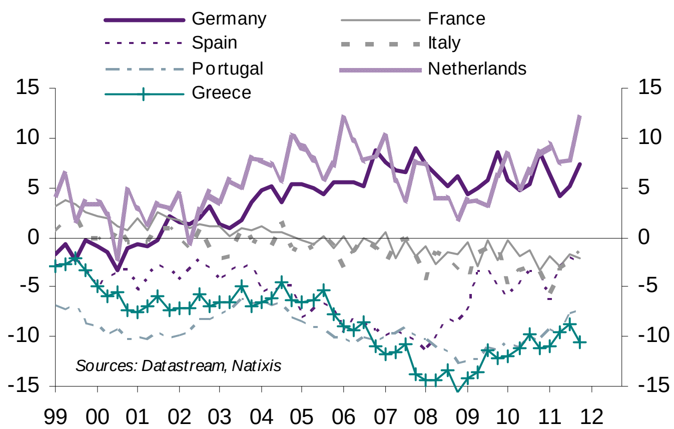


Chart 8
Current-account balance (as % of nominal GDP)



But this is unsustainable without federalism, as these external deficits lead to **an unlimited increase in external debt (Chart 9)**, and therefore to **an external solvency crisis.**

There are then only **two solutions for these countries:**

- **the first solution, which is being implemented now and which will prove to be socially and politically unacceptable, consists in reducing the standard of living (Chart 10A) until the external deficit disappears** thanks to the fall in domestic demand **(Chart 10B)** and in imports **(Chart 10C)**;

- **the second solution is to implement federalism, with which government transfer payments enable countries specialised in services to maintain a trade deficit,** as can be seen in the United States **(Table 3)**.

Chart 9
Net external debts or assets* (as % of GDP)

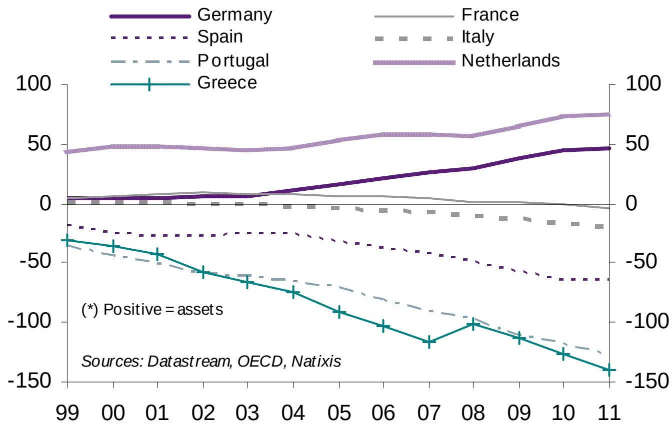


Chart 10A
Per capita GDP (in euros)

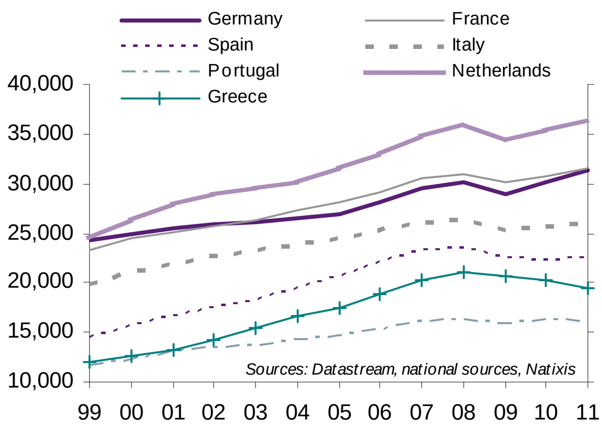


Chart 10B
Domestic demand
(in volume terms, 1999:1 = 100)

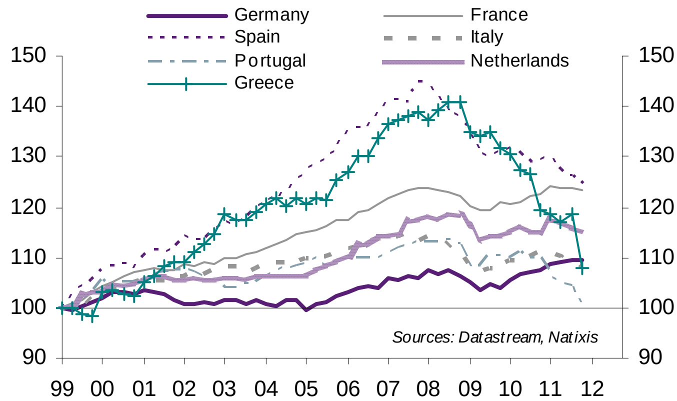


Chart 10C
Imports (in volume terms, 1999:1 = 100)

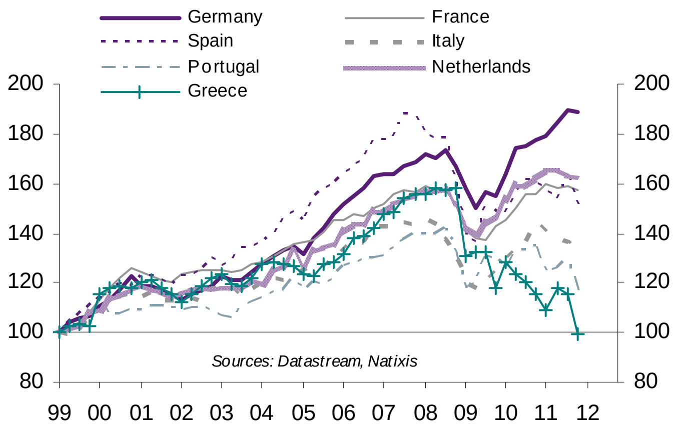


Table 3
United States: States' trade balances in goods (as % of GDP)

	2008	2009	2010
California	-10.6	-8.1	-9.7
Florida	-0.5	0.2	-0.1
Georgia	-7.2	-6.0	-7.7
Illinois	-10.1	-7.1	-9.0
Indiana	-0.6	-0.9	-1.6
Massachusetts	-1.1	-0.8	-1.2
Michigan	-12.0	-7.3	-11.3
New Jersey	-20.4	-14.2	-15.7
New York	-4.0	-3.1	-3.8
North Carolina	-5.6	-3.9	-4.1
Ohio	-2.9	-1.9	-2.4
Pennsylvania	-8.6	-5.4	-7.0
Texas	-7.9	-3.7	-4.9
Virginia	-1.1	-0.9	-0.8
Washington	1.8	4.3	3.1

Sources: Census Bureau, Natixis

Conclusion: Towards rapid institutional change in the euro zone?

The euro zone is currently in a double deadlock:

- some countries are destroying their growth through their restrictive fiscal policies without improving their fiscal deficit *ex post*;

- the countries that have small exporting sectors are doomed to reduce their standard of living and to maintain very high unemployment since they cannot have any external deficit in the absence of federalism.

When these countries (Spain, Italy, France, Portugal, Greece, Netherlands) understand that Germany in reality does not have any bargaining power, given the size of its assets in the rest of the euro zone, they will obtain rapid institutional reforms from Germany:

- **coordination of fiscal policies;**
- **stimulation of growth at the European level;**
- **federalism** (why not start with a European system of unemployment benefits?)

This runs counter to common wisdom, which holds that institutions can only be changed in the long term.

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