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# Interest rates, Eurobonds and intra-European exchange rate misalignments: The challenge of sustainable adjustments in the eurozone

*Manuscript prepared for the conference: Economics, Economic Policies and Sustainable*

*Growth in the Wake of the Crisis, 8-10 September, 2016, Ancona, Italy*

Vincent Duwicquet\*

Jacques Mazier\*\*

Jamel Saadaoui\*\*\*

**Abstract:** The euro crisis sheds light on the nature of alternative adjustment mechanisms in a heterogeneous monetary union. Exchange rate adjustments being impossible, it remains very few efficient alternative mechanisms. At the level of the whole eurozone the euro is close to its equilibrium parity. But the euro remains overvalued for Southern European countries, France included, and largely undervalued for Northern European countries, especially for Germany. This paper gives a new evaluation of these exchange rate misalignments inside the eurozone thanks to a FEER approach. In a second step, we use a two-country SFC model of a monetary union with endogenous interest rates and Eurobonds. Overvaluations amount to negative competitiveness shocks in Southern countries. In this respect, three main results are found. Firstly, an increase of intra-European financing by banks of northern countries or other institutions could contribute to reduce the debt burden and induce a partial recovery but public debt would increase. Secondly, the implementation of Eurobonds as a tool to partially mutualize European sovereign debt would have a rather similar positive impact with a public debt limited to 70 percent of GDP. Thirdly, Eurobonds could also be used to finance large European projects which could impulse a stronger recovery in the entire zone with stabilized current account balances.

**JEL Classification:** F31, F32, F37, F41, E12.

**Key words:** Euro crisis, Exchange rate misalignments, Eurobonds, Interest rates.

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\* CLERSÉ-CNRS, University of Lille 1, Bâtiment SH2 59655 Villeneuve d'Ascq Cedex, France; email: [vincent.duwicquet@univ-lille1.fr](mailto:vincent.duwicquet@univ-lille1.fr)

\*\* CEPN-CNRS, University Paris North, 99 avenue Jean-Baptiste Clément - 93430 Villetaneuse Cedex, France; email: [mazier@univ-paris13.fr](mailto:mazier@univ-paris13.fr)

\*\*\* BETA-CNRS and CEPN-CNRS, University of Strasbourg, 61 avenue de la Forêt Noire - 67085 Strasbourg Cedex, France; email: [saadaoui@unistra.fr](mailto:saadaoui@unistra.fr)

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## 1. Introduction

*“The second implication of the absence of fiscal transfers is that countries need to invest more in other mechanisms to share the cost of shocks. Even with more flexible economies, internal adjustment will always be slower than it would be if countries had their own exchange rate. Risk-sharing is thus essential to prevent recessions from leaving permanent scars and reinforcing economic divergence.”*

Mario Draghi (2015).

The euro crisis sheds light on the nature of alternative adjustment mechanisms in a heterogeneous monetary union. Adjustment mechanisms are defined in a broad sense as mechanisms that ensure a return to the initial situation or, possibly, to recover towards full employment after a slowdown. It remains very few efficient alternative mechanisms in the absence of exchange rate flexibility as underlined by the quotation of Mario Draghi. Budgetary policy could play a major role. In the United States, budgetary policy stabilizes 20 percent of shocks on the GDP (Italianer and Pisani-Ferry, 1992). But there is no equivalent in the European case.

Well integrated capital markets, with portfolio diversification and intra-zone credit, have been proposed as a powerful adjustment mechanism by the “international risk sharing” approach. Intra-zone credit and capital income from international portfolio could absorb near from 40 to 60 percent of the shocks (Asdrubali and Kim, 2004). These results have been used during the 2000 by proponents of liberal economic policies in the EU to promote a deeper financial integration instead of having to develop a federal budget (European Commission, 2007; Trichet, 2007)<sup>1</sup>.

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<sup>1</sup> Mario Draghi (2015) acknowledges the crucial role of budgetary policies and that this approach “the less public risk-sharing we want, the more private risk-sharing we need” could be insufficient in case of financial storms in the future. However, he concludes that Members States should achieve structural reforms to have sound public finances in order to be able to deal with periods of financial and economic turmoil.

This approach is still present in the last Action Plan of the European Commission (2015) on the Capital Market Union with the goal of creating one single market for shares, bonds and securitized bank loans. However, the theoretical basis, the empirical methodology and the results seem to be highly questionable (Clévenot and Duwicquet, 2011).

Consequently, relative wage and price flexibility are proposed in order to take place, at least partially, of exchange rate adjustments. Actually, these mechanisms allow only a very slow and partial return to equilibrium with an important cost in terms of growth and employment and with large differences between countries, due to huge structural specificities. They are more inefficient when they are implemented simultaneously in interdependent countries, as it is the case in the eurozone, especially in the Southern European countries. They are more efficient in a largely opened economy like Ireland than in rather closed ones like Greece or even Portugal (Mazier and Saglio, 2008).

At the level of the whole eurozone, the current account is close to equilibrium and the fiscal deficit is smaller than in many other OECD countries. The euro is close to its equilibrium parity but intra-European imbalances are huge.

The euro is strongly overvalued for Southern European countries, France included, and largely undervalued for Northern European countries, especially for Germany (Jeong *et al.*, 2010). These overvaluations slow growth and induce fiscal and current deficits in the South while undervaluations boost growth in the North via exports, especially towards the rest of the eurozone, and deficits are reduced. This situation is equivalent to implicit positive transfers in favor of the North and negative transfers at the detriment of the South, which are largely ignored in the public debate.

In order to investigate these issues, Duwicquet *et al.* (2013) have used a two-country Stock-Flow Consistent (hereafter, SFC) model of a monetary union along the lines of Godley and Lavoie (2006, 2007a, 2007b), Lavoie (2003) and Duwicquet and Mazier (2010, 2011). The

model described the real sector and assets and liabilities of economic agents in order to analyze financial integration in a consistent manner. A federal budget has been introduced with federal expenditures and social transfers financed by federal taxes and Eurobonds issuance. The stabilizing role of such a federal budget has been confirmed facing asymmetric shocks or, equivalently, exchange rate misalignments within the monetary union. Similarly, the stabilizing role of Eurobonds, used to finance European investment projects, has been illustrated. But the model was limited to exogenous interest rates, which can only be regarded as a preliminary step, as we have witnessed large movements of interest rates in Southern European countries since the onset of the euro crisis.

This paper is organized as follow. In a first part, we give a new evaluation of these exchange rate misalignments inside the eurozone, using a FEER approach, and we discuss the structural heterogeneity of the eurozone. In a second part, we introduce an SFC model of a monetary union with endogenous interest rates. With this model, we examine to what extent these asymmetric evolutions due to intra-European misalignments can be adjusted. Interest rates on public bonds are now endogenous. Fiscal policy is partially endogenous and reacts to financial markets evolution with the implementation of budget cuts. An increase of intra-zone financing allows to contain upward pressure on interest rates. Eurobonds are introduced and used in two ways, on the one hand, in order to mutualize a part of the European public debts and, in the other hand, to finance European investments in growth sectors. A combination of tax rebate and budget cuts is also investigated.

## **2. Intra-European exchange rates misalignments and structural heterogeneity**

Since the beginning of the 2000s, a surge of current account imbalances within the eurozone has been observed in spite of a rather balanced current account for the whole area. On the one side, Northern European countries have accumulated huge current account surpluses and on the

other side, Southern European countries have run important current account deficits. After 2009, current account deficits of Southern European countries have been reduced mainly because of restrictive policies and internal devaluations. These evolutions reflect, at least partially, the increasing exchange rate misalignments inside the eurozone. Thanks to a FEER approach, introduced by Williamson (1983), Jeong et alii (2010) and Duwicquet et alii (2013) have shown a divergence within the eurozone between some countries increasingly undervalued (like Germany, Austria, Netherlands and Finland) and others increasingly overvalued (like Greece, Portugal, Spain and France).

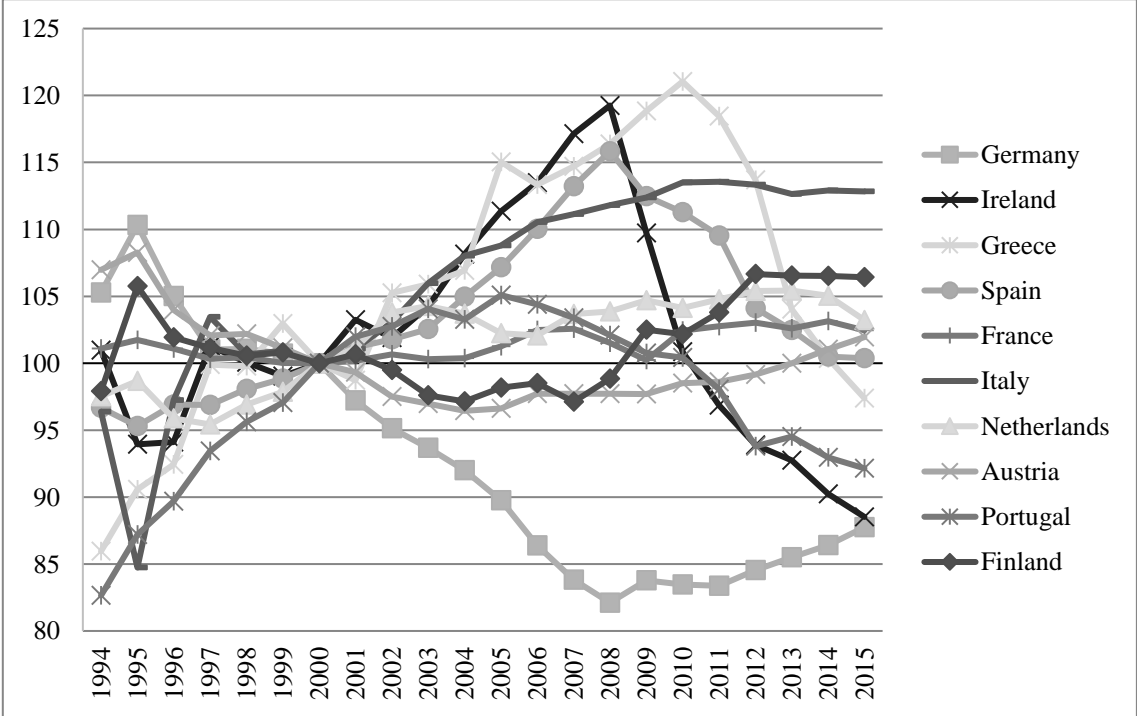
**Table 1: Misalignments in real effective terms (in percent)**

	EU	FRA	GER	ITA	SPA	AUT	FIN	IRL	NLD	PRT	GRC
1994	-3.4	2.4	-7.4	6.9	1.4	4.8	-5.8	-0.7	-5.3	0.9	15.1
1995	1.2	-0.7	-7.5	8.2	9.6	-1.5	5.1	-1.7	-7.5	3.8	-0.1
1996	4.2	3.2	-4.8	6.7	-0.1	-4.1	8.3	-0.8	-7.2	-10.4	-11.3
1997	3.5	12.9	-1.6	5.4	1.1	-6.1	20.1	-1.5	-3.5	-18.5	-8.2
1998	0.6	14.0	-4.3	2.1	0.5	0.6	22.9	-2.6	-6.6	-16.8	-1.7
1999	2.0	19.2	-7.3	-1.5	-5.0	-2.0	21.6	-0.3	-3.3	-21.4	-7.2
2000	0.1	8.7	-8.1	-3.8	-7.6	1.4	24.9	-0.6	-6.7	-29.3	-16.8
2001	6.9	6.8	-2.9	-3.1	-7.9	-7.1	25.3	-4.0	-9.5	-36.1	-17.4
2002	6.6	2.5	3.8	-6.3	-4.8	5.7	25.6	-4.8	-13.4	-30.1	-19.0
2003	2.2	-2.9	1.3	-8.5	-3.2	-0.4	15.2	-3.6	-7.7	-26.1	-9.1
2004	7.2	-0.1	5.6	-5.4	-15.4	-4.0	19.6	-3.8	-5.2	-40.1	5.0
2005	1.9	-4.6	5.3	-4.1	-20.3	-2.2	7.8	-4.8	-5.7	-46.1	-7.6
2006	1.6	-4.8	9.1	-3.8	-24.6	4.0	9.7	-2.0	-1.6	-47.9	-6.3
2007	-0.2	-6.0	13.1	-0.7	-26.4	11.3	15.5	-0.9	-1.5	-34.5	-5.2
2008	0.9	-13.3	13.0	-4.5	-33.3	13.7	11.7	-4.7	-3.1	-46.3	-3.7
2009	6.6	-8.3	13.9	-2.9	-10.2	3.0	0.2	-0.7	-2.7	-34.4	-8.5
2010	4.9	-6.9	16.8	-4.2	-14.6	5.0	2.5	-0.9	0.0	-28.1	-21.1
2011	8.6	-10.1	16.8	-5.8	-22.9	2.6	-5.9	-2.5	-1.2	-19.6	-53.1
2012	16.3	-12.6	19.3	-2.5	-14.1	1.5	-8.9	-7.9	-2.1	-12.2	-30.9
2013	18.0	-5.0	18.7	1.5	-3.6	2.2	-7.2	1.4	-0.9	6.8	-20.3
2014	20.1	-10.1	19.4	3.8	-2.7	-0.9	-7.4	5.9	-0.8	4.4	-15.4
2015	26.1	-8.2	18.7	2.4	6.1	-2.3	-6.7	12.8	-3.9	8.6	1.9
2016	28.6	-5.2	15.8	2.0	14.3	-4.1	-8.6	11.7	-5.2	14.1	-5.2

Notes: Forecasts for 2016 based on IMF WEO April 2016; See Jeong *et al.* (2010) for a complete description of the model of world trade and the methodology used to compute misalignments. Source: authors' calculations. A positive (negative) number indicates an undervaluation (overvaluation) expressed in percent of the observed value. See appendix A for details about the methodology used to correct current account balances from the effect of differences between output gaps in the eurozone. This correction, especially important after the crisis (due to a desynchronization of business cycles in the euro area), is based on Bayoumi and Faruqee (1998).

As we can see in table 1, on average between 2005 and 2010, Germany, Austria, Netherlands and Finland have been undervalued by 13 percent while Greece, Portugal, Spain and France have been overvalued by 23 percent. These intra-European exchange rate misalignments reflect a strong structural heterogeneity between European countries at several levels (nature of the international specialization, size and productivity of the firms, R&D effort and qualification of the labor force). They are at the heart of the current woes of the eurozone. However, since the onset of the euro crisis in 2010, a reduction of misalignments has been observed for most of the Southern European countries. Irish, Spanish, Italian and even Portuguese euros seemed no more overvalued in 2013. But Greek and French euros remained overvalued by around 15 percent and German euro undervalued by around 20 percent in 2014. These movements have been mainly driven by large real effective devaluations in Ireland, Spain, Portugal and Greece, as shown in figure 1 with the evolutions of the relative unit labor cost (RULC).

**Figure 1: Real effective exchange rates based on unit labor cost**

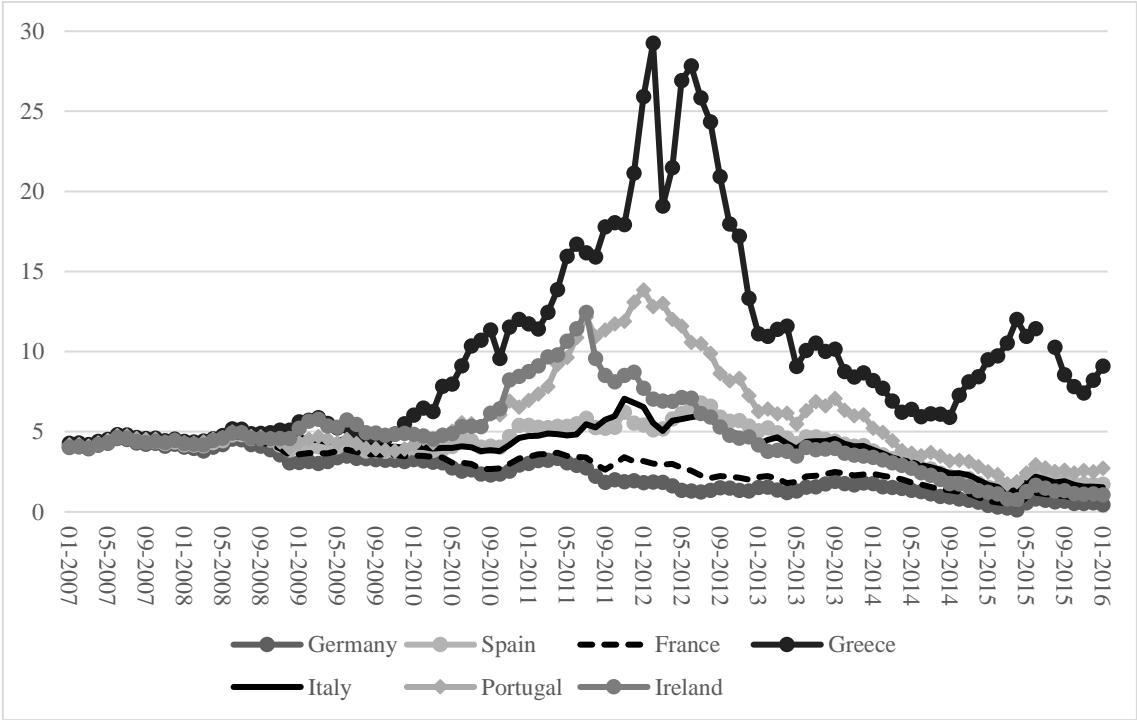


Source: authors' calculations based on European Commission data (AMECO), basis 100 in 2000.

These politics of internal devaluation have been very painful and has led to a deep recession in Greece, as in other Southern European countries. We have observed a reduction of current account deficits mainly due to the reduction of imports. However, *ex-post* improvement of public finances had been limited.

The financial crisis of 2008 was, in any case, due to a rise of public deficits and debts. Nevertheless, it has led to a huge increase in the government deficits and debts due to measures implemented to rescue banks and support the economic activity and, also, to the fall of tax incomes induced by the recession. The European Central Bank (hereafter, ECB) switched to a more active monetary policy. But the weakest European countries faced difficulties to finance their deficits as the financial markets feared sovereign debt default. As they could not attack national currencies thanks to the monetary union, the financial markets concentrated their attacks on the public bonds. Interest rates soared, first, in Ireland and in Greece, then in other Southern European countries while they remained very low in Germany, but also in France.

**Figure 2: 10-years government real interest rates in percent**



Source: ECB's Statistical Data Warehouse.



The true existence of the monetary union was at stake and a reversal only took place after the announcement of the ECB in September 2012 to intervene without restriction on the public bonds secondary markets in case of necessity (see figure 2).

But this ECB intervention was accompanied by very restrictive fiscal policies in the framework of the Fiscal Pact and by structural reforms in favor of more liberalization.

On the whole, results have been uneven amongst member states. Real devaluation has been inefficient in Greece and, to a large extent, in Portugal due to their limited degree of trade openness and the social costs have been important. Combined with restrictive fiscal policies, it has led to a deep recession which has limited the improvement of public finances. The public debt ratio has increased massively.

In Ireland and, to a less extent, in Spain the real devaluation has been more operational thanks to the role played by the export sector but the initial negative shock has not been offset and the rate of unemployment remained important (in January 2016, the unemployment rate was 8.9 percent in Ireland and 20.5 percent in Spain).

In Germany, between 2000 and 2008, sharp wage and productivity adjustments have led to a large reduction of the German relative unit labor cost. These adjustments have been preserved during the crisis.

On the opposite, in France, the successive governments have been reluctant to implement cost adjustments and the euro remained overvalued. The strategy adopted has been, since 2013, to reduce costs through tax rebates (around 1.5 percent of GDP). The target of these measures is not clear and they raise, at least, two questions. If the government wants to improve the competitiveness, this measure is inaccurate as all the firms, including those of the non-tradable sector like banks and retailers, can benefit from the tax rebates. Consequently, the transfer in favor of the tradable sector is too limited, compared with the cost disadvantage which currently prevail. A larger transfer would be necessary but could not be easily supported by public

finances. If the target is to improve employment, as it seems to be more the case with the “Pacte de responsabilité et de solidarité”, the past experiences show that efficiency is not warranted and the problem of cost-competitiveness, which cannot be ignored, is not solved. The government is aware of these limits and has completed his array of measures by re-launching industrial policy measures (major industrial projects, innovation policy, etc.) to improve non-price competitiveness. Nevertheless, this kind of measures takes a long time (around 10 years) to be fully operational.

The risk is, therefore, that any target can be reached. The competitiveness problem will remain and financing the current account deficit might become more important. Tax rebates could have a limited impact on employment, since profit rates have been squeezed during the crisis, especially for the export sector. The financing of the tax rebates will imply substantial expenditures cuts. Thus, the more likely outcome would be a long lasting period of stagnation. In this context, it is worthwhile, using an SFC model of a monetary union, to assess various alternative economic policies scenarios which try to tackle this problem of intra-European misalignments.

### **3. SFC modeling of adjustment mechanisms in a monetary union**

#### **3.1. The structure of the model**

An SFC model allows to obtain a consistent description of assets and liabilities of all associated real and financial flows in a monetary union. This monetary union is composed of two countries ( $n$  and  $s$ ) with an asymmetry of size. The country  $n$  is five times larger than the country  $s$ . This configuration eases the exploration of the adjustment mechanisms of the country  $s$  facing the rest of the monetary union.

We introduce in this model the possibility of public federal expenditures and Eurobonds. This will open the road to investigate stabilizing effects of Eurobonds. Firms can accumulate both real and financial capital. They can finance their investments by non-distributed profits, bank

loans or equities. Commercial banks are able to supply credit and to ration credit. The single central bank (i.e. the ECB) refinances the commercial banks. Households hold banking deposits, bonds and equities. The two national governments issue bonds and Treasury bills.

In table 2, we describe the balance sheet in terms of assets (written with a positive sign) and liabilities (written with a negative sign) of each sector: households, firms, government, commercial banks, the single central bank and a federal budget.

**Table 2: Balance sheet of a monetary union**

	Country $n$						Country $s$				$\Sigma$
	$HH$	$F$	$G$	$B$	$FB$	$ECB$	$HH$	$F$	$G$	$B$	
$C$		$+k_n$						$+k_s$			0
$D$	$+bd_n$			$-bd_n$			$+bd_s$			$-bd_s$	0
$Cs$	$+hh_n$			$+h_n$		$-h$	$+hh_s$			$+h_s$	0
$Cr$		$-l_n$		$+l_n^n$						$+l_s^n = 0$	0
				$+l_n^s$				$-l_s$		$+l_s^s$	0
$R$				$-rf_n$		$rf_n + rf_s$				$-rf_s$	0
$Bd$	$+pb_n b_n^n$		$-pb_n b_n$				$+pb_n b_s^n$				0
	$+pb_s b_n^s$						$+pb_s b_s^s$		$-pb_s b_s$		0
$E$				$+bte_n$	$-bte_n$					$+bte_s$	0
$Bi$			$-bt_n$	$+bt_n^n$						$+bt_s^n = 0$	0
				$+bt_n^s$					$-bt_s$	$+bt_s^s$	0
$Eq$	$+pe_n eh_n^n$	$+pe_n ee_n^n$					$+pe_n eh_s^n$	$+pe_n ee_s^n$			0
		$-pe_n e_n$									0
	$+pe_s eh_n^s$	$+pe_s ee_n^s$					$+pe_s eh_s^s$	$+pe_s ee_s^s$			0
							$-pe_s e_s$				0
$W$	$-vh_n$	$-v_n$	$-d_n$	$-vb_n$	$-de_n$		$-vh_s$	$-v_s$	$-d_s$	$-vb_s$	0
$\Sigma$	0	0	0	0	0	0	0	0	0	0	0

Notes: For the agents in the economy,  $HH$  stands for households,  $F$  for firms,  $G$  for national government,  $B$  for private banks and  $FB$  stands for federal budget or a federal institution in charge of the emission of Eurobonds. For the type of financial assets held and issued in the economy,  $C$  stands for physical capital,  $D$  for deposits,  $Cs$  for cash,  $Cr$  for credit,  $R$  for advances of the central bank,  $Bd$  for bonds,  $E$  for Eurobonds,  $Bi$  for bills,  $Eq$  for equities and  $W$  stands for wealth.

Beyond physical capital ( $k$ ), eight kinds of monetary or financial assets are distinguished<sup>2</sup>: bank deposits ( $bd$ ) held by households, bonds issued by governments ( $pb.b$ ) and held by households of both countries, loans ( $l$ ) supplied by each commercial bank to firms of the two countries, equities issued by firms ( $pe.e$ ) and held by households and firms of both countries, Treasury bills issued by each State ( $bt$ ) and held by commercial banks of both countries, high powered money ( $h$ ) held by households ( $hh$ ) as well as by commercial banks (mandatory reserves), advances supplied by the central bank to commercial banks ( $rf$ ) and finally Eurobonds ( $bte$ ) issued by a federal authority and held by banks.

Our model relies on the main features of the contributions of Duwicquet and Mazier (2010, 2011) and Duwicquet et al. (2013). Nevertheless, several crucial changes are included to examine current developments in the eurozone crisis:

- Interest rates on Treasury bills supplied by the State are endogenous. The demand of Treasury bills by private banks is an increasing function of interest rate. Thus, in case of an insufficient demand, this mechanism induces upward pressures on interest rates.
- Budgetary policy is partially endogenous and is linked to financial markets. When interest rates on sovereign debt increase, the national government can reduce public expenditures in reaction.
- The possibility to increase intra-zone financing is introduced in order to reduce the pressure on interest rates. This can be achieved through foreign banks purchases of public bonds or Treasury bills, through the European Stability Mechanism or even through direct intervention of the central bank on the public bond markets.

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<sup>2</sup> When there are two symbols ( $n$  and  $s$ ), the subscript denotes the country where the asset is held, the superscript the country where the asset is issued. For example,  $bt_n^s$  represents the amount of bills held by country  $n$  and issued by the country  $s$ .

- The role of Eurobonds is examined in two ways. On the one hand, Eurobonds are aimed at mutualizing a part of sovereign debt in the eurozone. On the other hand, Eurobonds could be used to finance European investment projects in several sectors namely education, health and innovation.
- Last the rather traditional policy mix combining tax rebates and expenditures cuts (roughly the French government strategy) is also discussed.

The main equations are presented below. The model has been calibrated to represent the structure of the European Monetary Union. The value of coefficients and the entire model are available in the working paper version of this text<sup>3</sup>.

### *The demand side*

The model dynamics relies essentially on the investment function. As we can see below, investment reacts positively to the rate of profit and to variation of aggregate demand. It responds negatively to the debt structure and to credit costs.

$$g_n = k_{0n} + k_{1n} \frac{up_n(-1)}{k_n(-2)} + k_{2n} \frac{\Delta y_n}{y_n(-1)} - k_{3n} \frac{l_n(-1)}{k_n(-1)} - k_{4nm} r l_n - k_{4sn} r l_s \quad [1]$$

where  $g$  stands for the rate of accumulation of physical capital;  $up$  represents the amount of undistributed profits;  $l$  is the firms' indebtedness;  $rl$  is the credit cost and  $y$  is the gross domestic product.

At the macroeconomic level, an increase in investment spending will generate more profits. These profits will be, on the one hand, distributed in part to shareholders (here, households and other firms) and, on the other hand, undistributed.

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<sup>3</sup> The EViews codes used for the numeric simulations are, also, available from the authors upon request.

The household consumption function includes a positive wealth effect. This wealth effect describes the behavior of households which target a constant ratio between wealth and disposable income.

$$c_n = a_{0n} + a_{1n}yh_n + a_{2n}vh_n(-1) \quad [2]$$

where  $vh$  stands for the households' wealth and  $yh$  for the disposable income with capital gains.

The disposable income of households is defined as the sum of after-tax labor incomes (wages) and after-tax capital incomes (interest rates and dividends). A part of disposable income augmented with capital gains is consumed whereas the residual saving corresponds to bank deposits, money holdings and to financial assets (bonds supplied by the State and equities supplied by private firms). The financial wealth covers a large array of financial assets (bank deposits, cash money, equities and bonds).

The government receives taxes from households and banks, spends and pays interests. The public deficit is financed by issuance of bonds and Treasury bills. Supply of Treasury bills balances the gap between public deficit and bonds issuance thus:

$$\Delta bt_n = gn_n + r_n bt_n(-1) + b_n(-1) - t_n - tb_n - te b_n - pb_n \Delta b_n + ps_n - cl_n - tf_n \quad [3]$$

where  $bt$  is the amount of T-bills;  $gn$  stands for the national public expenditures;  $r$  is the interest rate on T-bills;  $b$  represents the amount of bond issued;  $t$  are the taxes paid by the households;  $tb$  are the taxes paid by commercial banks;  $te b$  are the taxes paid by the ECB;  $tf$  are the taxes paid by firms;  $ps$  stands for social benefits and  $cl$  for firms' social contributions.

### ***The banking sector***

The central bank supplies money and provides an unlimited amount of refinancing to private banks at the key interest rate ( $ib$ ) thus acting as the lender of last resort. The interest rate on bank deposit ( $id$ ) is simply determined with a margin on the key interest rate of the central bank.

$$\Delta rf_n = \Delta h_n + \Delta l_n^n + \Delta l_n^s + \Delta bt_n^n + \Delta bt_n^s - bp_n - \Delta bd_n \quad [4]$$

$$id = ib - m_{2b} \quad [5]$$

The central bank does not make any profit as in Godley and Lavoie (2007). Thus interests paid to the central bank are equal to taxes paid to the State. This is in line with the practice of most modern central banks in the world economy.

Besides, commercial banks supply the entire amount of demanded credit:

$$\Delta l_n = inv_n - up_n - pe_n \Delta e_n + pe_n \Delta e_n^n + pe_s \Delta e_n^s \quad [6]$$

The credit market is open to foreign banks. We suppose that banks of the smaller country (country  $s$ ) do not lend to firms of the larger country  $n$  ( $l_s^n = 0$ ). Bank loans are allocated between domestic and foreign firms relatively to their respective trade openness. The interest rate on bank loans is endogenous and depends on the lagged value of Treasury bills' rate of each country and on their own lagged value.

$$rl_n = (1-a)rl_n(-1) + a.r_n(-1) \quad [7]$$

$$rl_s = (1-a)rl_s(-1) + a.r_s(-1) \quad [8]$$

Treasury bills play a key role in the model resolution. Banks purchase a limited amount of Treasury bills with a demand which depends positively on the rate of interest. Thus interest rates become endogenous, as they adjust the supply of Treasury bills determined by the public deficit (which has to be financed) and the private demand of Treasury bills in each country.

Bills issued by the southern country and domestically held in the private sector ( $bt_s^s$ ) as well as bills held in the rest of the union ( $bt_n^s$ ) depends on the interest rates differential between the two countries:

$$\frac{bt_s^s}{y^s} = a_{1ss}r_s - a_{2ss}r_n$$

$$\frac{bt_n^s}{y^n} = a_{1ns}r_s - a_{2ns}r_n$$

By summing demands of these two countries, we obtain the global demand for Treasury bills issued by the southern country:

$$bt_s = (a_{1ss}r_s - a_{2ss}r_n)y_s + (a_{1ns}r_s - a_{2ns}r_n)y_n$$

The interest rate on Treasury bills issued by the southern country becomes endogenous and we can write:

$$r_s = \frac{bt_s + [a_{2ss}r_n y_s] + [a_{2ns}r_n y_n]}{[a_{1ss}y_s] + [a_{1ns}y_n]} \quad [9]$$

Regarding the rest of the union (the northern country), we assume that the southern country does not hold bills issued by the northern country which finances its public deficit only domestically:

$$bt_s^n = 0$$

$$bt^n = bt_n^n$$

The global demand for Treasury bills issued by the northern country depends on the level of interest rate ( $r_n$ ) and the national income ( $y_n$ ):

$$bt_n^n = \frac{(r_n - a_{1nn})y_n}{b_{2nn}}$$

Consequently, we have the following interest rate determination for the northern country:

$$r_n = a_{1nn} + \frac{b_{2nn}bt_n^n}{y_n} \quad [10]$$



After an increase of public deficit, the public deficit remains financed by commercial banks. However, the level of interest rates is higher. This tightening of financial conditions is partially transmitted to rates on bank loans granted to firms and to interest rates on public bonds which are supposed to be equal to interest rates on Treasury bills.

### ***Baseline scenario***

Our model represents a monetary union characterized by a sluggish growth in the baseline scenario (around 1 percent per year). Several sensitivity tests have been conducted on the most relevant parameters (see appendix D). They indicate a rather good robustness of the results. From this baseline scenario, we simulate an asymmetric loss of competitiveness in the southern country due to an exchange rate misalignment. As underlined by Blanchard and Milesi-Ferretti (2012), overvaluations induce distortions in prices of internationally traded goods. Thus, cumulative effects of overvaluations amount to negative competitiveness shock. To illustrate this loss of competitiveness, the term  $ti$  is equal to 10 between periods 10 and 45 in the import equations:

$$\log(im_n) = \mu_{0n} + \mu_{1n} \log(y_n) + \mu_2 \log\left(\frac{w_n - ti}{y_n}\right) - \mu_2 \log\left(\frac{w_s + ti}{y_s}\right) \quad [11]$$

$$\log(im_s) = \mu_{0s} + \mu_{1s} \log(y_s) + \mu_2 \log\left(\frac{w_s + ti}{y_s}\right) - \mu_2 \log\left(\frac{w_n - ti}{y_n}\right) \quad [12]$$

This shock deteriorates the current account of the southern country and improves external trade of the northern country. Consequently, we observe a decline of national income in the South and an increase of national income in the North. In order to investigate the current developments of the eurozone crisis, we compare the effect of this shock in different versions of the model. In addition to the baseline scenario, five versions of the model will be examined.

### **3.2. Alternative scenarios of economic policies**

#### ***Scenario 1: Budget cuts***

In this first scenario, public expenditures become endogenous and react to rising interest rates on Treasury bills:

$$gn_n = a_{gg1}gn_n(-1) - a_{gg2}r_nbt_n(-1) \quad [13]$$

In line with the objectives of the revised Stability and Growth Pact as well as aims of the Fiscal Compact, we assume that the government targets to reach a debt-GDP ratio of 70 percent in period 45. To achieve this challenge, the government progressively reduces its public expenditures. The speed of public expenditures reduction is governed by the evolution of interest rates. The year of the shock, public expenditures decrease by 0.2 percent of GDP relatively to the baseline scenario. In the baseline scenario, public expenditures amount to 19.5 percent of GDP in period 45. In this first scenario, they drop to 12 percent of GDP in period 45.

#### ***Scenario 2: Intra zone financing***

We investigate, here, implications of financial support granted by the northern country to the southern country. In the wake of a loss of competitiveness in the southern country, the issuance of public securities will rise to finance an increasing deficit. We assume that private banks of the northern country will sustain a supplementary demand to bring down interest rates. This scenario can also be seen as an illustration of the European Stability Mechanism where northern countries grant loans with low rates of interest to southern countries. Similar effects are also expected if the ECB purchases directly Treasury bills of southern countries. In each case, the southern country receives financial aid to substantially reduce the debt burden.

#### ***Scenario 3: Issuance of Eurobonds***

In this scenario, Eurobonds are issued in order to partially mutualize sovereign debt of southern countries. We assume that there is threshold (a debt-GDP ratio of 60 percent) from which Eurobonds are issued to finance public debt in the eurozone as a substitute to national debt.

Nevertheless, national governments have to pay interest on issued Eurobonds. Southern countries must be committed to stabilize their public debt.

$$\text{If } \frac{d_n}{y_n} < 60\% \text{ then} \quad [14]$$

$$\Delta bt_n = (g_n^n + r_n bt_n(-1) + b_n(-1) - t_n - tb_n - teb_n - pb_n \Delta b_n + ps_n - cl_n - tf_n) + reuro.bte_n(-1)$$

$$\text{If } \frac{d_s}{y_s} < 60\% \text{ then} \quad [15]$$

$$\Delta bt_s = (g_s^s + r_s bt_s(-1) + b_s(-1) - t_s - tb_s - teb_s - pb_s \Delta b_s + ps_s - cl_s - tf_s) + reuro.bte_s(-1)$$

Each government may appeal the issuance of Eurobonds ( $bte_n$  for the northern government and  $bte_s$  for the southern government).

$$\text{If } \frac{d_n}{y_n} > 60\% \text{ then} \quad [16]$$

$$\Delta bte_n = (g_n^n + r_n bt_n(-1) + b_n(-1) - t_n - tb_n - teb_n - pb_n \Delta b_n + ps_n - cl_n - tf_n) + ge_n$$

$$\text{If } \frac{d_s}{y_s} > 60\% \text{ then} \quad [17]$$

$$\Delta bte_s = (g_s^s + r_s bt_s(-1) + b_s(-1) - t_s - tb_s - teb_s - pb_s \Delta b_s + ps_s - cl_s - tf_s) + ge_s$$

The aggregate supply of Eurobonds is obtained by the sum of the two countries.

$$bte = bte_n + bte_s \quad [18]$$

Demand for Eurobonds simply depends on the interest rate ( $reuro$ ) and the level of GDP of the entire eurozone ( $y_e = y_n + y_s$ ).

$$bte = \frac{(reuro - a_{0e}) y_e}{a_{1e}}$$

In the model, we use the following determination of interest rates:

$$reuro = a_{0e} + a_{1e} \left( \frac{bte}{y_e} \right) \quad [19]$$

#### ***Scenario 4: Issuance of Eurobonds and European projects***

To complete the previous scenario, Eurobonds are used as a tool to finance European projects in innovative sectors. Southern countries as well as northern countries can use Eurobonds in order to stimulate their economic growth.

#### ***Scenario 5: Tax rebate and public expenditures cuts***

This scenario describes roughly the French “Crédit d'impôt pour la compétitivité et l'emploi (CICE)” and the “Pacte de responsabilité et de solidarité” the government reduces the social contributions paid by the firms to partly compensate the competitiveness loss due to the overvaluation ( $trs = 1.5$  for  $ti = 10$  in period 10 in scenario 5). To avoid an increase of the public debt, public expenditures are cut in the same proportion ( $gs_s = a_{gg1}gs_s(-1) - trs$  in period 10 in scenario 6). However, these measures are not sufficiently devoted to the tradable sector and the total effect on employment, which is the other main target, is very uncertain. That is why the government toolkit includes also industrial policy measures such as innovation and technology policy or relocation policy. These measures are complex to design and to manage and their effects are only felt in the long run. As an illustration and in an optimistic way, it is assumed that after period 30 the non-price competitiveness of country  $s$  is improved (the import income elasticity of country  $s$ ,  $\mu_{1s}$  declines from 1 to 0.98 while the import income elasticity of country  $n$ ,  $\mu_{1n}$  increases from 1 to 1.02 in scenario 7).

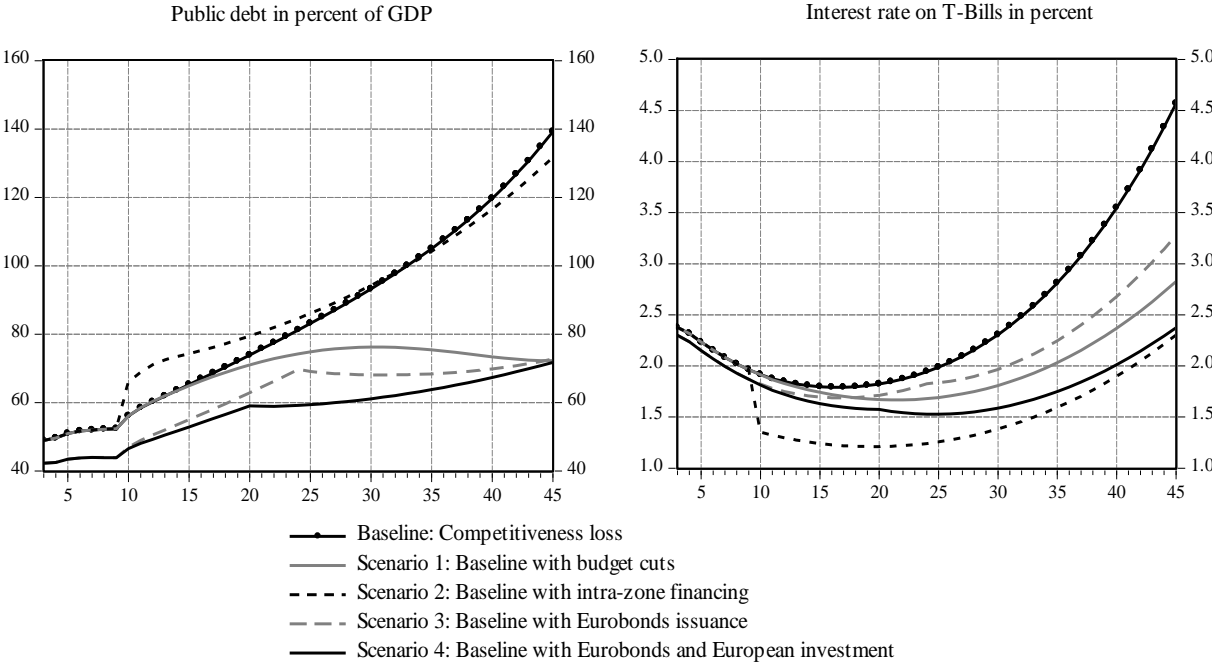
### **3.3. Adjustments in the monetary union and economic policies**

In figure 3, we can observe the evolution of interest rates and public debt in the southern country in the baseline scenario (competitiveness loss in the southern country) and in the first four versions of the model.

In the baseline scenario, we assume that any adjustment mechanism is implemented to face the competitiveness loss. Thus, this competitiveness loss widens the external deficit and in the same time increases the need of external financing. In addition, the negative impact of trade deficit

on the GDP implies a diminution of taxes collected by the government and thus an increase of the public deficit. On the Treasury bills market, interest rates increase alongside the debt increase and the slowdown of GDP. This “snowball” effect implies a tremendous increase in debt levels (140 percent of GDP in period 45) and of interest rates (4.5 percent in period 45).

**Figure 3: Evolutions of public debt and interest rate in the southern country**

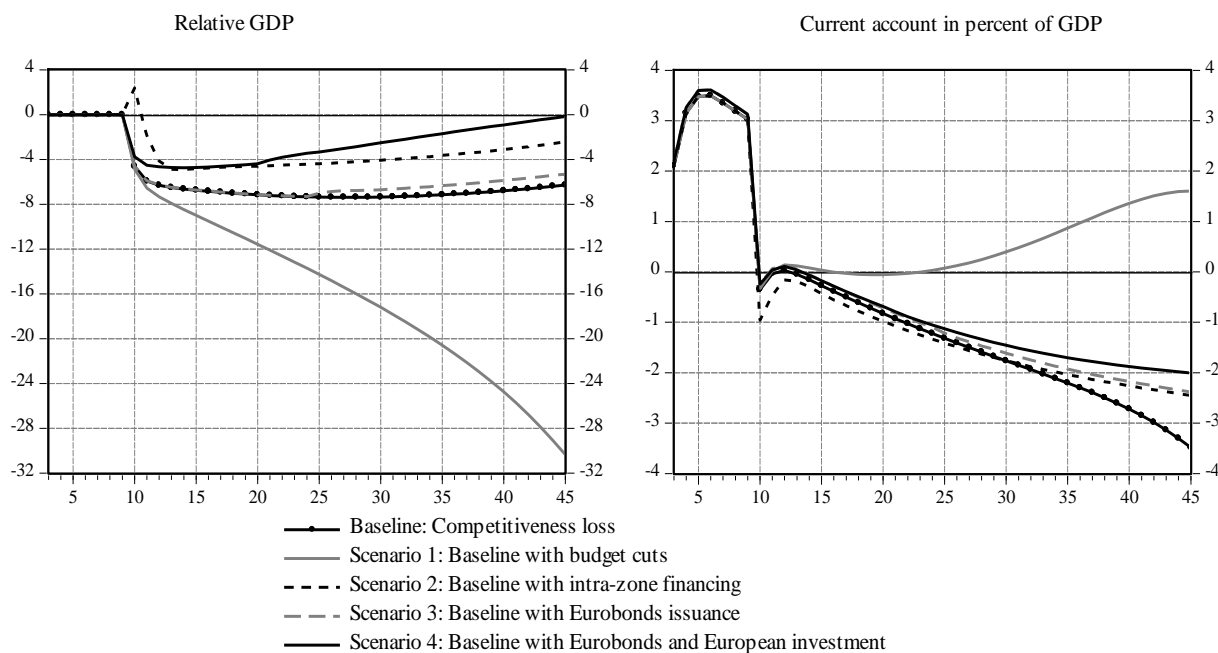


Source: authors’ calculations.

In order to eschew another “Greek drama”, European authorities can react by implementing various alternative economic policies in order to achieve more sustainable adjustments.

In the first scenario, the government tries to reduce its public expenditures in order to prevent an increase of interest rates. The long run purpose of this policy is to reach a debt-to-GDP ratio limited to 70 percent. However, due to the Keynesian multiplier effect, public expenditures reduction puts a huge strain on economic activity as we can see in figure 4. Interest rates are reduced compared with the baseline scenario but still rise in the medium run and reach 2.8 percent in period 45 due to a smaller demand of Treasury bills induced by the decline of the activity.

**Figure 4: Relative GDP and current account in the southern country**

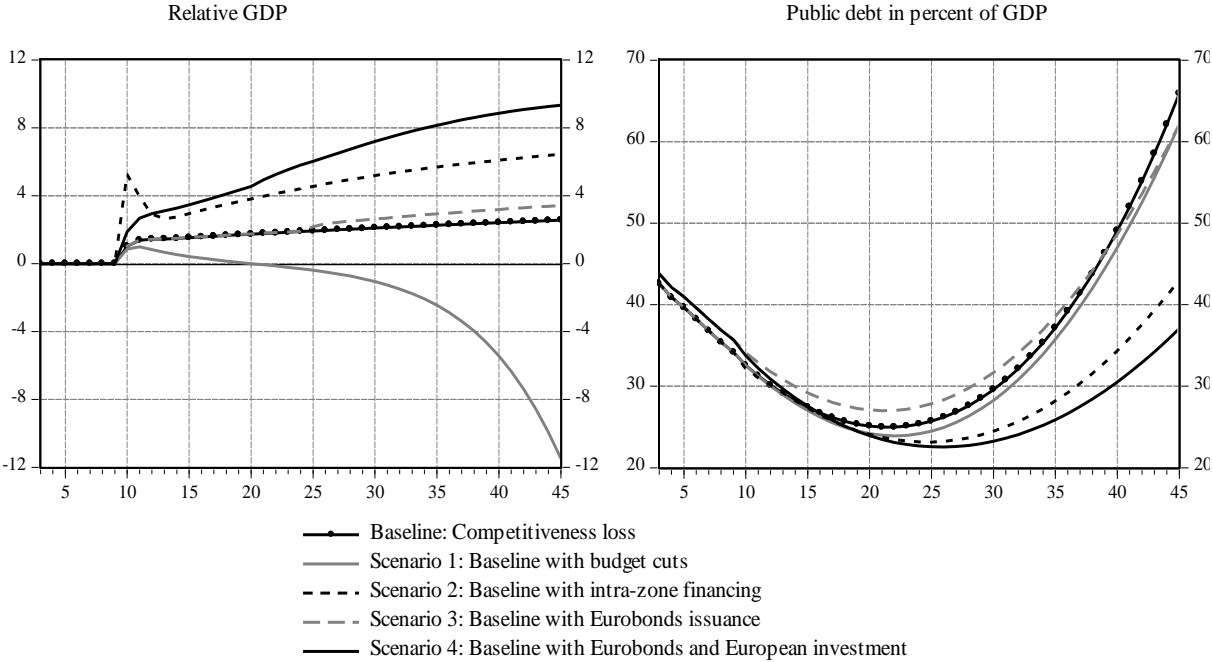


Source: authors' calculations.

In the second scenario, we assume that intra-zone financing is important thanks to an eased demand from private banks of the Northern countries or to the implementation of a European Stability Mechanism. This allows to keep interest rates at low level (2.4 percent in period 45) in spite of a huge increase of public debt-to-GDP ratio (130 percent in period 45). The negative impact on economic growth is largely offset in the long run but the competitiveness problem is not solved (see figure 4). We can recall that the Treaty ratified in March 2012 which gives an institutional background to the European Stability Mechanism stipulates that members States must reach a debt-to-GDP ratio of 60 percent in the medium run. The results of the second scenario will be greatly affected if the goal targeted by the European Stability Mechanism was respected. In such a case the result in terms of relative growth rates would be largely similar to those of the first scenario.

The third and the fourth scenario analyze the impact of an issuance of Eurobonds in the eurozone. We can observe that interest rates increase less rapidly in the fourth scenario than the third scenario. In the fourth scenario, Eurobonds finance investments in innovative sectors therefore economic growth is stronger and upward pressures on interest rates are weaker.

**Figure 5: Relative GDP and public debt in the northern country**



Source: authors’ calculations.

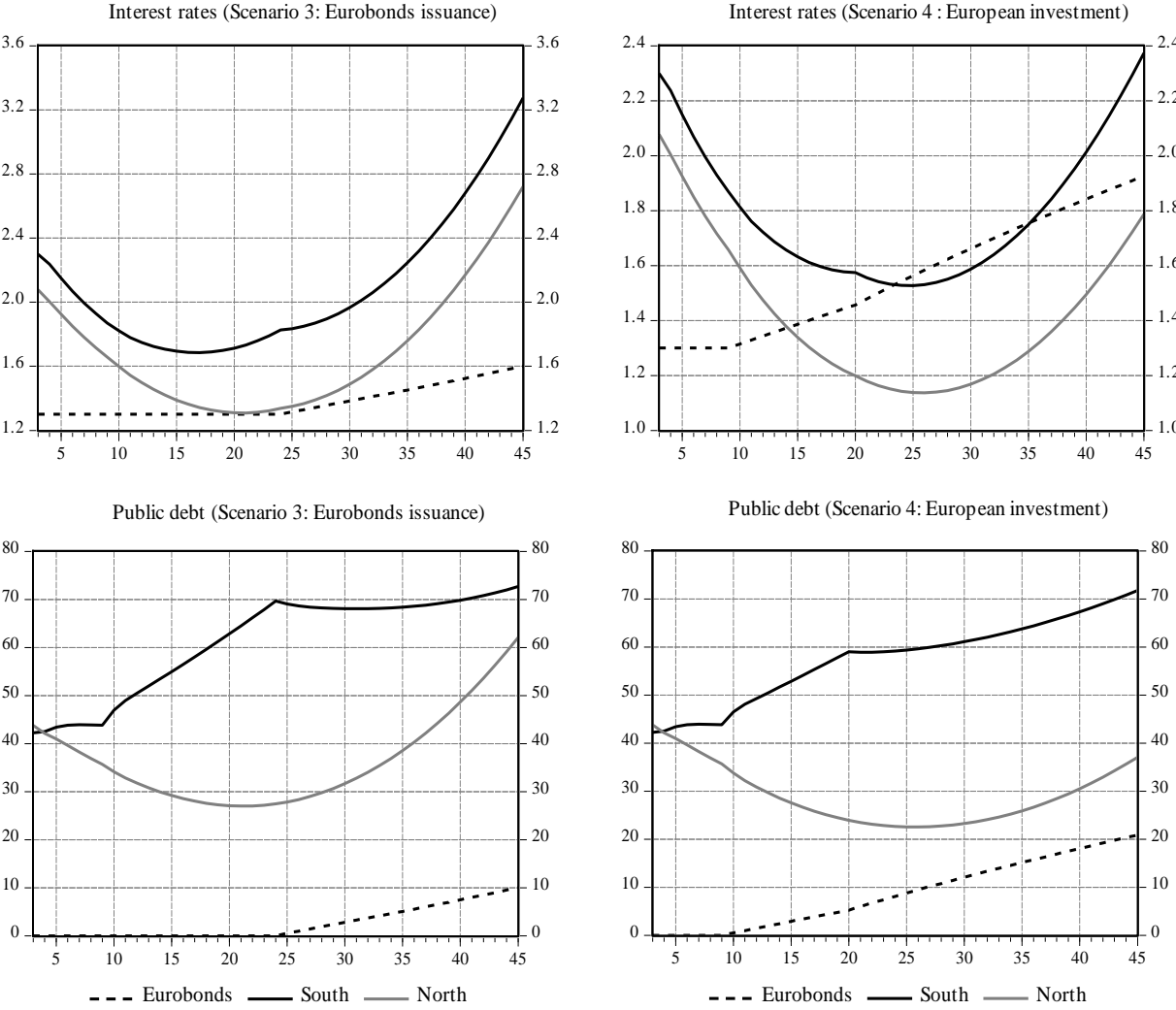
These growth gaps can be observed in the figure 4. We compute adjustments on GDP thanks to the following formula:

$$Relative\ GDP = \frac{GDP_{competitiveness\ loss\ with\ adjustment} - GDP_{competitiveness\ loss\ without\ adjustment}}{GDP_{competitiveness\ loss\ without\ adjustment}}$$

Initially, the GDP drops after the negative competitiveness shock. The implementation of European projects financed by Eurobonds (scenario 4) absorbs completely the competitiveness loss in the long run as GDP returns to its value before the shock in period 45. Eurobonds issuance to partially mutualize sovereign debt (scenario 3) induces a partial adjustment. We can observe that intra-zone financing (scenario 2) appears to be more efficient than Eurobonds issuance alone (scenario 3). The implementation of a European Stability Mechanism, aimed at providing low interest rates to governments and firms, stimulates investment. In terms of relative growth, the worst case is the first scenario where governments implement drastic budget cuts in order to achieve a debt-to-GDP ratio of 70 percent in the long run. The GDP drops by 30 percent in relative terms in period 45. The slowdown of economic activity induces a decrease of imports and then a massive adjustment of the current account balance. Without any policy

reactions (baseline scenario) after the competitiveness loss, external deficits of the southern country steadily increase and reach 3.5 percent of GDP in period 45. In other scenarios, we observe a stabilization of the external deficit around 2 percent in the long run.

**Figure 6: Interest rate and public debt in scenario 3 and 4**



Source: authors' calculations.

In figure 5, we can analyze the consequences of the various scenarios in the northern country in terms of growth and public debt. Again, drastic budget cuts in the southern country have negative impact on economic activity (even) in the northern country. In the long run, the fall of GDP will bring public debt to 65 percent of GDP. In other scenarios, public debt increases less thanks to a stronger growth, particularly in the fourth scenario.

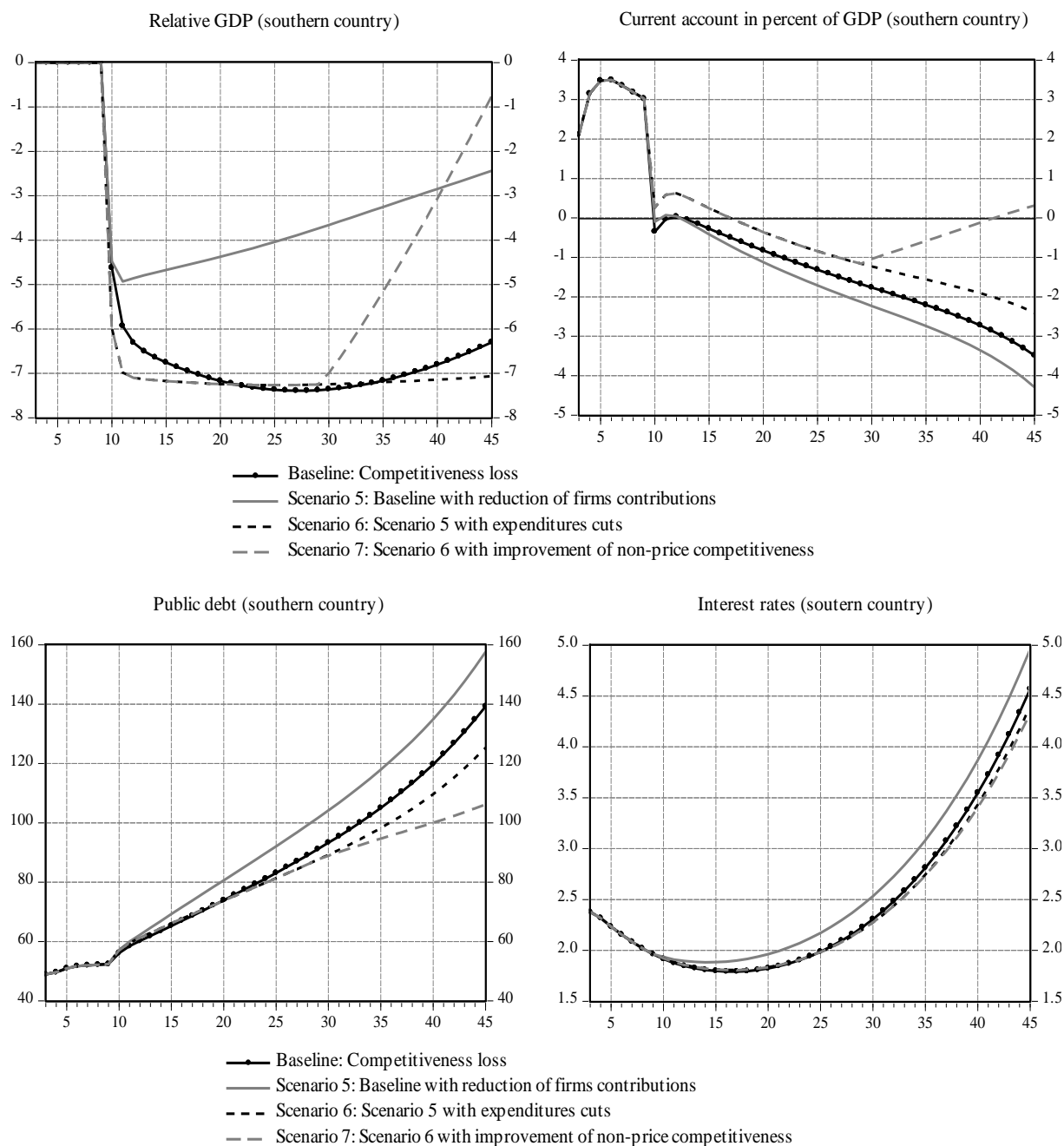


According to our numerical simulations, the emission of Eurobonds constitutes a useful tool to ensure a strong recovery in the entire eurozone. Figure 6 shows levels of public debt and evolution of interest rates on Treasury bills and Eurobonds in the third and the fourth scenario. As growth is stronger in the fourth scenario, interest rates on national T-bills are lower when Eurobonds play a role in financing the real economy. Conversely, the interest rate on Eurobonds is slightly higher in the fourth scenario (1.9 percent) than in the third scenario (1.6 percent). Regarding levels of public debt, again, European debt in Eurobonds is higher in the fourth (20 percent of GDP) relatively to the third scenario (10 percent of GDP). Nevertheless, European indebtedness remains sustainable as well as national indebtedness in spite of the fact that national governments have to pay interests on these issued Eurobonds.

We now move towards the last scenarios with tax rebate and public expenditures cuts. In scenario 5, the reduction of the social contributions paid by firms partly offsets the effect of overvaluation of the euro for southern countries and their loss of competitiveness. The GDP fall is less noticeable but the current account balance remains deteriorated while the public deficit and debt increase a lot, inducing a substantial increase of interest rates (see figure 7). To avoid this unsustainable worsening of the public finance, public expenditures are cut of an amount equivalent to the tax rebate (scenario 6). These cuts partially limit the rise of public debt and of the interest rate but at the expense of the GDP growth which returns to the depressed baseline scenario.

This strategy of the French “Pacte de responsabilité et de solidarité” uses simultaneously the accelerator and the brake and can have only a limited effect. The initial tax rebate represents a high cost for the public finances without being targeted on the tradable sector, mainly due to European competition rules. The only way of escape would be the success of industrial and innovation policies able to improve at medium term the non-price competitiveness, as it is illustrated in the scenario 7.

**Figure 7: Tax rebate and public expenditures cuts (scenarios 5 to 7)**



Source: authors' calculations.

## 4. Conclusion

If European authorities do not react by implementing new economic policies to achieve sustainable adjustments, the intra-European exchange rates misalignments and the subsequent competitiveness loss in southern countries induce economic stagnation in southern countries. Current account imbalances will continue to diverge and public debt dynamics will not be stabilized. Restrictive fiscal policies, as they have been implemented in southern countries, can contain interest and public indebtedness but at the cost of a deeper recession. This policy-mix based on tax rebate to improve competitiveness and public expenditures cuts, illustrated by the French “Pacte de responsabilité et de solidarité”, has only a limited effect.

Increasing intra-European financing by banks of northern countries or by the European Stability Mechanism or even by the intervention of the ECB itself could contribute to reduce the debt burden and induce a partial recovery. But the problem of competitiveness of the southern countries would not be solved and public debt would increase (scenario 2).

Implementation of euro-bonds as a tool to partly mutualize European sovereign debt would have a rather similar positive impact, but with a public debt limited to 70 percent of GDP, which could be considered as an important advantage (scenario 3). Furthermore, Eurobonds could also be used to finance large European projects which could impulse a stronger recovery in the entire eurozone with stabilized current account imbalances (scenario 4). To improve non-price competitiveness, it could (and should) be completed by more structural policies (industrial and innovation policies) which are complex to implement and effective only in the long run.

However, the creation of a European institution in charge of the emission of Eurobonds would face strong political obstacles. The northern countries fear that Eurobonds would give to the southern countries the opportunity to continue irrelevant policies. They would ask that the launching of Eurobonds would be accompanied by more restrictive fiscal policy in the respect of the Stability pact and by a stricter monitoring of national fiscal policies. This could generate

numerous political tensions between Member States. Actually, the European Stability Mechanism organizes the rescue of countries facing difficulties only under the condition of a strict control of the public finance. In such a configuration, Eurobonds would not be more efficient than the present institutional framework. On the opposite the southern countries could argue that a part of the debt induced by the overvaluation of their euro could be financed by Eurobonds without being subjected to tougher constraints.

Ultimately, as pointed out by Stiglitz (2016), the efficiency of these institutional innovations inside the monetary union could be compared with an alternative framework where the possibility of intra-European exchange rate adjustments would be reintroduced thanks to a new type of monetary regime (cohabitation of a global euro with national euros, new European Monetary System with a euro reduced to a simple ECU, exit of the Germany or of southern countries).

These various monetary regimes are a more straightforward solution to the problem of competitiveness of southern countries and allow a more efficient adjustment at short term, with a more balanced growth regime at medium term (Mazier and Valdecantos, 2015). They could also be completed by structural policies to improve non-price competitiveness. However, the main difficulty, raised by this alternative strategy, is the transition period which would be difficult to manage with the risk of capital flights and multiple bank crises.

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## Appendix A: Methodological note on the underlying current account

A simple foreign trade model is used for all the countries with export and import equations for goods and services related to real exchange rates, domestic output gap for import and foreign output gap for export. The interested reader could consult the IMF occasional paper 167 in which this correction is completely described (Bayoumi and Faruquee, 1998). Lagged effects of exchange rate variations are spread on three years ( $t : 0.6$ ;  $t+1 : 0.25$  and  $t+2 : 0.15$ ). Export price in domestic currency is independent from the real exchange rate while on the contrary import price in domestic currency depends immediately and completely of the exchange rate variation. The current account in percentage of GDP can be written as:

$$CA/Y = \alpha + [(M/Y)\beta_m + (X/Y)\beta_x](0,6R + 0,25R_{-1} + 0,15R_{-2}) - (M/Y)R - (M/Y)\psi_m YGAP + (X/Y)\psi_x YGAPF$$

where  $YGAPF$  is the average output gap of the main partners;  $R$ , the logarithm of the real exchange rate (*an increase of  $R$  indicates a depreciation*);  $\beta_x, \beta_m$ , the long run export and import price elasticities, respectively;  $\psi_x, \psi_m$ , long run export and import volume elasticities, respectively.

In case of real appreciation (*a decrease of  $R$* ), import in volume increases while exports decreases with lagged effects of the exchange rate variations but current account is improved thanks to cheaper imports. Last rising domestic output gap has a negative impact on current account while foreign output gap has an opposite effect. The underlying current account is the current account corrected by the effects of past and present exchange rate variations and by the effects of the domestic and foreign output gaps:

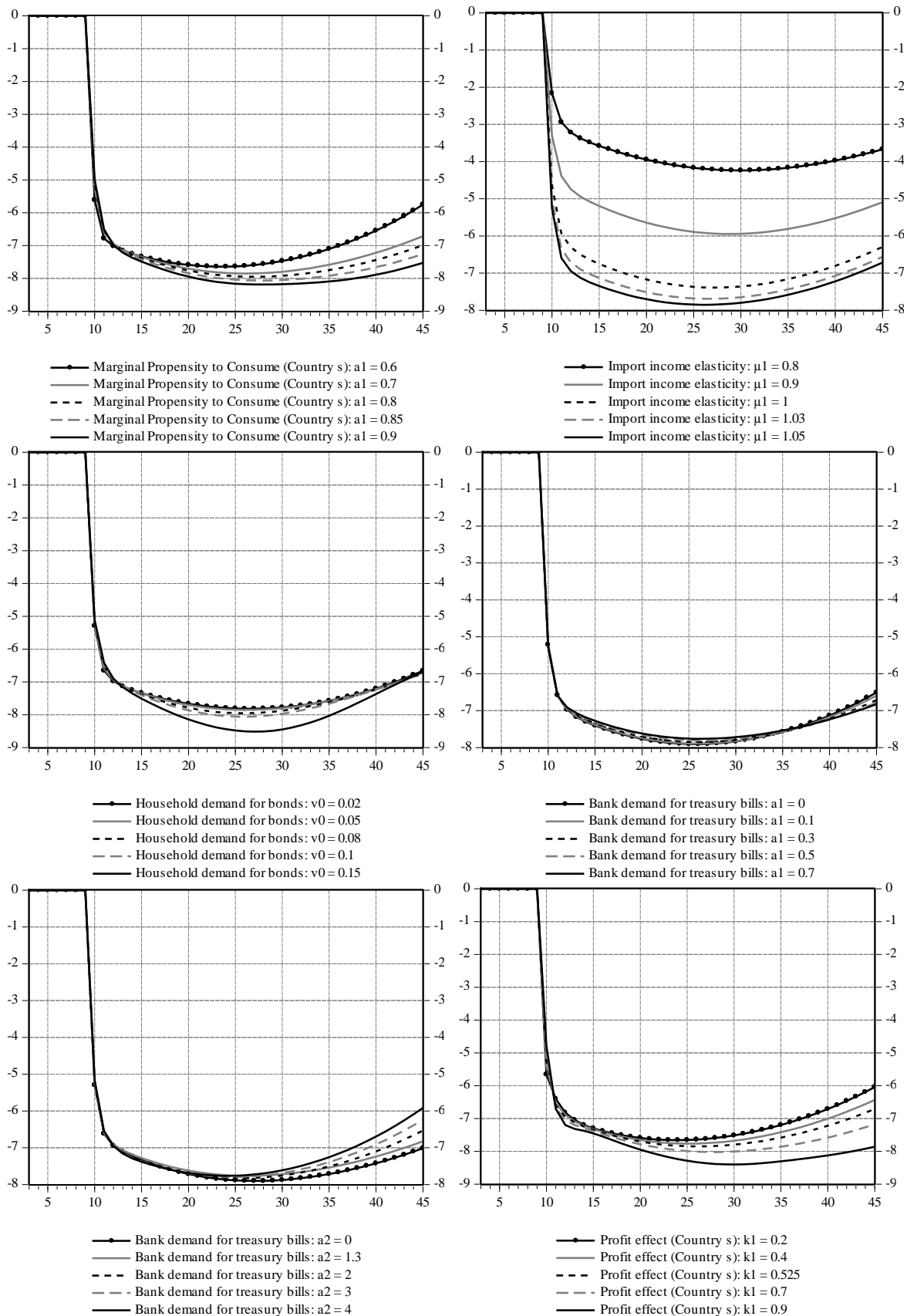
$$CA/Y_{UND} = \alpha + [(M/Y)\beta_m + (X/Y)\beta_x]R - (M/Y)R$$

By substitution, we obtain:

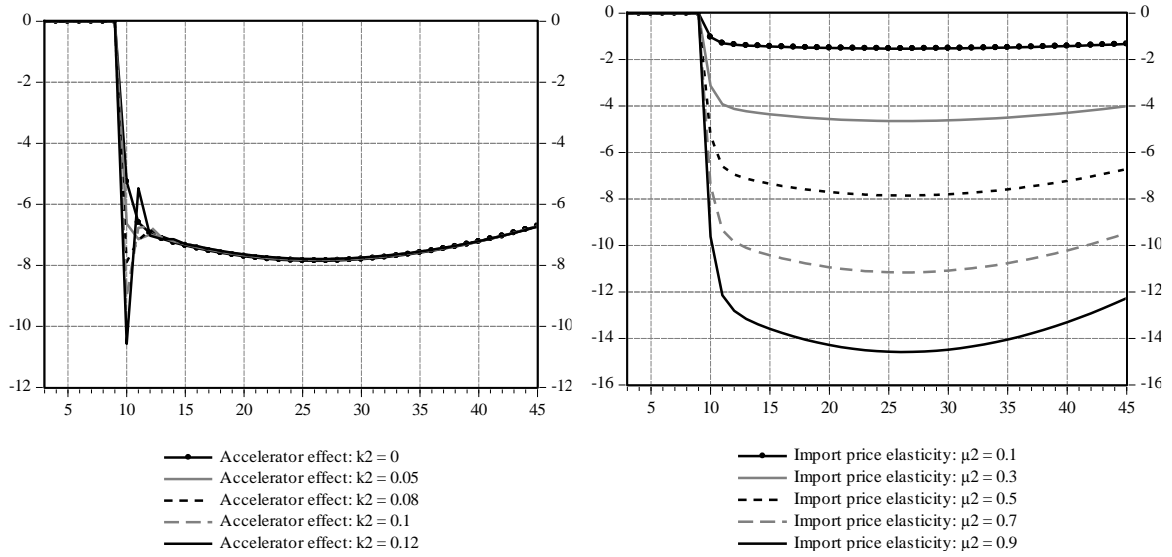
$$CA/Y_{UND} = CA/Y + [(M/Y)\beta_m + (X/Y)\beta_x](0,4\Delta R + 0,15\Delta R_{-1}) + (M/Y)\psi_m YGAP - (X/Y)\psi_x YGAPF$$

## Appendix B: Sensitivity analysis

Figure B1. Impact of a competitiveness loss on country S GDP (in percent relative to the baseline)







Source: authors' calculations.