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# The Current Eurozone – an impediment to critical French reform


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## Abstract

France currently needs deep structural reforms to boost competitiveness; but such reforms seem impossible while France remains in the straitjacket of the rules-bound transfer union that is the current Eurozone. High outstanding sovereign debt coupled with almost zero economic growth pose a real challenge to the French economy saved only by the relatively low government bond yield but this is subject to market swings. An unacceptably large proportion of the French workforce is trapped in long-term unemployment with the most affected part of the population being the young and older workers suffering from long term unemployment because of the adverse incentives brought about by a social safety net financed by taxing labour.



**Keywords:**

Euro, transfers, internal devalution, current account, public debt, inflation.

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# The current Eurozone - an impediment to critical French reform[1]

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## Introduction

The European Monetary Union (EMU) has caused substantial costs, both political and economic, which threaten the harmony and cooperation in Europe essential for the continent's long term prosperity and well-being. The ideal of 'ever closer union' enshrined in the 1957 Treaty of Rome is precious. That ideal is threatened by the present flawed construction of the monetary union.[2]

A monetary union between fiscally-sovereign states locks in and deepens differences in competitiveness between participating countries. This produces increasing current account deficits in the less competitive countries. As a result, these countries are bound to suffer lower economic growth and stagnant even declining living standards in the absence of some mixture of an "internal devaluation" (that is a reduction in relative wage costs) and transfers.

Up until very recently, that adjustment has been effected by the second route – i.e. transfers since they are painless, whereas "internal devaluation" means short-term reductions in living standards as the condition for longer-term growth. Until the 2008 financial crash, those transfers took the form of cross-border private sector lending to governments and, especially, to banks which in many cases lent the money to borrowers offering real estate as collateral. Since the credit bubble burst in 2008, these private financial flows have been replaced by state budget transfers and, therefore, ballooning budget deficits. As a result, the fiscal position in many of the less competitive eurozone economies has become unsustainable

[1] This paper was presented on 24 January 2013 in Brussels at the conference in Brussels, "Alternative solutions to the eurozone crisis – Presentation of the European Solidarity Manifesto" hosted by "Open Europe and New Direction". See http://www.openeurope.org.uk/Article/Page/en/LIVE?id=9765&page=Events

[2] The European sovereign debt crisis is analysed in Lane (2012) and Shambaugh (2012). The flaws of the EMU's institutions have and are the source of a large debate in the academic literature, see for instance Bordo, Markiewicz and Jonung (2011: 2) for examples of surveys reviewing this literature.

without transfers from the more competitive Eurozone economies led by Germany. Such transfers will be of taxpayers' money – provided either directly through the European Stability Mechanism (ESM), or indirectly via the banks in the creditor countries which have lent money to the troubled countries. For in the event of creditor banks having to agree to some form of sovereign debt restructuring, those banks would have to be recapitalized with money provided by taxpayers in their home countries.

This reality of extraordinary transfers of taxpayers' money of one Eurozone country to other Eurozone countries is political dynamite. For such transfers to be politically acceptable, they are bound to be made conditional on strict budgetary discipline and structural measures aimed at longer-term sustainability through "internal devaluation". Even if such conditions were met in such a "Rules-Based Transfer Union", it is by no means certain that taxpayers-voters in creditor countries like Germany would ever be reconciled to such transfers, creating the risk of an anti-European backlash in Germany. Such a backlash would become certain in the plausible event that the rules were, in practice, bent or shelved.

As for the debtor countries, many governments would much like to avoid such tough conditionality by having their budget deficits financed by money printed by the central bank. Such a desire has been explicitly stated by senior officials in France. But the best that the Eurozone debtor countries can hope for is not the political control of the ECB that French officials dream of, but rather ECB purchases of short-term government bonds ("Outright Monetary Transactions") which, if they happen at all, will be subject to the same tough fiscal conditions enshrined in IMF programmes as apply to transfers from the ESM. The outlook is therefore one of relentless fiscal tightening and demand repression lasting several years – resulting in shrinking or, at best, stagnating output and living standards. This has already caused anti-European and, increasingly, specifically anti-German backlashes in these countries' domestic politics and this problem will become increasingly severe.

It follows that the only way to prevent Europe tearing itself apart in a vicious circle of resentment and recriminations must be to dismantle the present monetary union by means of Germany and the other creditor countries leaving the monetary union. By doing so, these creditor countries will, de facto, provide substantial transfers to the indebted and less competitive countries in a way that will not cause anything like the same political bitterness or resistance. For the transfers will be effected by means of a revaluation of the German currency or possible new common currency shared between Germany and the other creditor countries that will make Germany less competitive and increase German imports from the hitherto less competitive countries. Another means by which transfers will be effected will be by a German-led group of banks writing off their claims on the governments of the indebted and less competitive countries, and those banks in surplus countries banks then being recapitalized by surplus countries taxpayers.

In short, this whole scenario would appear to keep the redistribution of German and other surplus countries taxpayers' money within these countries, thereby removing the risk of an anti-Europe political explosion. And because this scenario would provide relief in the indebted and less competitive countries from grinding austerity and recession, in those countries too, the risk of anti-Europe political backlashes would be replaced by a more pro-European public mood.

The question is whether, in this scenario, France should join Germany (or a German-led group) in a "northern" currency union, or lead a rump or "southern" Eurozone, or else – a third option – reinstate the French franc. To address this question, I start with an "internal" analysis of France's domestic economic distortions and in the light of that analysis I address the issue of which currency arrangements would maximise the chances of France making a success of the necessary internal structural reforms.

## Section 1 – The French Model

The following analysis assumes that French society maintains its historic preference for expensive state-financed welfare and high quality public services. France runs a large and costly welfare system which includes public services of a relatively high standard. The country also has invested heavily in relatively well-developed physical infrastructure. This welfare state is often referred to as the "French Model", founded on a deep and dearly-held national consensus. However, unlike in Scandinavian countries, which have a similar preference for expensive welfare, the French welfare state is not financed by relatively high rates of taxation on consumption and personal incomes. Egert (2011: 26) mentions that:

> "The effective tax rates on labour and capital (calculated as receipts over the base) in France are each among the highest in OECD countries, while consumption is taxed (including VAT and excise tax) at or below the European average (arithmetic or

> weighted by the GDP of each country), which is 22 percent and 19.7 percent respectively. In relative terms this implies that as in Italy and Spain the tax burden on capital and labour is twice as high as on consumption."

The French model has been financed instead by crushing taxation of labour (through employers' social security contributions and other forms of taxation) (table 1) and increasing public debt (Figure 1) from about 64 percent in 2007 to about 90 percent in 2012 (IMF (2012: 47)

Table 1 - Social security and other labour costs* paid by employer, percent of total labour costs, 10 employees or more.

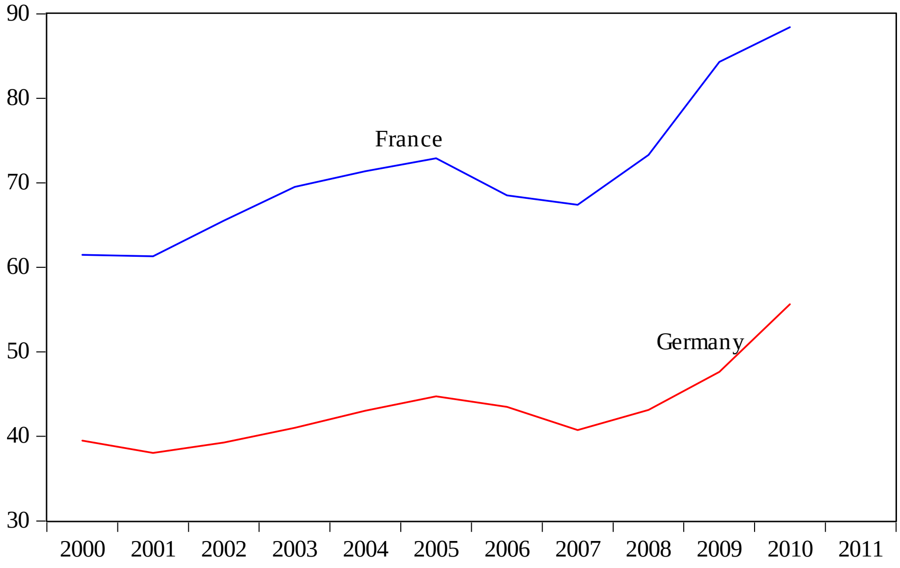
| | **2008** | | **2009** | | **2010** |
|---|---|---|---|---|---|
| Sweden | 33.2 | | 33.2 | | 33.2 |
| France | : | | 32.7 | | 32.9 |
| Belgium | 31.8 | | 32.2 | | 32.7 |
| Czech Republic | 26.4 | | 27.2 | | 27 |
| Spain | 26.7 | | 27.4 | | 27 |
| Austria | 26.3 | | 26.9 | | 26.6 |
| Greece | : | | 23.9 | | : |
| Slovakia | : | | 25.8 | | 25.5 |
| Romania | : | | 24.6 | | 23.3 |
| Germany | 21.5 | | 21.6 | | 21.6 |
| Finland | 22.6 | | 21.9 | | 21.6 |
| Bulgaria | 18.3 | | 16.7 | | 15.8 |
| Ireland | 15.8 | | 16.2 | | 15.3 |
| United Kingdom | 14.5 | | 14.6 | | 14.5 |
| Slovenia | 15.4 | | 14.4 | | 14.3 |
| Denmark | 12.7 | | 13.1 | | 12.8 |

Source: Eurostat

*Labour Costs are the total expenditure borne by employers for the purpose of employing staff. They include employee compensation (including wages, salaries in cash and in kind, employers' social security contributions), vocational training costs, other expenditure such as recruitment costs, spending on working clothes and employment taxes regarded as labour costs minus any subsidies received.

: not available

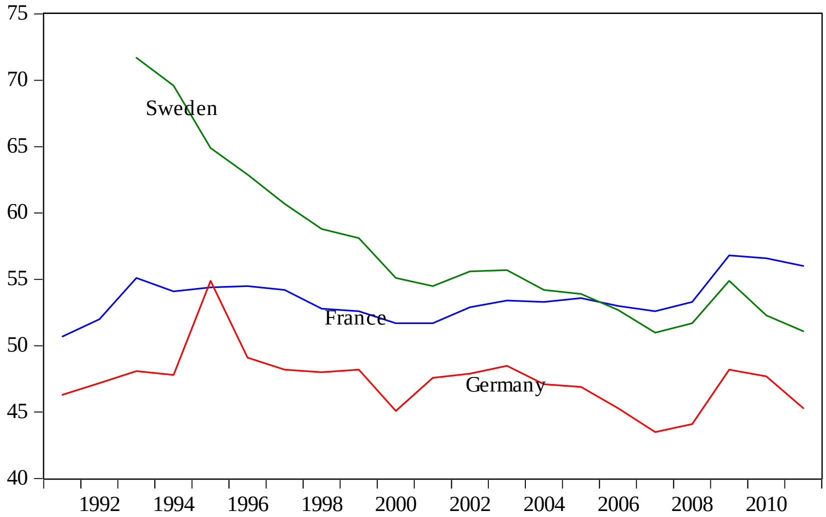
Figure 1 – Central Government Debt, Percent of GDP




Source: World Bank

The Scandinavian countries also have generous state welfare but it is combined with pro-business policies and traditions contrary to France. The Scandinavian social compact rests on the logic that citizens must pay high taxes in return for good public services. While French public spending – which stood at 56 per cent of GDP in 2011 – is at or above the levels seen in Scandinavia, French households enjoy lower tax rates on consumption and personal incomes (figure 2).

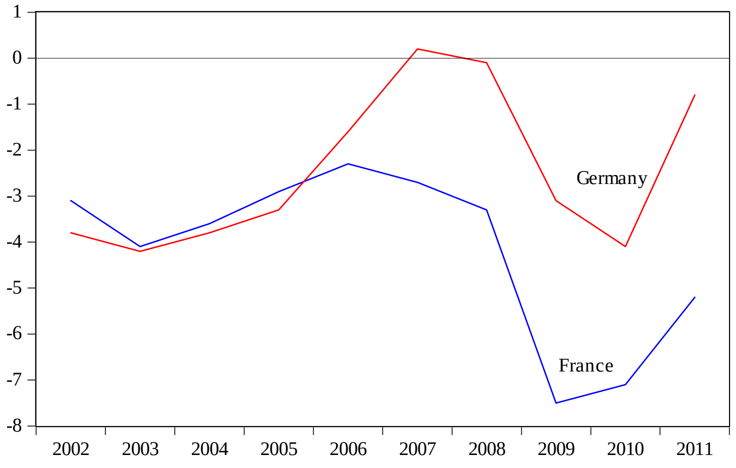
Figure 2 - Total general government expenditure, Percent of GDP




Source: Eurostat

As already mentioned, the gap is filled by a mixture of debt and heavy taxation of employment – which means taxes on business (figure 3).

Figure 3 – Central Government Budget Deficits, percent of GDP




Source: Eurostat

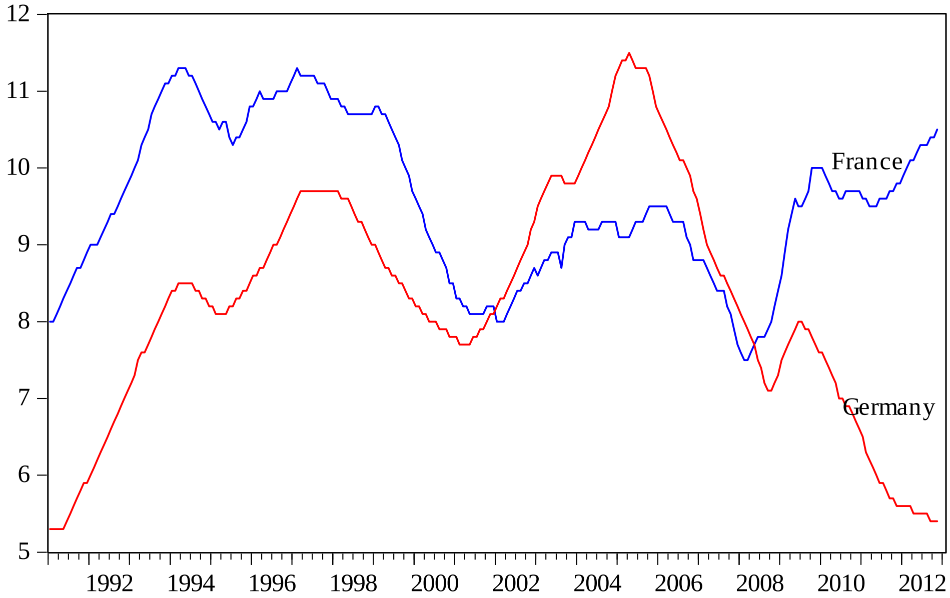
This emphasis on taxing labour has been, in political terms, the path of least resistance, since it maintains the political and social delusion of costless welfare according to which welfare is financed by companies (aka "filthy rich bosses") *as opposed to* people. Thus have the French avoided the pain of paying up-front for their cherished model. Having long maintained the illusion of getting something for nothing, these two expedients – relentless government borrowing and payroll taxes (social security contributions payable by employers) – have now undermined, respectively, the public finances and competitiveness.

The delusion that taxing companies is a painless way of financing welfare and public services is now laid bare in chronically high unemployment, eroding competitiveness and relatively poor growth performance, and living standards that are at best stagnant.

Households end up picking up the tab. In fact, they have already been doing so for years in the form of France's chronically high unemployment. With unemployment now standing at 10.6 percent, the most affected part of the population are the young and older workers (figure 4).

The difference now is that citizens face higher taxes and public services cuts. This is because the negative effects of high payroll taxes on competitiveness have weakened economic growth and hence the public finances. The social costs of labour borne by French employers are among the highest in the euro zone: Eurostat notes that the Ile-de-France region with EUR 49 per hour has the highest average labour cost in Europe, this contrasts with Bulgaria which has the lowest average labour cost with EUR 2 per hour.

Figure 4 – Unemployment rates




Source: Eurostat

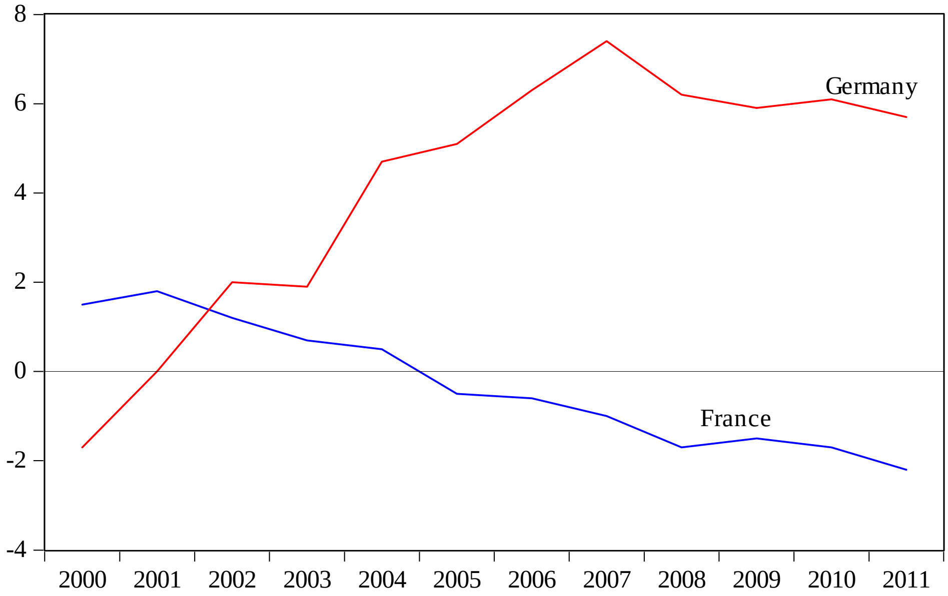
The damaging effects of this whole method of financing costly welfare/public services is aggravated by the closely related phenomenon of excessive state regulation of the labour market and distorting state interference in product and service markets.

Services remain more regulated in France than in most other OECD countries, notably in transport, professional services, and retail trade. The counterpart tends to be higher prices (for households and enterprises), owing to lower productivity or higher rents. By raising the purchasing power of households, deregulation of services would also support labour market reforms.

The burden of social charges – and also employment regulation – stifles ‘animal spirits’. Even the most patriotic entrepreneurs who themselves might be prepared to stay in the country despite Mr Hollande’s tax hikes – on income, dividends, capital gains and capital assets (the wealth tax) – will continue to be deterred from building businesses by the cost of hiring and the difficulty of firing. In this context business sentiment is declining fast and on October 8, the Bank of France estimated that the French economy had contracted by 0.1 per cent in the third quarter of the year, the first quarterly contraction since France exited recession in the spring of 2009.

In the past decade France has faced a sharp loss of export market share and contrary to Germany, France has a current account deficit as opposed to Germany surplus current account balance (figure 5). This loss of exports has been accompanied by low profit margins of enterprises, which constrain their capacity to invest, innovate and create jobs. Risks are becoming severe as major trading partners notably Italy and Spain which, following Germany, are now engaged in deep reforms of their labor markets and services sectors.

Figure 5 – Current Account, percent of GDP




Source: Eurostat

It follows that the French economy needs a “supply-side shock”, as recommended in a report on France’s competitiveness problem by Louis Gallois, a leading – and left-leaning – French industrialist. The Rapport Louis Gallois has opened the debate on *France’s competitiveness*, but unfortunately too few of its recommendations look like being acted upon by the government.

Moody’s announced on 19 November that it had downgraded French sovereign debt by one notch from the top AAA rating. In the run-up to the Moody’s downgrade decision, a Moody’s analyst was quoted as saying that the decision would be based in large measure on whether the government heeded Mr Gallois’ call for a “competitiveness shock”. The implication now is that Moody’s regards the measures announced on 6 November 2012 by Prime Minister Mr Ayrault as inadequate.

Far from signifying a pro-business shift, the government's response to the Gallois report demonstrates the enduring dirigiste mentality. Instead of a deep and permanent cut in social charges on business, the government announced that it would hand companies willing to invest and hire workers, a tax rebate of €20 billion, or 1 percent of GDP (the full tax rebate will be front-loaded with €10 billion in 2013 and an additional €5 billion in 2014 and in 2015). This measure will be financed by additional spending cuts worth €10 billion, and additional taxes on consumption also worth €10 billion (both starting in 2014).

Since this tax credit will be linked to employment and conditional on the rebated cash being used to invest and recruit new workers, this measure has been presented by the government as cutting taxes on labour and creating jobs. This is fantasy. Above all, a temporary tax break is useless for changing incentives. In any case, the complexity of the tax administration means that companies will not receive this cash until 2014-15. Finally, and typically, the government insists on dictating to business owners what they must to do with the cash – as if the state can know that reinvesting in the same enterprise will always be a better way to allocate resources than paying out dividends which the owners could use to start some new venture.

Rather than opt for a tax rebate, many had expected the government to reduce labour costs by lowering the social contributions paid by corporates. This was also the recommendation of the Gallois report and would be easier to implement. Shifting the cost of social security contributions from employers to income is unlikely to have durable effects if it is not accompanied by productivity gains that allow for real wages to recover the loss in purchasing power over time. It would also have undesirable effects on investment, by raising taxes on income from capital. A more promising avenue would have been to shift the burden to indirect taxes (for example VAT, property taxes or excises), part of which would fall on imported goods.

Other measures include a public guarantee for small and medium-sized companies with solvency problems; a new public bank to finance investment projects for small and medium-sized companies; and more funding for private research projects.

Here we see once again the unshakeable assumption that officials and lawmakers, themselves secure in their generous pay and untransparent perks, know better than market participants grappling with the real risks of business. Apart from promises to lighten labour regulation, all the other concrete new measures to boost competitiveness boil down to officials directing state budget money and subsidies to companies and projects deemed deserving.

France needs much more fundamental structural reforms. Taxes on labour must be slashed. A reduction of taxes on labour - so called 'fiscal devaluation' - has the same effect as a reduction in wages and will reduce unit labour costs. To maintain fiscal sustainability, taxes on labour should be replaced by higher taxes on household consumption (which will also reduce imports) along with cuts in the bloated state.

But in a very radical structural reform of this nature, the replacement revenue would have to be eased in over time. For a transition period, therefore, France would need the flexibility to run larger fiscal deficits, which the market would willingly finance because of the credibility of the supply-side shock reform.

But such fiscal flexibility would be impossible within a “Rules-Based Transfer Union” – that is, the Eurozone as presently constituted. France, despite “kicking and screaming”, has ratified the new Fiscal Treaty.

The amount of fiscal tightening about EUR 30 billion, the largest in three decades, that is required to reduce the fiscal deficit to 3.0 percent of GDP in 2013 from the 4.5 percent is unprecedented especially as the planned adjustment is based on a very optimistic projection of 0.8 percent GDP expansion for 2013 compared to the 0.4 percent forecast of the IMF (table 2).

Table 2 – France: Contributions to GDP, in percent

| | IMF | IMF | French authorities |
|---|---|---|---|
| | **2012** | **2013** | **2013** |
| Real GDP growth | 0.2 | 0.4 | 0.8 |
| Total domestic demand | -0.4 | 0.5 | 0.6 |
| Private consumption | 0 | 0.2 | 0.2 |
| Gov consumption | 0.3 | 0.3 | 0.3 |
| Gross fixed investment | 0 | 0 | 0.2 |
| Stockbuilding | -0.7 | 0.1 | 0 |
| Foreign balance | 0.6 | -0.1 | 0.2 |
| Exports | 0.7 | 0.2 | 1.3 |
| Imports | 0.1 | 0.3 | -1.1 |

Source: IMF (2012: 10)

If France were to join a Northern euro-zone, France would have to improve rapidly its competitiveness relative to Germany and the other Northern euro members, implying a drastic reduction in relative wage costs, especially as a Northern euro will appreciate damaging further France‘s competitiveness.

Given these points, there may be some economic case for France to stay out of Northern euro. However, the political and social obstacles to breaking away from Germany may prove to be insurmountable. Instead, there may be attractions for France to join or lead a Southern euro: but it is not clear that the southern countries will choose to stay in a monetary union owing to their economic divergence, limited levels of trade with each other, or instead prefer the attraction of setting their own monetary policy and allowing their exchange rates to float.

France needs to encourage domestic demand while working at improving competitiveness and putting its preferred model of generous welfare and high quality public services onto a sound and sustainable footing. Put another way, the required supply side shock will only succeed if appears credible both to the French public and to financial markets. And such deep reform policies will not be credible unless they are undertaken in an environment that allows from the outset some monetary and fiscal flexibility and in a context of decent economic growth. Neither of those two conditions for credibility – i.e. flexibility and growth – can be met in the present straitjacket of the “rules-bound transfer union” that is the current Eurozone. It follows that France should leave the Euro.

## Section 2 - LEAVING THE EURO

Leaving aside objections to this conclusion on ideological grounds, doubts might also be voiced on the pragmatic grounds that while this Euro exit conclusion may make sense in principle, the practical “real world” implications of leaving the present monetary union would be too traumatic to contemplate such a course. This section argues, on the contrary, that France risks much more traumatic consequences – mainly on the fiscal side – from *staying* in the Euro (including an involuntary exit from the monetary union a little further down the road); and that the practical consequences of a voluntary departure from the Euro now would be perfectly manageable.

The main problem for France is its lack of competitiveness relative to Germany and other euro partners, which in turn results in large differences in trade balances. If France was not part of the monetary union, the exchange rate would automatically adjust taking care of the trade deficit. With its debt to GDP ratio now standing at about 90 percent, France is in serious need of structural reform which will be almost impossible without its currency being able to respond to foreign demand and domestic conditions.

If the public debt was to worsen further, interest rates on the French debt may rise rapidly leading to the risk of insolvency and eventual default. Before accepting to refinance the debt, investors may ask how France will grow its way out of the crisis when demand in Europe is flat and French goods are becoming ever less competitively priced in export markets. Therefore a worsening of the French public debt or a turn in sentiment could force France out of the EMU.

The underlying reality here is that deficit financing either by debt issuance or by seigniorage and the inflation tax has a limit measured by the intertemporal budget constraint:

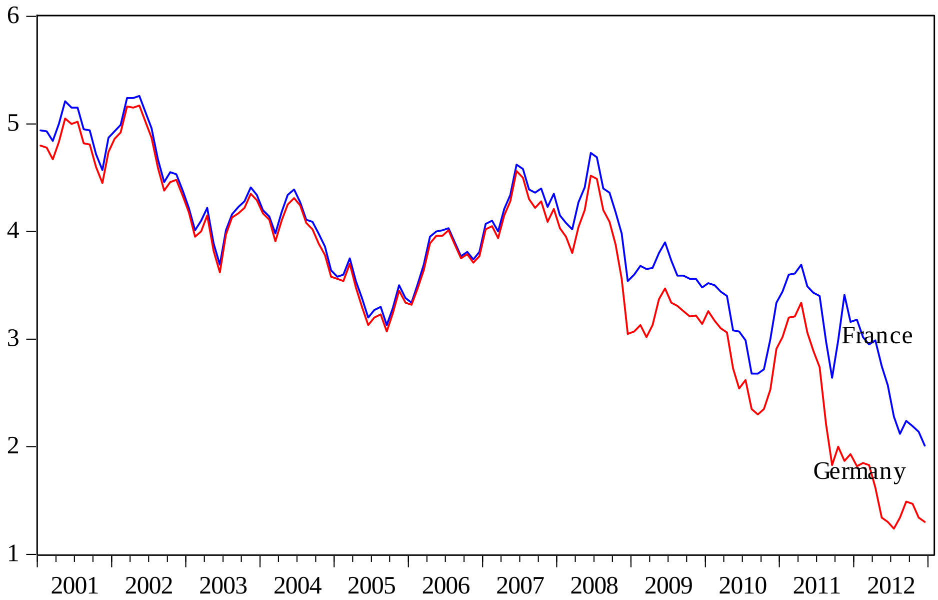
$$\Delta b = (r - n)b_{-1} + d - \Delta m$$

With *b* being the debt to GDP ratio, *r* the real rate of interest on government bonds, *n* the rate of real GDP growth, *d* the primary budget and *m* the monetary base both as a share of GDP. When the real rate of interest exceeds the GDP growth rate, the debt ratio feeds on itself, as interest payments add more to public debt than growth adds to GDP. Bond financing of the deficit with a real interest rate that exceeds the rate of output growth leads to rising debt ratios in the absence of any deficit correction (that is, an adjustment of fiscal policy to channel more and more public expenditure to debt service).

Rising debt, in turn, increases the deficit and thus leads to ever-increasing debt and debt ratios. Financing the deficit leads to its expansion. Bond deficit financing reaches its limit when interest rates are too high or when market participants refuse to roll over the debt. At that point the authorities have either to default on their debt or to call on monetary financing. The choice is between debt repudiation (default), or eventually to a much higher rate of inflation than the one previously required to stop the growth of debt. Put another way, if the default option is rejected in these circumstances, the choice is not whether to inflate away the debt but when.

Whether voluntarily or forced, an exit from the euro would mean that France’s currency – given the current account deficit – would depreciate relative the euro. In this scenario, prices of imports will go up helping to reduce further the trade deficit. The French debt crisis might initially deepen as interest payments costs on the French debt would likely increase. Until recently interest rates on French and German government bonds tended to move together and be quite close. In December 2012, yields on 10 year French government debt was 2.01 percent compared to 1.3 percent for Germany (Figure 6) but the last quarter of 2012 saw a real GDP growth of only 0.1 percent. Reinhart, Reinhart and Rogoff (2012) compile evidence showing that on balance at a debt to GDP ratio around 90 percent, public debt slows the rate of economic growth by about one percentage point per year.

Figure 6 – French and German 10 years Government bonds yields




Source: European Central Bank

French 10Y bond yields will be pressured higher upon exit due to the market asking for risk premia for inflation, currency depreciation and default. The French policy rate will be raised by the French central bank to counter the implicit loosening resulting from a weaker currency. This will impact yields relative to current levels given that the ECB deposit rate is currently at zero. With regards to default risk premium, this could be expected to increase once France leaves the Euro.

Norman and Sandilya (2011: 3) explain that in the case of France 100 percent of debt (sovereign and corporate) is issued in local currency: “These securities will be governed by local law and therefore exposed to redenomination risk since domestic law can be changed at will”. While the redenomination of the French debt would not legally be a default, it would most probably be considered as a technical default by the market including rating agencies and international organizations even if France continues to service its debt but in French local currency – which, having regained its monetary sovereignty, it would automatically be able to do. In any case, redenomination of the debt might not even be necessary. The devaluation would allow France to earn currency (the euro or a successor currency) from the Northern bloc via exports, while allowing local inflation to reduce the real value of the debt.

The risk of capital flight might also put pressure on bond yields. However, domestic and foreign investors and corporates could soon become convinced of the successor currency's intrinsic value due to a perception that the country's credit fundamentals are improving and future fiscal and monetary policy is more credible. Such positive perceptions would hinge on the return to healthy economic growth – that is, the immediate boost to growth as a result of leaving the euro and the long-term boost to growth potential from the implementation of supply-side shock structural reforms as described in the previous section.

Here lies the solution to the financing problem as a result of the consequences of a Euro exit – devaluation (for sure) and (possibly) the redenomination of existing debt contracts into a new currency. As pointed out by Roger Bootle (2012: 67), a combination of debt reduction and devaluation might convince the market that the French government is ready to undertake the necessary reforms and in doing so establish enough credibility of its monetary and fiscal policy for France to be able to re-enter the international financial market rapidly. Bootle mentions Uruguay "which in 2003 was able to borrow within five months of a distressed bond exchange which was labelled as a 'default' by the rating agencies. Historically as well there is "little historical evidence that default had led to significant denial of access to external financing." (Aggarwal and Granville, 2003: 3).

Moreover using IMF data on recent devaluations episodes, Weisbrot and Ray (2011) compare the Latvian experience of 'internal devaluation' maintaining its fixed exchange rate with thirteen countries that have used external devaluation and debt default. They show that while devaluation can be painful, the pain tends to be relatively short term and to be followed by successful period of recovery. Table 3 shows that:

> "most of the countries are considerably above their pre-devaluation level of GDP. The average economy is up by 6.5 percent over their pre-devaluation level of GDP. Latvia, by contrast, is down 21.3 percent of GDP, three years after the crisis began" (Weisbrot and Ray, 2011: 7)

Table 3 - Major Recent Devaluations and Ensuing GDP Loss

| | | Devaluation | | | | GDP decline | | |
|---|---|---|---|---|---|---|---|---|
| | | Months | National Currency | | Size | Quarters | Loss | Change in GDP |
| | | Until | per US dollar | | Of | Until | of | 3 years after |
| | Date | Trough | Before | Trough | Devaluation | Trough | GDP | Devaluation |
| Argentina | Jan-01 | 5 | 1 | 3.6 | -72.2% | 2 | -4.9% | 17.2% |
| Finland | Sep-92 | 11 | 4.4 | 5.8 | -23.9% | 4 | -2.4% | 6.8% |
| Georgia | Dec-98 | 2 | 1.5 | 2.3 | -36.8% | 1 | -1.6% | 6.5% |
| Iceland (1) | Oct-08 | 1 | 91.2 | 135.3 | -32.6% | 6 | -10.4% | -5.7% |
| Indonesia | Jul-97 | 12 | 2,446.6 | 13,962.5 | -82.5% | 5 | -13.4% | -7.9% |
| Iran | Mar-93 | 2 | 67.3 | 1,635.7 | -95.9% | 4 | -1.6% | 10.6% |
| Italy | Aug-92 | 12 | 1,102.6 | 1,605.1 | -31.3% | 2 | -1.7% | 6.0% |
| Malaysia | Sep-97 | 4 | 2.7 | 4.4 | -37.8% | 5 | -8.5% | 6.7% |
| Mexico | Dec-94 | 3 | 3.4 | 6.7 | -48.6% | 4 | -8.0% | 5.9% |
| South Korea | Dec-97 | 1 | 1,025.6 | 1,701.5 | -39.7% | 2 | -9.1% | 14.0% |
| Sweden | Nov-92 | 9 | 6.2 | 8.1 | -22.8% | 2 | -0.4% | 8.9% |
| Thailand | Jul-97 | 6 | 25.8 | 53.8 | -52.1% | 5 | -14.2% | -4.7% |
| UK | Aug-92 | 12 | 0.5 | 0.7 | -23.1% | 0 | 0.0% | 9.7% |
| Latvia | 2007Q4 | 24 | 0.49 | 0.48 | 2.1% | 8 | -24.1% | -21.3% |

[1] Not enough time has elapsed to measure Iceland's GDP three years after devaluation. Shown here is the most recent data: 2.75 years after devaluation.

Source: Weisbrot and Ray (2011, Table 1: 7)

In fact Weisbrot and Ray show that the social and economic costs of the "internal devaluation" for Latvia have been huge especially in terms of unemployment (officially up from 5.3 percent at the end of 2007 to 20.1 percent at peak in early 2010 mainly because of the dramatic recession). The lesson of the Latvian experience for France here seems clear, 'internal devaluation' is not an option being far too costly especially when the long term unemployment rate averages 10 percent. It would be far, better to choose the option of exiting from the euro, as this would allow France to grow again.

In these circumstances, any initial capital flight would be controllable through use of forex intervention and higher interest rates. Thus the redenomination risk might be considered a potential value boost from any redenomination, and the disruption to commercial and financial activity from contractual issues (possible modification of debt contracts) may not be so severe. The main problem instead would be the banking system, which would be insolvent as a result of its bond holdings but here again as long as the French central bank is ready to step in quickly through provision of liquidity, panic could be avoided.

## Conclusion

As Martin Feldstein (2011:3) remarks "There is of course nothing in economic logic or experience that implies that free trade requires a single currency." But what is sure is that free trade has to be maintained and the euro due to the way its institutions were built has now led to tensions which, if not addressed, could lead to social and political backlashes that would threaten free trade and might also cause wider conflicts.

The economic crisis that France currently faces necessitates deep structural reforms to boost competitiveness; but such reforms seem impossible while France remains in the straitjacket of the rules-bound transfer union that is the current Eurozone. High outstanding sovereign debt coupled with almost zero economic growth pose a real challenge to the French economy saved only by the relatively low government bond yield but this is subject to market swings. An unacceptably large proportion of the French workforce is trapped in long-term unemployment with the most affected part of the population being the young and older workers suffering from long term unemployment because of the adverse incentives brought about by a social safety net financed by taxing labour. Of course exiting the euro will not be without costs starting with inflation following the devaluation but the benefits in terms of increasing competitiveness and erosion of the real value of debt will quickly outweigh the costs.

The only remaining objection to France leaving the euro would presumably be geopolitical. For French elites since the Second World War, alignment with Germany has been central to projecting French power and influence both in Europe and the wider world. But such ambitions must be sacrificed for the sake of the basic well-being of the people. And, if regarded intelligently, the sacrifice would be more in the nature of a gambit than some kind of eternal renunciation. France will not recover economic strength without the adjustment of setting aside the present European Monetary Union. Even during that adjustment, there is no reason why relations with European partners should suffer in any fundamental sense. And the sustainable prosperity that would result from that adjustment would create a much healthier long-term foundation for continuing the quest for an “ever closer union” in Europe.

This leaves the question of what French government could actually pursue this course of radical supply-side reforms facilitated by the monetary and fiscal flexibility and the revived economic growth that would result from leaving the Euro. Such a “regime change” in economic policy might ordinarily be assumed to require a change of government based on a powerful mandate derived from the ballot box. In practice, however, it will suffice for either of the main camps in the French elite to abandon the taboo about the Euro. In the case of the ruling socialists, radical supply-side reforms seem contrary to their predilections. Yet they could present such reforms – truthfully – as the only way to save France’s ‘social model’ of generous welfare and high quality public services.

The worst outcome of all, however, would be for France to leave the European Monetary Union and then combine a currency devaluation and monetary deficit financing *without the above-mentioned supply-side structural reform*. Such a scenario would probably produce even worse long-term results both for France and the rest of Europe than continuing with the existing disaster of the Eurozone in its present form.

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