The law on the separation of banking activities: political symbol or new economic paradigm?

By [Céline Antonin](#) and [Vincent Touzé](#)

Imprudence, moral hazard and systemic gridlock were key words for the banking crisis. Governments that were unhappy to have had no choice but to come to the rescue of the banks are now trying to regain control and impose new regulations. The regulations with the highest profile concern the separation of trading activities (trading on own account or for third parties) from other banking activities (deposits, loans, strategic and financial consulting, etc.). These are expected to have the advantage of creating a tighter barrier between activities, with the idea that this could protect investors if bank operations go badly on the financial markets. On 19 February 2013, the French Parliament passed a law on the separation of banking activities. Although the initial targets were ambitious, the separation is only partial, as only proprietary financial activities will be spun off. As these cover less than 1% of bank revenues, this measure tends to be symbolic. However, by giving legal force to the principle of separation, the State is demonstrating its willingness to take a more active role in supervision.

The idea of compartmentalizing banking activities is not new. In the aftermath of the 1929 crisis, the United States adopted the Glass-Steagall Act (1933), which required a strict separation between commercial banks (specialized in lending and in managing deposits) and investment banks (specialized in financial activities). France followed suit with its own banking law of 1945 [1]. The expected benefits of separating banking activities are twofold. On the one hand, customers' deposits would be better protected, because they could no longer be asked to absorb the potential losses of market activities; on the other hand, in case of bankruptcy, State aid would be limited, because only the retail part of the bank would be covered by a government guarantee.

Forty years later, in the wake of the major wave of deregulation in the 1980s-1990s, France was one of the first to abolish this distinction, with the Banking Act of 1984, thus establishing the principle of universal banking. This principle leads to grouping activities with high needs for liquidity (the financing of the economy) with those that make it possible to gather liquidity (deposit activities). This grouping has the undeniable merit of giving the banks a more solid financial foundation. Other benefits also flow from this: greater leverage; the size factor leads to economies of scale; and the banks' ability to internationalize allows them to join the "too big to fail" category. Across the Atlantic, these arguments certainly worked in favour of the abolition of the Glass Steagall Act in 1999 by the Clinton administration.

Since 2008, the banks have been hit by a number of shocks: the subprime crisis; the fall in financial stocks; the slump in economic growth; and fear of defaults on sovereign debt (for banks in the euro zone). These shocks have shown that some of the advantages of universal banking could turn into disadvantages if leverage is used too systematically and if large banks in difficulty begin to pose a systemic risk. Many voices then began to be heard advocating a new Glass-Steagall Act, based on a view that separating market activities [2] from other banking activities is a way of preventing large-scale banking crises. Trading on own-account activities concentrates the bulk of bank malfunctions, in particular reckless risk-taking and the occasional "mad" trader [3]. This compartment has thus now become the focus of increasing attention by the regulators.

The Dodd-Frank Wall Street Reform and Consumer Protection Act [4] adopted in the United States in 2010 did not establish the separation of banking activities in a strict sense, but adopted the "Volcker rule," which prohibits banks from "playing" with depositors' money. This led to a virtual ban on the speculative proprietary activities of banking entities as well as on investments in hedge funds or private equity funds. In addition to this rule, this Act also represented a major reform in favour of the tighter regulation of all financial agents (banks, insurance companies, hedge funds, rating agencies, etc.) as well as closer monitoring of systemic risks.

Europe is in turn planning legislation on the separation of banking activities. At the request of European Commissioner Michel Barnier, the group of experts led by the Governor of Finland's Central Bank, Erkki Liikanen, presented a report on 2 October 2012. It advocates a strict bank compartmentalization [5] but also reviews the remuneration of financial managers and traders, with a view to overhauling the current arrangements, which tend to "push people into crimes" such as excessive speculation, in order to make these arrangements more compatible with long-term objectives. If this report is turned into a European directive, it will then have to be transposed into the national law in each Member State. However, this Europe-level approach is likely to be overtaken by the legislative processes in several European countries. In Germany, a bill on banking regulation [6] was introduced by the government on 6 February 2013, and could enter into force by January 2014 (with implementation by July 2015). The United Kingdom stood out in 2011 with the publication of the Vickers report [7], although the British government is in no hurry to implement its recommendations, with a probable deadline of 2019. France, with its "law on the separation and regulation of banking activities", has not been left behind.

A MODEST FRENCH ACT …

The French law has several components. In addition to establishing the principle of separation, it also provides for measures to protect bank clients and to strengthen the supervision and control of the banks.It does this in several ways:

– Each bank will be forced to develop a preventive recovery plan [8] for dealing with a crisis and a resolution plan in case it is failing (a bank testament). The resolution plan will be submitted for the appreciation of the Prudential Control Authority (ACP), which becomes the Prudential Control and Resolution Authority (ACPR).

– The Deposit Guarantee Fund (FGD) becomes the Deposit Guarantee and Resolution Fund (FGDR), with an increased capacity to intervene in the event of a bank failure.

– Macro-prudential supervision is strengthened by the establishment of the Financial Stability Council (CSF).

– The rights of bank clients are enhanced (transparency on the cost of loan insurance, free choice of loan insurers, right to a bank account, etc.).

However, the flagship measure in the reform is the separation between "activities useful to the economy" and speculative activities. Banks are to confine their proprietary or "own account" activities in an ad hoc subsidiary that is subject to specific regulation and funded independently. These subsidiaries will be prohibited from practicing certain speculative activities that are deemed "too risky or that may be harmful to the economy or society", such as activities on the markets for derivatives whose underlying assets are agricultural commodities, or high-frequency trading. Many activities will nevertheless be spared, such as providing services to customers, market-making activities, cash management, and bank investment or hedging operations to cover its own risks.

This law separating bank activities, which was initially presented as ambitious, will ultimately have only a limited impact. The universal banking model is not called into question. The admission of the head of the Société Générale bank could not be any clearer [9]: less than 1% of revenues are concerned. We are therefore a long way from how banking was compartmentalized prior to 1984. The criterion for separation is ambiguous. In fact, the border is porous between hedging risk and pure speculation: the law advances a fuzzy principle of "economic relevance", and the banks may be tempted to play around in this legal vacuum. As for market making [10], it is difficult to distinguish between speculative proprietary activities, which have to be spun off, and activities to promote market liquidity: high-frequency trading is for instance usually practiced under the guise of market-making agreements, so the law may be no more than a sword slashing water if the status of market maker is not defined more precisely [11].

The law also provides for prohibiting a banking group from holding shares of a speculative type, like a hedge fund. However, the loans granted by banks to hedge funds are always accompanied by guarantees. From this point of view, the law will also have little impact.

… BUT COULD IT GO FURTHER?

Finding a new financial paradigm for a banking model is a complex exercise. In practice, it is not easy to separate banking activities purely and simply without causing problems, and there are generally many limits to banking reform.

First, limiting investment banks' access to deposits as a source of liquidity, or eliminating this outright, would lead them to resort to more debt financing, which might be difficult to reconcile with the constraints set by the Basel III prudential regulations, which took effect on 1 January 2013. It is already very demanding in terms of equity levels.

Furthermore, it is important to note that banking risk is not inherent just in market activities. There are many other recent examples. Mortgage lending has also been an important source of risk: in Spain, falling house prices and the insolvency of borrowers virtually bankrupted the banks; in the United States, the subprime crisis is a crisis of real estate loans that affected the markets through sophisticated securitization mechanisms that allowed the banks to take the risk off of their balance sheets (at least ostensibly); in the UK, Northern Rock is a retail bank that specialized in mortgages and was hit hard by the credit crunch and the housing crisis. To some extent, universal banks have played an important role in saving banks that were too specialized, for example, JPMorgan Chase (Universal) took over Washington Mutual (savings and loan) and Bear Stearns (business), and Bank of America (universal) rescued Merrill Lynch (business).

In addition, the separation is supposed to wall off banking activities more tightly. But what happens if the subsidiary that manages the proprietary speculation goes bankrupt and causes heavy losses to the parent? In the past, two of the four major French groups, Crédit Agricole and BPCE, had insulated their market activities in their respective subsidiaries, Natixis and Cacib, but nevertheless had to come to their rescue in 2008 and 2011, respectively. The insulation seems to be very permeable.

In a context of financial globalization, compartmentalization may never be very effective. By its very principle globalized finance makes it possible to connect everything. This is in particular the role of the interbank markets [12].

In practice, it is difficult for a government to reform its banking sector in the absence of coordination with other countries. The domestic banks have foreign subsidiaries that may not be subject to the regulations. And above all, the profitability of rival foreign banks might improve, which would weaken the competitiveness of the domestic banks. At the European level, national interests differ, and each country may be tempted to impose its own bill. If the Liikanen report is turned into a Directive, then each Member State will be required to transpose it into their legal system. For the moment, the legislation of Germany and France is taking the lead. It is possible that these changes will influence any future directive.

If the effort to compartmentalize goes too far, there is also a risk of shifting the interconnections to less visible levels. It is essential to avoid falling into the trap posed by the dangerous illusion of thinking that we have eliminated a risk, when in fact it has just been moved.

Finally, too much regulation can sometimes kill regulation. In the financial sector, regulatory constraints may serve as a basis for speculation. So if a bank is having difficulty meeting certain regulatory constraints, the markets will be encouraged to speculate in order to provoke its failure and then profit from this. Caution is therefore needed before introducing new regulations.

Trying to apply the principle of separation too strictly could also lead to not supporting a commercial bank that is facing significant liquidity problems. However, according to the principle of “too big to fail”, such a decision is not always wise. The failure to support Lehman Brothers was punished in a way that had a significant long-term impact, as its collapse hit the entire economic and financial network.

It is also worth noting that taking banking and financial regulation to be a miracle cure could have deleterious effects on individual and collective responsibility. People think that the law can resolve any problem. Yet at the same time, it is very likely that the vectors of the next financial crisis will manage to circumvent the regulatory constraints, hence the importance for the supervisory authorities to remain vigilant and adopt a critical approach at all times.

GOING BEYOND THE POLITICAL SYMBOL

The government undeniably has little leeway to separate banking activities, because too much regulation may be ineffective or even dangerous. As a consequence, this law separating banking activities is not radical and will have a moderate effect on the banks. For its part, the government may have a clear conscience for having done something along the lines of its foreign counterparts. The bankers in turn are probably not unhappy at having given the impression of serving the public interest, especially at such a low cost.

Some will view this as just a poor political symbol. Others will try to go further and view this as giving hope that this reform will be seen as a strong signal to the banking world. This hope may not be in vain, as the principle of separation is now enshrined in law, and future governments will have plenty of time to strengthen it.

In practice, a change in economic paradigm that would lead to harmful speculation becoming increasingly rare will not result simply from a separation of activities. Banking laws should not be too complicated, because the devil has a tendency to hide in the details. The supervisory authorities must constantly keep a critical eye on the functioning of the markets, and the law needs to allow them some flexibility in determining when and how they should intervene. On these issues, Volcker’s statement in 2011 is unambiguous [13]: “I’d write a much simpler bill. I’d love to see a four-page bill that bans proprietary trading and makes the board and chief executive responsible for compliance. And I’d have strong regulators. If the banks didn't comply with the spirit of the bill, they'd go after them." It is also worth examining various measures to make financial professionals (managers and market operators) more responsible. In this respect, the Liikanen report proposes revising the pay systems for bank executives and financial managers in order to make these systems more compatible with a long-term vision. It is also necessary to explore the possibility of increasing the criminal liability [14] of financial leaders. The permeability of the interface between careers in the regulatory sector and in the regulated sector also needs to be examined. In this regard, there are certainly ways to make the system less permeable. After all, recent history has shown that it is possible to go from being Chairman of the Fed to being a trusted advisor for a rich and powerful hedge fund….

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[1] Law 45-15 of 2 December 1945 provided for the specialization of financial institutions by classifying the banks in three categories: deposit banks, business banks and long-term and medium-term lending banks (Articles 4 and 5).

[2] Asset management can be exercised:

– for one's own account (*proprietary trading*): the bank buys or sells financial instruments that are funded directly out of its own resources. These resources include not only the bank's capital, but also savers' deposits and loans. This means that, in addition to its own funds, the other categories involved in the bank's financing, including customer deposits, indirectly bear a risk.

– or on behalf of third parties (*non-proprietary trading*): unlike proprietary trading, the market or borrowing risks are borne mainly by the client. However, on certain products, the bank could face significant operating risks.

[3]

http://lexpansion.lexpress.fr/economie/trading-pour-compte-propre-la-face-cachee-des-banques_233686.html.

[4] Title VI of the Act proposes improving regulation and is considered to be an application of the *"Volcker Rule", http://useconomy.about.com/od/criticalssues/p/Dodd-Frank-Wall-Street-Reform-Act.htm.*

[5] The report recommends a separation of proprietary market activities but also of certain other activities on the financial markets and derivatives for third parties.

[6] Germany is also preparing a bill, under which the German banks will be obliged to wall off their proprietary trading. As in France, the universal banking model will not be called into question. http://m.lesechos.fr/redirect_article.php?id=reuters_00495696&fw=1.

[7] In September 2011, the Vickers Report recommended separating retail banking services from investment activities, by ringfencing retail banking services in subsidiaries, along with the requirement of a 10% equity cushion for retail banks. The British government is committed to introducing the reforms into law by 2015, with implementation set for 2019.

[8] This plan provides for different possibilities for recovery (recapitalization, a savings plan, restructuring, etc.) and excludes any call for public financial support.

[9] "We believe that, while in 2006-2007, 15% of activities could be considered market activities, 15% to 20% of which could be classified as disconnected from the customer, and consequently transferred to a subsidiary, this proportion is now less than 10%, and ranges from 3.5% to around 5% on average." Frédéric Oudéa, 30 January 2013, at a hearing before the Finance Committee of the National Assembly, http://www.assemblee-nationale.fr/14/pdf/cr-cfiab/12-13/c1213060.pdf.

[10] Market-making corresponds to the permanent presence of an operator who provides liquidity to the market.

[11] In this respect, we should mention the amendment tabled by Karine Berger, who wants Bercy [the Ministry of the Economy] to set the threshold above which market activities must always be spun off.

[12] Since 2008, the crisis of confidence in the banking market has posed great difficulties for access to liquidity in some banks, even though they are perfectly solvent, which has forced the central banks to intervene and take the place of the interbank market.

[13] 22 October 2011, http://www.nytimes.com/2011/10/22/business/volcker-rule-grows-from-simple-to-complex.html?pagewanted=all&_r=0.

[14] In this respect, the American authorities have not hesitated to take action against financial institutions that have failed to meet their obligations. See, for example, the recent action taken against Standard & Poor's, http://www.bloomberg.com/news/2013-02-06/s-p-lawsuit-portrays-cdo-sellers-as-duped-victims.html. See too the proceedings taken against a former employee of Goldman Sachs: http://www.sec.gov/litigation/complaints/2010/comp-pr2010-59.pdf and http://dealbook.nytimes.com/2013/01/31/trader-accused-of-misleading-clients-leaves-goldman/ or the investigation into the infamous "London whale": http://www.reuters.com/article/2013/02/15/us-lehman-jpmorgan-londonwhale-idUSBRE91E00W20130215.

So far so good …

By Christophe Blot

The euro zone is still in recession. According to Eurostat, GDP fell again in the fourth quarter of 2012 (-0.6%). This figure, which was below expectations, is the worst quarterly performance in the euro zone since the first quarter of 2009, and it is also the fifth consecutive quarter of a decline in activity. For 2012 as a whole, GDP decreased by 0.5%. This annual figure masks substantial heterogeneity in the zone (Figures 1 and 2), since Germany posted annual growth of 0.9% while for the second consecutive year Greece is likely to suffer a recession of more than 6%. Moreover, taking all the countries together, the growth rate will be lower in 2012 than in 2011, and some countries (Spain and Italy to name but two) will sink deeper into depression. This performance is all the more worrying as several months of renewed optimism had aroused hopes that the euro zone was recovering from the crisis. Were there grounds for such hope?

Although it is very cautious about growth for 2012, the European Commission, in its annual report on growth, noted the return of some good news. In particular, the fall in long-term sovereign rates in Spain and Italy and the success on the financial markets of the public debt issues by Ireland and Portugal reflected renewed confidence. It is clear now however that confidence is not enough. Domestic demand has stalled in France and is in freefall in Spain. All this is hurting trade within the zone, since a decline in imports by one country means a decline in exports from others, which is amplifying the recessive dynamics afflicting the countries in the zone as a whole. As we noted in our previous forecasting exercise and on the occasion of the publication of the iAGS (independent Annual Growth Survey), a recovery cannot in any case rely solely on a return of confidence so long as highly restrictive fiscal policies are being carried out synchronously throughout

Europe.

Since the third quarter of 2011, the signals have all confirmed our scenario and showed that the euro zone has gradually sunk into a new recession. Unemployment has continued to rise, setting new records every month. In December 2012, according to Eurostat 11.7% of the euro zone working population were jobless. However, neither the European Commission nor the European governments have adjusted their fiscal strategy, arguing that fiscal efforts were needed to restore credibility and confidence, which would in turn lower interest rates and create a healthy environment for future growth. In doing this, the Commission has systematically underestimated the recessionary impact of the fiscal consolidation measures and has ignored the increasingly abundant literature showing that the multipliers rise in times of crisis and may be substantially higher than one (see the post by Eric Heyer on this subject). Advocates of fiscal austerity also believe that the costs of such a strategy are inevitable and temporary. They view fiscal consolidation as a prerequisite for a return to growth and downplay the long-term costs of such a strategy.

This dogmatic blindness recalls the final comment in the film *La Haine* (directed by Mathieu Kassovitz): “This is the story of a society that is falling, and to reassure itself as it falls constantly repeats, so far so good, so far so good, so far so good … what’s important is not the fall, it’s the landing.” It is time to recognize that the economic policy in force since 2011 has been a mistake. It is not creating the conditions for a recovery. Worse, it is directly responsible for the return of recession and for the social catastrophe that is continuing to deepen in Europe. As we have shown, other strategies are possible. They do not neglect the importance of eventually making the public finances sustainable once again. By postponing and reducing the scale of austerity (see the note by Marion Cochard, Bruno Ducoudré and Danielle Schweisguth), it would be possible to make more rapid progress in restoring growth and cutting unemployment.

Should family benefits be cut? Should they be taxed?

By Henri Sterdyniak

The government has set a target of balancing the public accounts by 2017, which would require cutting public spending by about 60 billion euros. The Prime Minister, Jean-Marc Ayrault, has given Bernard Fragonard, President of the Haut Conseil à la Famille, France’s advisory body on the family, a deadline of end March to propose ways to restructure family policy so as to balance the budget for the family accounts by 2016. Aid to families thus has to be cut, by 2.5 billion euros (6.25% of family benefits), *i.e.* the equivalent of the 2012 deficit for the CNAF, the French national family allowances fund. Is this justified from an economic perspective and a social perspective?

The CNAF accounts have been hit by the recession, as the amount of social security contributions and CSG tax that it receives has gone down. Based on an estimate that total payroll is 5% below its normal level, the loss of revenue for the CNAF can be estimated at 2.5 billion euros. The CNAF deficit as a whole is thus cyclical. Arguing that the way to cut the deficit is by reducing benefits undermines the stabilizing role of public finances. Consider a fall in private demand of 1% of GDP; assuming a multiplier equal to 1, GDP also shrinks by 1%; the deficit in the public finances will then increase by 0.5%. If you want to avoid this deficit, then government spending would need to be cut by 0.5% of GDP, which would then reduce GDP, and consequently tax revenue, thereby requiring further reductions. *Ex post*, public spending would fall by 1% and GDP by 2%. Fiscal policy would then be playing a destabilizing role. The CNAF therefore needs to be managed based on looking at its structural dimension, which was in fact balanced in 2012. On the economic front, in a situation of a deep depression, when consumption and activity are stagnant, nothing can justify undermining the purchasing power of families [i].

Moreover, successive governments have gradually made the CNAF responsible for both pension benefits for stay-at-home parents (4.4 billion euros in 2012) and increases in family pensions (4.5 billion in 2012). Thus, of the CNAF’s 54 billion euros in funds, nearly 9 billion is being diverted into the pension scheme and does not directly benefit children.

This diversion has been possible because family benefits have risen only slightly in the past, as they are generally indexed to prices, not wages. Worse, in some years, benefits have not even risen at the same pace as inflation. Finally, from 1984 to 2012, the monthly basis for calculating the family allowance (the BMAF) lost 5.7% in absolute purchasing power (column 1 of the table), but 25% in purchasing power relative to median household income (column 2). Should we perpetuate and even widen this growing gap?

Young people under age 20 represent 25% of the population. Using the INSEE’s equivalence scale, 12.5% □□of household income should be provided by the family benefits that go to families with children in order to ensure that they have the same standard of living as people without children. Yet the totality of family benefits represents only 4.2% of household income [ii].

The RSA income support is significantly lower than the pension minimum under the pretext of encouraging RSA beneficiaries to work, but this is hurting the living standards of children, who usually live with people in the workforce, not with pensioners. The creation of the RSA *activité* [the income supplement for the working poor] could have provided significant additional resources for many families of low-wage workers, but it is poorly designed: many potential beneficiaries don't even apply for it. Moreover, it does not benefit the unemployed (and thus their children). In 2010, the poverty rate of children (at the 60% threshold) was 19.8%, compared with 14.1% for the population as a whole. At the 50% threshold, it was 11.1%, against 7.8% for the general population. This means that 2.7 million children are below the 60% poverty line, with 1.5 million even below the 50% line.

A family with three children has a lower standard of living than a childless couple earning the same wages: by 16% at the level of two times the minimum wage, and by 30% at the level of five times the minimum wage. Family allowances have become very low for the middle classes; the family quotient simply takes into account the reduction in living standards caused by the presence of children, but it does not provide specific assistance to families. Aid to children is not excessive at any level of income. In 2010, the average standard of living was 10% lower for children than for the average population. The opposite should be the case, since children need a decent standard of living to develop their full potential, and parents who raise their children play a fundamental social role, in addition to their role in the workforce.

Should the family allowance be taxed? This would mean ignoring that the amount is already very low compared to the cost of children. Median income per consumption unit was around 1 660 euros in 2012; the average cost of a child, who represents 0.3 consumption unit, is thus about 500 euros. Yet the allowance amounts to 64 euros per child for a family with two children and 97 euros per child for a family with three children. The allowance would thus have to be at least multiplied by 5 before taxing it became a legitimate question.

Making progress toward the goals on French family policy proclaimed in the Social Security Financing Act (LFSS) [iii] – reducing disparities in living standards due to family structure, lifting all children out of poverty, increasing the number of places in childcare – would require devoting greater resources to family policy. This is a burden that should be borne by all taxpayers, not just by middle-class families, who are not the ones most favoured under the existing system.

Cutting the amount that the nation spends on its children by 2.5 billion euros would be a mistake in terms of both macroeconomic policy and social policy. As Charles Gide observed, "Of all the investments a country can make, it is the education of the children that is the most profitable."

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[i] For a similar argument, see Gérard Cornilleau, 2013, "Should spending on unemployment benefits be cut?", *OFCE blog*, 6 February.

[ii] See Henri Sterdyniak, 2011, "Faut-il remettre en cause la politique familiale française", *Revue de l'OFCE*, no. 116.

[iii] See the PLFSS, 2013, *Programme de qualité et d'efficience, Famille*.

What monetary policy for the ECB in 2013?

By Paul Hubert

After the monthly meeting of the Board of Governors of the European Central Bank on 7 February 2013, the ECB decided to hold its key interest rate at 0.75%. The analysis of the economic situation by Mario Draghi made during the press conference afterwards pointed to contrasting developments justifying the status quo. In a recent study, we showed that the inflation forecasts of the ECB can shed new light on future trends in interest rates.

The status quo can be explained by a number of mutually offsetting factors. The banks have started to repay some of the cash obtained through the LTRO facility (140 billion euros out of 489 billion), which reflects an improvement in their financial position, while at the same time lending to non-financial firms is continuing to contract (-1.3% in December 2012) and consumer loans are still at very low levels.

From a macroeconomic viewpoint, the situation in the euro zone is not giving clear signals about future monetary policy: after shrinking by 0.2% in the second quarter of 2012, real GDP in the euro zone fell another 0.1% in the third quarter, while inflation, as measured on an annual basis, decreased from 2.6% in August 2012 to 2% in January 2013 and is expected to drop below the 2% mark in the coming months based on the figures for GDP growth and for current and anticipated oil prices.

Furthermore, the inflation expectations of private agents, as measured by the *Survey of Professional Forecasters*, remain firmly anchored around the ECB's inflation target. In the fourth quarter of 2012, expectations were for 1.9% inflation for the years 2013 and 2014. Given that the target of "below but close to 2%" has now been reached, and with a euro zone in recession and unemployment at record levels, the ECB could give a boost to real activity. However, it anticipates that economic activity should gradually pick up in the second half of 2013, partly due to the accommodative monetary policy being followed today.

Given expectations, and in light of the historically low levels of key interest rates and the lag in the transmission of monetary policy to the real economy [1], a future rate cut seems very unlikely. One final element is sending out mixed messages: the recent rise of the euro – though it is still far from record levels – could nip in the bud the weak economic recovery that is underway, and could in the eyes of some justify support for export sectors [2].

In a recent OFCE working paper (No. 2013-04), we discuss how the ECB could use its inflation forecasts to improve the implementation of its monetary policy. We propose a new element to shed light on future developments in interest rates, based on the macroeconomic projections published quarterly by the ECB. In this study on the effects of the publication of the ECB's inflation forecasts on the inflation expectations of private agents, we show that a 1 percentage point reduction in the ECB's inflation projections is associated with a key interest rate cut by the ECB of 1.2 percentage points in the next two quarters. We conclude that the ECB's inflation forecasts are a tool that helps to better understand current monetary policy decisions and to anticipate future decisions.

The latest inflation projections, published in December 2012, were 1.6% and 1.4% for the years 2013 and 2014, respectively.

The publication on March 7th of new projections could provide a further indication of the direction monetary policy is likely to take in 2013.

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[1] On average, a change in the key rates is estimated to have an impact on inflation after 12 months and on GDP after 18 months.

[2] Remember, however, that about 64% of trade in the euro zone is conducted with euro zone partners, and thus is independent of fluctuations in exchange rates.

Is it possible to get over a banking crisis? Comparative analysis of Ireland and Iceland

By Céline Antonin and Christophe Blot

In economics, miracles sometimes prove to be mirages. Iceland and Ireland are witnesses. These two small open economies, paradises of liberalized deregulated finance, harboured growth in the early 2000s, but were hit hard by the financial crisis. The subsequent almost complete nationalization of their financial systems has had a negative impact on the public debt of the two countries. To stem the rising debt and the risk of unsustainability, since 2010 the two governments have implemented fiscal austerity plans, but with a difference: Ireland belongs to the euro zone, while Iceland doesn't. The latest [*Note of the OFCE* (no. 25 dated 4 February 2013 [in French])] reviews the recent macroeconomic and financial situation of the two countries to show the extent to which different policy mixes may account for different trajectories for a recovery.

While in Iceland the banking crisis was amplified by a currency crisis, the depreciation of the crown was then a factor in the recovery, so that the country is now growing again. GDP was very volatile: between the third quarter of 2007 and the second quarter of 2011, GDP declined by more than 13%, but has rebounded by 5.7% since. There was less volatility and a shorter recessionary phase in Ireland than in Iceland (8 quarters), and the amplitude of the decline was smaller (-10.7%). However, the recovery is more timid, with GDP growth of only 3.4% since late 2009.

Our analysis leads us to two main conclusions: first, an internal devaluation is less effective than an external devaluation; and second, fiscal consolidation is less costly when it is accompanied by favourable monetary conditions and exchange policy. It is in light of these points that one can redefine the optimal policy mix in the euro zone, as we suggest in more detail in the iAGS report. An active monetary policy is essential to allow the refinancing of the public debt. The European Central Bank should therefore act as lender of last resort for the member countries. The countries running a surplus need a "reflationary" policy to help reduce their current account imbalances. Fiscal adjustments should be relaxed or even postponed to allow a more rapid return to growth.

Should spending on unemployment benefits be cut?

By Gérard Cornilleau

The Cour des comptes [Court of Auditors] has presented a report on the labour market which proposes that policy should be better "targeted". With regard to unemployment benefits in particular, it focuses on the non-sustainability of expenditure and suggests certain cost-saving measures. Some of these are familiar and affect the rules on the entertainment industry and compensation for interim employees. We will not go into this here since the subject is well known [1]. But the Cour also proposes cutting unemployment benefits, which it says are (too) generous at the top and the bottom of the pay scale. In particular, it proposes reducing the maximum benefit level and establishing a digressive system, as some unemployed executives now receive benefits of over 6,000 euros per month. The reasoning in support of these proposals seems wrong on two counts.

In the first place, the diagnosis of the system's lack of sustainability fails to take the crisis into account: if Unedic is now facing a difficult financial situation, this is above all because of falling employment and rising unemployment. It is of course natural that a social protection system designed to support employees' income in times of crisis is running a deficit at the peak of a crisis. Seeking to rebalance Unedic's finances today by cutting benefits would abandon the system's countercyclical role. This would be unfair to the unemployed and economically absurd, as reducing revenues in a period of an economic downturn can only aggravate the situation. In such circumstances, it is also easy to understand that arguments for work incentives are of little value: it is at the top of the cycle, when the economy is approaching full employment, that it makes sense to raise the issue of back-to-work incentives. When the economy is bumping along the bottom, encouraging a more active job search may change the distribution of unemployment, but certainly not its level.

The current deficit in the unemployment insurance system simply reflects the situation of the labour market. A few calculations can help to show that the system's generosity is fully compatible with financial stability in "normal" times. To establish this, we simply measure the impact of economic growth, employment and unemployment on the system's deficit since 2009. In 2008, Unedic was running a financial surplus of nearly 5 billion euros [2]. This turned into a deficit of 1.2 billion euros in 2009 and 3 billion in 2010, before recovering somewhat in 2011 with a deficit of only 1.5 billion, which then rose to 2.7 billion in 2012. For 2013, the deficit is expected to reach 5 billion. The Table shows our estimates of the impact of the crisis on the system's revenues and expenditures since 2009. The estimated revenue lost due to the crisis is based on the assumption of an increase in annual payroll of 3.5% per year (which breaks down into 2.9% for increases in the average wage and 0.6% for rises in employment) if the crisis had not occurred in 2008-2009. On the expenditure side, the estimated increase in benefits due to the crisis is based on the assumption of a stable level of "non-crisis" unemployment, with spending in this case being indexed on the trend in the average wage.

Table. Impact of the crisis on Unedic's accounts

In billions of euros

	Impact of the crisis...		Impact
	... on revenue	... on expenditure	on the balance
2009	-1,8	+4,1	-5,9
2010	-2,1	+5,1	-7,2
2011	-2,6	+5,5	-8,1
2012	-3,1	+6,5	-9,6

Source : Author's calculations.

The results of this estimation clearly show that the crisis is solely responsible for the emergence of the substantial deficit run up by the unemployment insurance system. Without rising unemployment and falling employment, the system would have continued with a structural surplus, and the reform of 2009, which allowed compensation for unemployed people with shorter work references (4 months instead of 6 months), would have had only a minimal effect on its financial situation. There was no breakdown of the system, which was in fact perfectly sustainable in the long term … so long as counter-cyclical economic policies are implemented that prevent a surge in unemployment, whose sustainability is now undoubtedly more of a concern than the finances of Unedic [3].

Based on a diagnosis that is thus very questionable, the Cour des comptes has proposed reducing the generosity of unemployment benefits. Since it is difficult to put forward proposals for cutting lower benefit levels, the Cour put more emphasis on the savings that could be achieved by limiting very high benefits, which in France may exceed 6,000 euros per month for executives on high-level salaries that are up to 4 times the maximum social security cap, which in 2013 was 12,344 euros gross per month. In reality, from a strictly accounting perspective, it is not even certain that this will have positive effects on Unedic's finances. Indeed, few people benefit from these top benefit levels, because executives are much less likely to be unemployed than are other employees. On the other hand, their higher salaries are charged at the same contribution rates, meaning that they make a net positive contribution to financing the scheme. Calculations based on the distribution of wages and of the benefits currently received by unemployed people insured by Unedic show that employees who earn more than 5,000 euros gross per month receive about 7% of unemployment benefits but provide nearly 20% of the contributions. For example, we simulated a reform that would bring French unemployment insurance into line with the German system, which is much more severely capped than the

French system. The German ceiling is 5,500 euros gross per month (former Länder), against 12,344 in the French system. By retaining a cap of 5,000 euros gross per month, the maximum net benefit level in France would be around 2,800 euros. Based on this assumption, the benefits received by the unemployed in excess of the ceiling would be reduced by nearly 20%, but the savings would barely amount to more than 1% of total benefits. On the revenue side, the lower limit would result in a reduction in revenue of about 5%. The existence of a high ceiling in the French unemployment insurance system actually allows a significant vertical redistribution because of the differences in unemployment rates. Paradoxically, reducing insurance for the most privileged would lead to reducing this redistribution and undermining the system's financial stability. Based on the above assumptions, shifting to a ceiling of 5,000 euros would increase the deficit by about 1.2 billion euros (1.6 billion revenue – 400 million expenditure).

This initial calculation does not take into account the potential impact on those whose unemployment benefits would be greatly reduced. To clarify the order of magnitude of this effect, which is, by the way, unlikely, we simulated a situation in which the number of recipients of the highest benefits would be cut in half (*e.g.* by a reduction in the same proportion of the time they remain unemployed). Between the new ceiling and the highest level of the reference salaries, we estimated that the incentive effect increased linearly (10% fewer unemployed in the first tranche above the ceiling, then 20% fewer, etc., up to -50%). Using this hypothesis of a high impact of benefit levels on unemployment, the additional savings on benefits would be close to 1 billion euros. In this case, the reform of the ceiling would virtually balance (with an added potential cost [not significant] of 200 million euros). But we did not include the fact that the shortening of the duration of unemployment compensation for unemployed people on high benefits could increase the duration of the unemployed on lower benefits. In a situation of near full employment, it is possible to consider that the rationing of employment results from the rationing of the supply of work; in the current situation of a generalized crisis, the more realistic case involves the opposite situation of a rationing of demand for labour. Achieving budget savings by cutting high benefit levels is not credible, at least if we stick to a reform that does not change the very nature of the system.

One could of course obtain a more favourable result by reducing only the cap on benefits and not the cap on contributions. This would be very destabilizing for the system, since it would strongly encourage executives to try to pull out of a unified solidarity system that provides them with reasonable assurances today through the acceptance of a high level of vertical redistribution, while lowering the cap on benefits alone would force them to insure themselves individually while continuing to pay high mandatory fees. This type of change would inevitably call into question the basic principle of social insurance: contributions based on each person's means in return for benefits based on need.

The general economics in the Cour's report on unemployment benefits thus seem highly questionable because, by not taking into account the effect of the crisis, it winds up proposing a pro-cyclical policy that puts additional burdens on the unemployed at a time when it is less possible than ever to make them bear the responsibility for underemployment. As for the key measure that challenges the compromise on high level benefits, it would at best be budget neutral and at worst destroy the social contract that today makes possible strong vertical redistribution within the unemployment insurance system.

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[1] Unemployment insurance has a special scheme for interim workers in the entertainment industry worth a billion euros per year. It would obviously be sensible for this expenditure

to be borne by the general budget and not by Unedic.

[2] Excluding exceptional operations.

[3] On economic policy in Europe and the lack of macroeconomic sustainability, see the initial report of the Independent Annual Growth Survey project (IAGS) .

The tax credit to encourage competitiveness and jobs – what impact?

By Mathieu Plane

Following the submission to the Prime Minister of the Gallois Report on the pact for encouraging the competitiveness of French industry, the government decided to establish the tax credit to encourage competitiveness and jobs ("the CICE"). Based on the rising trade deficit observed over the course of the last decade, the sharp deterioration in business margins since the onset of the crisis and growing unemployment, the government intends to use the CICE to restore the competitiveness of French business and to boost employment. According to our assessment, which was drawn up using the e-mod.fr model as described in an article in the *Revue de l'OFCE (issue 126-2012)*, within five years the CICE should help to create about 150,000 jobs, bringing the unemployment rate down by 0.6 point and generating additional growth of 0.1 GDP point by 2018.

The CICE, which is open to all companies that are assessed on their actual earnings and are subject to corporation tax or income tax, will amount to 6% of the total wage bill for wages below 2.5 times the minimum wage (SMIC), excluding employer contributions. It will come into force gradually, with a rate of 4% in 2013. The CICE's impact on corporate cash flow will be felt with a lag of one year from the base year, meaning that the CICE will give rise to a tax credit on corporate profits from 2014. On the other hand, some companies could benefit in 2013 from an advance on the CICE expected for 2014. The CICE should represent about 10 billion euros for the 2013 fiscal year, 15 billion in 2014 and 20 billion from 2015. As for the financing of the CICE, half will come from additional savings on public spending (10 billion), the details of which have not been spelled out, and half from tax revenue, *i.e.* an increase in the standard and intermediate VAT rate from 1 January 2014 (6.4 billion) and stronger environmental taxation.

This reform is similar in part to a fiscal devaluation and in some respects bears similarities to the mechanisms of the "quasi-social VAT" (see Heyer, Plane, Timbeau [2012], "Economic impact of the quasi-social VAT" [in French]) that was set up by the Fillon government but eliminated with the change of the parliamentary majority as part of the second supplementary budget bill in July 2012.

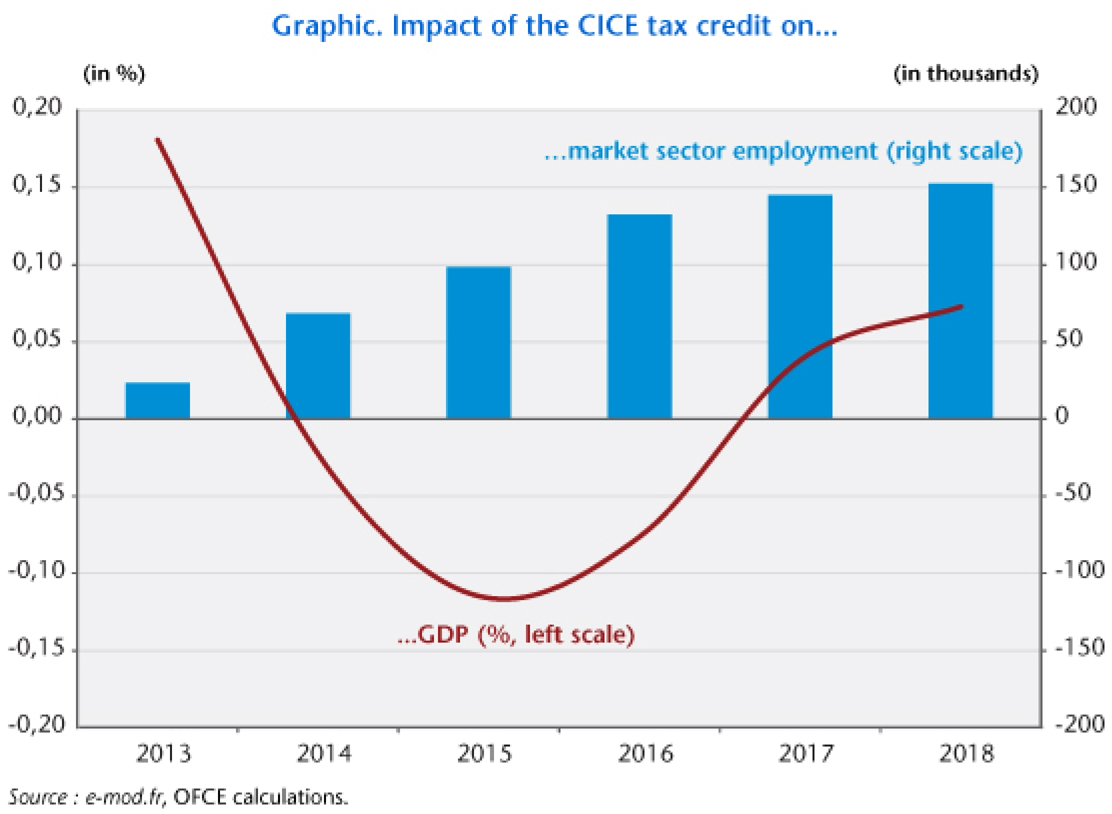
According to our calculations using 2010 DADS data, the CICE would lower average labour costs by 2.6% in the market sector. The sectors where labour costs would be most affected by the measure are construction (-3.0%), industry (-2.8%) and market services (-2.4%). The ultimate sectoral impact of the measure depends both on the reduction in labour costs and on the weight of wages in value added in a given sector. Overall, the CICE would represent 1.8% of the value added of industrial enterprises, 1.9% of the value added in construction and 1.3% in market services. In total, the CICE would represent 1.4% of the value added in market sector companies. According to our calculations, the total value of the CICE would be 20 billion euros: 4.4 billion in industry, 2.2 billion in construction and 13.4 billion for market services. Industry would therefore recover 22% of the total spending, *i.e.* more than its share of value added, which is only 17%. While this measure is intended to revive French industry, this sector would nevertheless not be the primary beneficiary of the measure in absolute value, but, along with the construction sector, has the best exposure relatively speaking due to its wage structure. Furthermore, industry can benefit from knock-on effects related to reductions in the prices of inputs generated by the lowering of production costs in other sectors.

The expected effects of the CICE on growth and employment differ in the short and long term (see graphic). By giving rights in 2014 based on the 2013 fiscal year, the CICE will have positive effects in 2013, especially as the tax hikes and public spending cuts will not take effect until 2014. The result will be a positive impact on growth in 2013 (0.2%), although it will take longer to affect employment (+23,000 in 2013) due to the time it takes employment to adjust to activity and the gradual ramping-up of the measure.

On the other hand, the impact of the CICE will be slightly recessive from 2014 to 2016, as the loss in household purchasing power linked to higher taxes and the cuts in public spending (household consumption and public demand will contribute -0.2 GDP point in 2014 and then -0.4 point in 2015 and 2016) will prevail over lower prices and the recovery of business margins. Apart from the first year, the CICE's positive impact on growth related to income transfers will be slow to be seen, as gains in market share related to lower prices and to higher business margins are dependent on a medium / long-term supply-side mechanism, with demand-side impacts being felt more rapidly.

The implementation of the CICE will gradually generate gains in market share that will make a positive contribution to activity by improving the foreign trade balance (0.4 GDP point in 2015 and 2016), whether through increased exports or reduced imports. From 2017, the external balance will not contribute as much to the economy (0.3 GDP point) due to the improved purchasing power of households, resulting in slowing the reduction in imports. Despite the higher margins and the improved profitability of capital, productive investment will fall off slightly due to the substitution effect between labour and capital and the negative accelerator effect related to the fall in demand.

With the decline in the cost of labour relative to the cost of capital, the substitution of labour for capital will gradually boost employment to the detriment of investment, which will lead to job-rich GDP improvements and to lower gains in productivity. This dynamic will result in steady gains in employment despite the slight fall-off in activity between 2014 and 2016. Due to the rise in employment and the fall in unemployment, but also to possible wage compensation measures in companies arising from the greater fiscal pressure on households, wages will regain part of their lost purchasing power based on an increase in real pay. This catch-up in purchasing power will help to generate growth, but will limit the impact on employment and productivity gains.



Is the euro crisis over?

By Catherine Mathieu and Henri Sterdyniak

As of early 2013, it is possible to make two contrasting assessments of the crisis. On the one hand, the euro has survived. Europe's institutions and Member states have of course been slow and hesitant to react, and their reluctance has often fueled speculation. But its institutions have gradually managed to develop solidarity mechanisms, such as the European Financial Stability Facility and then the European Stability Mechanism, and they were able to impose strong fiscal discipline on Member states (strengthening the Stability and Growth Pact, adjustment programs, fiscal treaty).

The Member states have agreed to implement austerity policies and structural reforms. From the beginning of the crisis, the European Central Bank was willing to put in place unconventional policies, and it has supported the public debt of countries in difficulty by intervening in the secondary markets. It then undertook to commit unlimited resources to support countries in trouble that implemented satisfactory policies, which helped to reassure the financial markets and to lower risk premiums.

On the other hand, the euro zone has been unable to regain a satisfactory level of growth or to recover the 9 points of activity lost to the crisis. The Member states have been forced to implement austerity policies during a recession. According to the outlook of the Commission itself, the unemployment rate is expected to stay at about 11.8% in 2013. Imbalances between countries persist, even if they are somewhat mitigated by the deep depression that has engulfed the countries of southern Europe. The rigid standards that have been imposed on the Member states, with no real economic foundation, cannot replace the genuine coordination of economic policies. The solidarity mechanisms implemented are conditional on the loss of any autonomy and the introduction of drastic austerity policies. In the future, national policies will be paralyzed by European constraints and by the threats of the financial markets. Social Europe is not making progress, and, even worse, Europe is requiring countries in difficulty to call into question universal health care and to cut pension, unemployment and family benefits. Tax competition is continuing, and the crisis has not been seen as a time to challenge tax havens and tax evasion. While Europe is at the forefront of the fight against climate change, it is hesitating to make a robust commitment to the ecological transition. Although many countries in the area are suffering from continuing deindustrialization, no industrial policy has been implemented. A banking union will be established, but its content is not being democratically decided. The European authorities are persisting in a strategy – paralyzing national policies and imposing free market structural reforms – which has so far failed to boost growth and has made Europe unpopular. Europe is sorely lacking a socially unifying project, an economic strategy and a means of functioning democratically.

* Issue 127 of the "Debates et Politics" collection of the *Revue de l'OFCE*, which appeared in January, contains analyses that provide contrasting insights into the origins of the euro zone crisis and into strategies for resolving the crisis. This issue brings together twelve papers following the 9th EUROFRAME conference [1] in June 2012 on issues concerning the European Union's economic policy.

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[1] EUROFRAME is a network of European economic institutes, which includes: the DIW and IFW (Germany), WIFO (Austria), ETLA (Finland), OFCE (France), ESRI (Ireland), PROMETEIA (Italy), CPB (Netherlands), CASE (Poland) and NIESR (United Kingdom).