

Doesn't real estate capital really contribute to inequality?

By [Guillaume Allègre](#) and [Xavier Timbeau](#)

[In a response to *Capital in the twenty-first century*, Odran Bonnet, Pierre-Henri Bono, Guillaume Chapelle and Etienne Wasmer \(2014\)](#) attempt to show that the book's conclusions regarding an explosion in wealth inequality are "not plausible". The authors point out an inconsistency in Thomas Piketty's thesis: the model of capital accumulation is implicitly a model of the accumulation of productive capital, which is inconsistent with the decision to include real estate capital at its market value in measuring capital. If valued correctly, the ratio of capital to income would have remained stable in France, Britain, the United States and Canada, which contradicts the thesis of Piketty's work.

In [OFCE Briefing Note, no.9/2015 \("Does housing wealth contribute to wealth inequality? A tale of two New York"\)](#), we respond that the authors minimize the contribution of housing to inequality. In particular, we do not believe that trends in real estate prices have "second order effects (actual distributional effects) that are attenuated". As is often the case, the disagreement is due in part to a lack of consensus about what kind of inequality actually matters: inequality in wealth? Income? Consumption? The potentially divergent dynamics of these inequalities? The disagreement is also due to the type of model used. The authors use a dynastic model in which property is passed from parents to children and grandchildren. In this model, changes in real estate prices do not have any real effect. This model is not relevant to accounting for inequalities generated by property in a society where people are mobile and have different life projects from

their parents.

The housing bubble could fuel the development of inequality. Home ownership in the world's metropolises is more and more becoming a closed club for the wealthy, which partitions young people between those with social, educational or financial capital, who can acquire property, and those who can only rent or move to less prosperous areas, with the consequence of further reducing their access to different types of capital. Would it not be better to build enough for everyone to find housing at a price that is in line with the amenities offered? Isn't it apparent that this latter situation is more egalitarian than the former?

For more on this, see: [Allègre, G. and X. Timbeau, 2014 : "Welcome to Nouillorc : Le capital-logement ne contribue-t-il vraiment pas aux inégalités?", Note de l'OFCE, no. 42 of 25 June 2014.](#)

Unemployment insurance for the euro zone?

By [Xavier Timbeau](#)

In the latest publication of France's Treasury Department, [Lettre Trésor-Eco, no. 132, June 2014](#) (Ministère des Finances et des Comptes publics and Ministère de l'Économie du Redressement productif et du Numérique), Thomas Lellouch and Arthur Sode develop the operating methods and the merits of a common unemployment insurance for the euro zone. They specify the main steps of how it would be applied, which would ensure

neutrality between the Member States. They argue for harmonized employment and labour market policies, leading in the long term to a single contribution rate in the euro zone:

- “Harmonization at the euro zone level of an unemployment insurance component would provide the euro zone a new solidarity instrument capable of giving a social Europe real substance while ensuring greater stability of the zone as a whole...

- This common base could compensate e.g. those who are unemployed less than one year (the most cyclical component) at 50% of their past salary, with financing determined on a harmonized base (e.g. payroll). It would be supplemented by national compensation in accordance with the preferences of each state, thus ensuring the continuation of the current level of compensation...

- Modulating the contribution rate of each member according to its unemployment level, with regular updates based on past trends, would ensure *ex ante* budget neutrality between the Member States...

- In the longer term, and after the unemployment rates of the various Member States converge, a system marking greater solidarity between the Member States could be considered, with financing through a single contribution rate ...”.

New solidarity, but posing three problems ...

Unemployment insurance functions as an important automatic stabilizer. Having a common system for the euro zone members would have made possible significant transfers during the crisis we have just been through. Based on the scheme proposed by the authors (pooling the most cyclical component), Spain could have benefited from almost 35 billion euros by end 2012, mainly from Germany and France. This would not be sufficient to cancel Spain's public deficit, but it would have kept down its level.

A system like this could play a major role in avoiding the sovereign debt crises that dry up a State's credit. It would introduce solidarity and neutral transfers during cycles, but would be responsive to the state of the cycle.

However, this proposal raises three problems: the first is that unemployment insurance systems are the fruit of a national social compromise that has won general acceptance and is consistent with the rest of the country's labour market policies, whether these are active policies or not. A European unemployment insurance component built on top of national systems could lead to confusion and to questions about the national balance. This could disrupt the social dialogue, since the social partners would have a potential resource for which they are not responsible, in addition to the issue of whether the European authorities or partner countries might also wish to have a say. Furthermore, unemployment insurance is often a sensitive subject, as was seen by the issue of entertainers and artists (*intermittents*) in France in early summer 2014.

This could be solved by limiting the sharing to macroeconomic transfers, independent of national arrangements. But, and this is the second problem, to ensure that transfers between states do not become permanent, the transfers need to be balanced over the business cycle. This requires a procedure for identification of the cycle that the stakeholders agree on. The recent experiences of the crisis and the calculation of structural deficits show that this is far from the case today. Another option would be to "replenish" the system prior to using it by accumulating contributions over a number of years before a major downturn. It would suffice to limit use to what has been accumulated to resolve discrepancies. But then the system would be bereft of value in the face of a systemic crisis. The day the buffer collapses, the Kings would be as naked as before. At best the crisis is delayed, at worst it is aggravated.

A final option would be to give up balancing the transfers *a priori* (or by the mechanics of the way it operates), leaving it to polarize gradually one way or another and to ensure an asymptotic convergence. But in this case the system could lead to undesired structural transfers that could very well call it into question.

Spain for instance has high unemployment, well above its structural rate; entering into a transfer system based on the differences between current unemployment and structural unemployment could be done only on an equilibrium basis, or would run the risk of a long-lasting initial transfer.

This then raises the third issue, governance. It is difficult to design such a system without implying, at least potentially, significant transfers between States. How could such transfers be justified without a legitimate common representation? Furthermore, what could be done to avoid these transfers becoming an instrument for control of macroeconomic policy as a whole? The establishment of a banking union is a reminder of how key this problem is. Likewise, Spain's refusal to submit to the conditions set for a conventional assistance program (EU / IMF) clearly indicates that in the absence of legitimate and sincere solidarity, the beneficiaries of transfers will be as suspicious as the payers.

Why a negative interest rate?

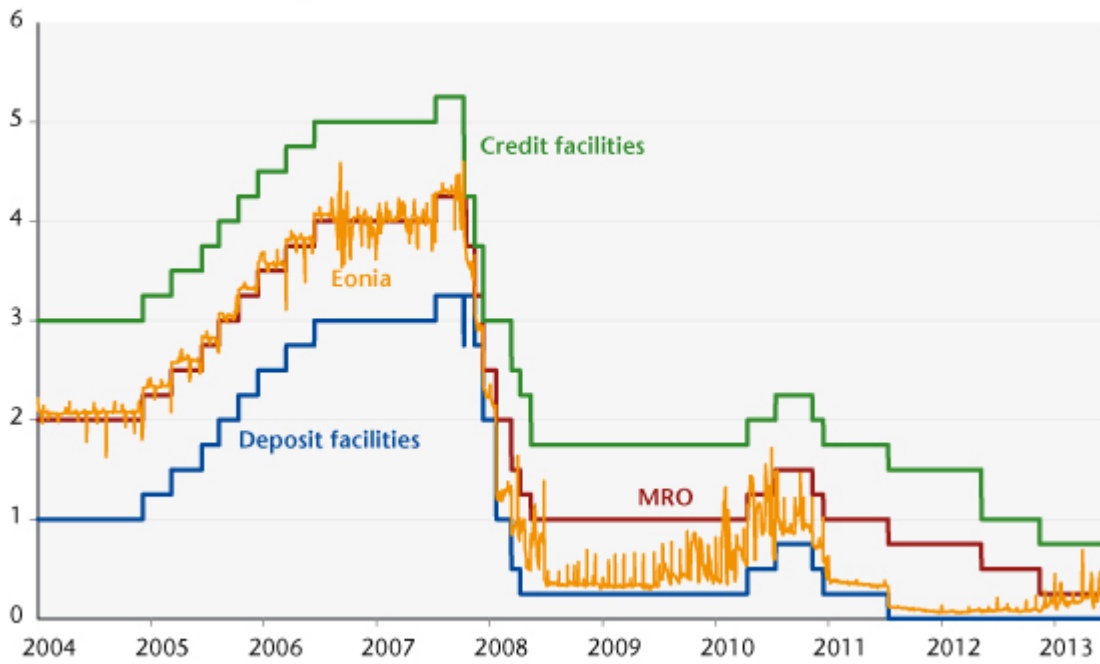
[Christophe Blot](#) and [Fabien Labondance](#)

As expected, on 5 June 2014 the European Central Bank (ECB) unleashed an arsenal of new unconventional measures. The aim is to curb deflationary tendencies in the euro zone. Among the measures announced, the ECB decided in particular to apply a

negative interest rate to deposit facilities. This unprecedented step deserves an explanation.

Note that since July 2012, the rate on deposit facilities has been 0%. It now falls to -0.10%, meaning that a bank depositing cash at the ECB will have its deposit reduced by that rate. Before considering the repercussions of this measure, it is worth clarifying the role of deposit facilities. The ECB's activity is based on loans to credit institutions in the euro zone through the channel of main refinancing operations (MRO) or long-term refinancing operations (LTRO). Prior to the crisis, these operations were conducted at variable rates based on an auction mechanism, but since October 2008 they have been conducted at fixed rates. The refinancing operation rates must allow the ECB to influence the rate charged by credit institutions for interbank loans (Euro OverNight Index Average rates, or Eonia) and, through this channel, the entire range of bank rates and market rates. To ensure the Eonia is not too volatile, the ECB provides the banks with two facilities: credit facilities, enabling them to borrow from the ECB for a period of 24 hours, and deposit facilities, enabling them to make cash deposits with the ECB for a period of 24 hours. In case of a liquidity crisis, the banks thus have a guarantee of being able to lend or borrow via the ECB, at a higher rate for credit facilities or a lower rate for deposit facilities. These rates can then be used to regulate fluctuations in the Eonia, as shown in Figure 1.

Figure 1. Main ECB rates and EONIA rate

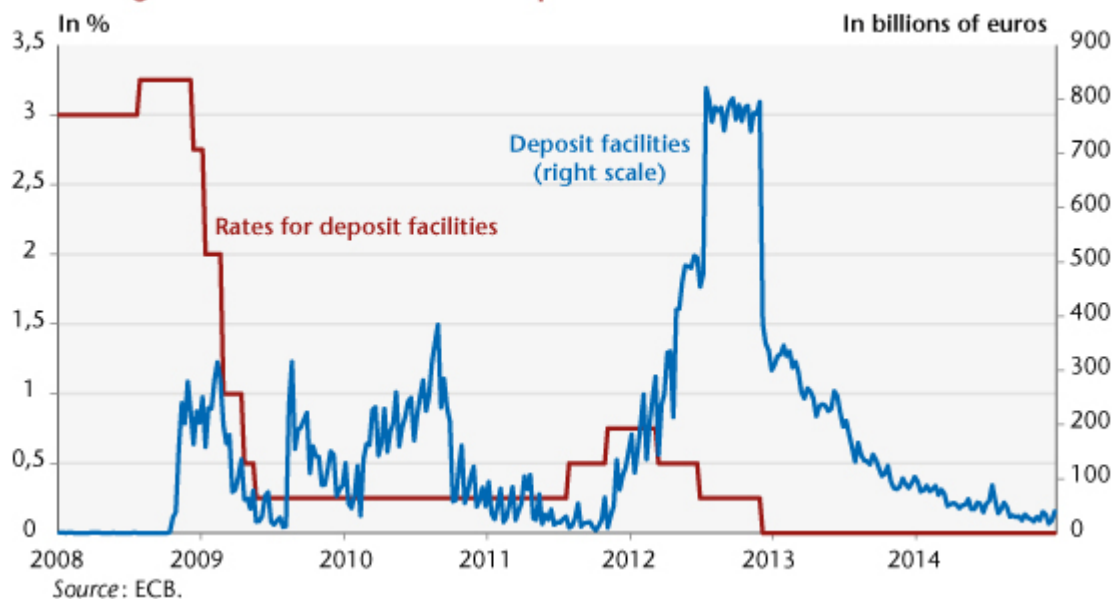


Source: ECB.

In practice, until the collapse of Lehman Brothers in September 2008, banks made little use of deposit facilities, indicating that the interbank market was functioning normally. The situation has radically changed since then, and the amount of deposits left with the ECB has fluctuated to a greater or lesser extent, depending on concerns over the sovereign bond crisis (Figure 2). The height of the crisis in spring 2012 coincided with a peak in the amounts deposited by the banks, which had excess liquidity. Over a period of three months, around 800 billion euros (equivalent to just under 10% of euro zone GDP), paid at 0.25%, were deposited by Europe's banks. In the context of fear of a euro zone collapse and uncertainty about the financial situation of financial and non-financial agents, the banks have been depositing poorly compensated sums with the ECB. They chose to do this rather than to exchange the excess liquidity in the money market or support activity by lending to companies or buying shares. It was not until Mario Draghi's statement in July 2012 that the ECB would do "whatever it takes" to support the euro zone that confidence returned and these sums fell. It was also then that the rate

went down to 0%, further reducing the incentive to use the deposit facilities. The level of deposits fell by half, from 795.2 billion euros to 386.8 billion. Since then, they have declined gradually, but are still high, especially given that they receive no interest. In the last week of May 2014, there were still 40 billion euros in deposits (Figure 2).

Figure 2. Rates and levels of deposit facilities with the ECB



This situation prompted the ECB to set a negative rate in order to encourage commercial banks to reallocate this money. We can be sure that once the negative rate applies, the level of deposits will quickly drop to zero. Even so, this will mean an impulse of only 40 billion euros, and further action will be needed to support the real economy. On its own, this step by the ECB has certainly not convinced the markets that it has dealt with the situation.

The ECB has thus once again demonstrated its proactive approach to curbing the risks facing the euro area. Its reaction can be compared to the response of Europe's other institutions, which have struggled to fully take on board the depth of the crisis. Looking outside the euro zone, it is noteworthy that the US Federal Reserve and the Bank of England moved with greater speed, even though the risk of deflation

was lower in the United States and the United Kingdom. This active approach is perhaps no stranger to the renewed growth seen in these countries. The ECB's action is therefore welcome. Now we need to hope that it will stave off the risk of deflation hanging over the euro zone, a risk that could have been avoided if the euro zone's governments had not generally adopted austerity policies, and if the ECB had taken less of a wait-and-see attitude.

The French fiscal devaluation, or the French Achilles strives to catch the German tortoise

By [Sarah Guillou](#)

In the 1980s, under the European Monetary System (EMS), France repeatedly carried out currency realignments – in 1981, 1982, 1983 and 1986 – that were tantamount to devaluations. For its part, Germany had – already! – adopted a rigorous strategy of competitive disinflation, which, it was said at the time, led to disciplining its companies, which could not rely on the temporary advantages gained by currency devaluations rendering its exports more competitive. They were compelled instead to make investments so as to build up their future non-price competitiveness. Which they did..

During this same period France's devaluations left it with imported inflation and companies that had less incentive to invest in non-price competitiveness. The peg to the deutsche mark and then the Monetary Union were presented as ways to

break out of this endless strategy of inflationary devaluations. France belatedly wound up adopting Germany's strategy of competitive disinflation and renouncing currency devaluations, with a strong franc strategy characterizing the 1990s.

Today, the terms of the debate seem reversed, even though France is still in the position of Achilles chasing the German tortoise. A new form of competitive devaluation is in favour: not based on the exchange rate, since the euro is part of a market mechanism that determines its value, but one that involves a reduction of the labour costs borne by business, funded in part by an increase in Value Added Tax (VAT). This is called a fiscal devaluation. In an article entitled "Changer de Modèle", P. Aghion, G. Clette and E. Cohen defend this on the grounds that it is necessary to "think differently" [\[1\]](#). The government is also implementing this through the Competitiveness and employment tax credit (CICE) and its plans in the 2015-2017 Stability Pact to cut social security charges.

How is a reduction in the cost of labour comparable to a "fiscal" devaluation? A devaluation, it should be recalled, leads to lowering domestic prices relative to foreign prices as the value of the domestic currency is decreased relative to a unit of foreign currency. A devaluation of the euro, if it were possible, would mean a higher amount of euros to buy a dollar; consequently, a European car at 10,000 euros would go for fewer dollars and thus become more attractive to an American buyer who would still be holding the same amount in dollars in his wallet. More generally, a devaluation ensures that the production cost of domestic firms becomes cheaper relative to their foreign competitors, so that the former have a cost advantage and become more competitive. Hence the term "competitive devaluation".

By lowering companies' labour costs, it is assumed that the prices of exported products (and the goods and services

included) will be lowered – despite the fact that labour costs do not cover the full cost of production. By increasing VAT on all products, the price of imported products increases as well. The devaluation effect – that is to say, the reduction in domestic prices relative to foreign prices – will take place only if the competitors' prices remain constant – in other words, only so long as the competitor does not implement the same policy at the same time! Furthermore, this will really have an impact on competitiveness if the price differential existing prior to the fiscal devaluation is more than offset by the reduction in labour costs.

Two further questions arise. First, we do not know the price elasticity of the labour costs. In other words, we do not know the extent to which firms pass lower employer costs onto prices. Second, labour market studies show that wages have a positive elasticity to labour costs. In other words, in the medium term and especially for higher wages, cutting payroll taxes on wages will result in increases in pay.

The medium-term effects are then drawn on to defend the fiscal devaluation policy. The reduction in employer contributions initially gives some manoeuvring room, or rather a cash flow, that then leads companies to invest, precisely because of the recovery in their margins. Incidentally, this excludes the previous effect, *i.e.* a reduction in prices, or in any case will have a maximum impact if the price drop does not occur. It is possible however that higher margins are a side effect of a reduction in prices, which pushes up sales, while increasing the profit per unit in a cost structure with increasing returns to scale, even if this affects only a few companies. Now suppose that the margins generated translate into investments. This could improve the companies' non-price competitiveness (the intrinsic product quality) in the future. This second aspect of fiscal devaluation is often put forward in parallel with the observation that French companies, in particular manufacturers, suffer both from crippling tax and

regulatory conditions that handicap their international competitiveness and from a lack of product quality. But here macroeconomic analysis can no longer be invoked, and with respect to non-price competitiveness we know much less about the microeconomic dynamics due to the reduction of charges.

Let's conclude by considering the effects expected over the longer term. As pointed out by Aghion *et al.* in a footnote on page 58, the effects of a fiscal devaluation are temporary. Indeed, as with a currency devaluation, a fiscal devaluation will lead to an increase in wages due to the dynamics described above. Moreover, if the financing of the reduction in charges results in reducing households' purchasing power due to the VAT hike, then the latter could also demand an increase in their nominal wages. The initial reduction in relative prices will be wiped out over the longer-term by the rise in wages. The authors could draw on the quasi-deflation in Europe to deal with this side effect of a devaluation. They argue instead that the interval will give a new impetus to business. In fact, what the authors defend is not the direct effect of the devaluation but its indirect effect on the level of investment due to the increase in margins.

However, this is also undoubtedly the aim of the CICE tax credit, as it targets taxes and not employer charges directly, unlike the Responsibility Pact which is aimed primarily at employment. By granting a tax credit, the CICE seeks to generate margins for investment in order to develop non-price competitiveness. The problem is that an improvement in competitiveness is far from guaranteed (see Guillou and Treibich, [Note de l'OFCE, no. 41 of 19 June 2014](#) [in French] on the CICE and competitiveness), while the dual objective of this tax credit (employment and competitiveness) will complicate companies' decision-making.

To pick up on the suggestion by Aghion *et al.*, the memory of the French competitive devaluations of the 1980s could lead us to "really think differently", that is to say, to stop

applying policies that others have already applied. To think otherwise would mean to anticipate future competition rather than to replicate a policy that other countries have already implemented, which is obviously not so simple. And the interest of the work of Aghion *et al.* is in embracing a set of reforms that, taken **simultaneously**, could put France on a **different** trajectory.

But to undertake a fiscal devaluation while all the countries of Europe potentially will do or actually have done the same would generally be insufficient and even dangerous if it leads to a race to social dumping. It would be justified only because European integration requires a certain alignment of companies' cost conditions, and thus due to fiscal competition. Repeatedly lagging behind fiscally in an integrated European market is very costly, it is true, but the French Achilles will not catch the German tortoise that has set off early in the field of competitiveness by using the weapon of a fiscal devaluation.

A better strategy would be to get ahead of the game. In the absence of being able to harmonize companies' fiscal conditions, it is necessary to anticipate. Germany anticipated competition from the emerging countries and implemented social VAT, or a fiscal devaluation. A policy that would change the "model" should anticipate future competition in Europe and around the world. However, this competition will not be over the cost of labour. Proof of this lies in the approach of countries with a low relative cost of labour that are more and more replacing labour with capital. China for instance has already become the world's largest purchaser of industrial robots (*Financial Times*, 1 June 2014). Future competition will be structured around the pursuit of two trends already taking place: the division of the production process as it is being accelerated by technological possibilities, and the replacement of labour by technology. Most value added will be focused upstream of production in design and / or downstream

in related services. In other words, the government also needs to take an interest in the cost of capital, particularly in terms of the opportunity cost of investment.

The question of labour costs concerns the employment of less-skilled workers (obviously of great importance *per se*), but it is not at the heart of the problem of competitiveness. In attempting to solve the problem of the day, the cost of labour, there is a risk of not making the investments that ensure the future. Could France stop being the Achilles that chases the German tortoise? One way to resolve Zeno's paradox would be to invent a government that maintains continuity. Otherwise, we need to do away with a strategy of catching-up and opt for a more winning "model".

[1] This is in fact the title of the first chapter of the book by P. Aghion, G. Cetto and E. Cohen, *Changer de modèle*, Ed. Odile Jacob, 2014.

What do we know about the end of monetary unions?

By [Christophe Blot](#) and [Francesco Saraceno](#)

The European elections were marked by low turnouts and increasing support for Eurosceptic parties. These two elements reflect a wave of mistrust vis-à-vis European institutions, which can also be seen in confidence surveys and in the

increasingly loud debate about a return to national currencies. The controversy over a country leaving the euro zone or even the breakup of the monetary union itself started with the Greek crisis in 2010. It then grew more strident as the euro zone sank into crisis. The issue of leaving the euro is no longer taboo. If the creation of the euro was unprecedented in monetary history, its collapse would be none the less so. Indeed, an analysis of historical precedents in this field shows that they cannot serve as a point of comparison for the euro zone.

Although there seem to be a number of cases where monetary unions split apart, few are comparable to the European Monetary Union. Between 1865 and 1927, the Latin Monetary Union laid the foundations for closer monetary cooperation among its member states. This monetary arrangement involved a gold standard regime that established a principle of monetary uniformity with a guarantee that the currencies set up by each member state could move freely within the area. Given the absence of a single currency created *ex nihilo* as is the case today with the euro, the dissolution of the Union that occurred in 1927 holds little interest for the current debate. In fact, experts in monetary unions instead characterise this type of experience as “areas of common standards”. A study in 2007 by Andrew Rose (see [here](#)) assesses 69 cases of exits from a currency union since the Second World War, which would indicate that there is nothing unique about the break-up of the euro zone. However, this sample of countries that have left a currency union cannot really be used to draw meaningful lessons. A large number of these cases involve countries that gained their political independence in the process of decolonization. These were also small developing economies whose macroeconomic and financial situations are very different from those of France or Greece in 2014. The most recent experience was the break-up of the rouble zone, following the collapse of the USSR, and of Yugoslavia, both of which involved economies that were not very open commercially

or financially to the rest of the world. In these circumstances, the impact on a country's competitiveness or financial stability of a return to the national currency and any subsequent exchange rate adjustments are not commensurate with what would happen in the case of a return to the franc, the peseta or the lira. The relatively untroubled separation of the Czech Republic and Slovakia in 1993 also involved economies that were not very open. Finally, the experience most like that of the EMU undoubtedly involves the Austro-Hungarian Union, which lasted from 1867 to 1918. It had a common central bank in charge of monetary control but no fiscal union [\[1\]](#), with each State enjoying full budgetary prerogatives except with regard to expenditure on defence and foreign policy. It should be added that this Union as such could not go into debt, as the common budget had to be balanced. While the Union established trade and financial relations with many other countries, it is important to note that its break-up occurred in the very specific context of the First World War. It was thus on the ruins of the Austro-Hungarian Empire that new nations and new currencies were formed.

It must therefore be concluded that monetary history does not tell us much about what happens at the end of a monetary union. Given this, attempts to evaluate a scenario involving an exit from the euro are subject to a level of uncertainty that we would call "radical". While it might be possible to identify certain positive or negative results of exiting the euro, going beyond this to give specific calculations of the costs and benefits of a break-up comes closer to writing fiction than to robust scientific analysis. As for the positive side, it can always be argued that the effects on competitiveness of a devaluation can be quantified. [Eric Heyer and Bruno Ducoudré](#) have performed such an exercise for a possible fall in the euro. But who can say how much the franc would depreciate in the case of an exit from the euro zone? How would other countries react if France left the euro zone?

Would Spain leave too? In which case, how much would the peseta fall in value? The number of these variables and their potential interactions lead to such a multiplicity of scenarios that no economist can foresee the result in good faith, let alone calculate it. The exchange rates between the new European currencies would once again be determined by the markets. This could result in a panic comparable to the currency crisis experienced by the countries in the European Monetary System (EMS) in 1992.

And what about the debt of the private and public agents of the country (or countries) pulling out? The legal experts are divided about what share would be converted by force of law into the new currency (or currencies) and what would remain denominated in euros, which would add to agents' debt burden. So it is likely that an exit would be followed by a proliferation of litigation, with unpredictable outcomes. After the Mexican crisis in 1994, and again during the Asian crisis in 1998, both of which were followed by devaluations, there was an increase in agents' debt, including government debt. Devaluation could therefore increase the problems facing the public finances while also creating difficulties for the banking system, as a significant share of the debt of private agents is held abroad (see [Anne-Laure Delatte](#)). The risk of numerous private defaults could therefore be added to the risk of default on the public debt. How would one measure the magnitude of such impacts? Or the increase in the default rate? What about the risk that all or part of the banking system might collapse? How would depositors respond to a bank panic? What if they seek to prop up the value of their assets by keeping deposits in euros and opening accounts in countries that they consider safer? A wave of runs on deposits would follow, threatening the very stability of the banking system. It might be argued that, upon regaining autonomy for our monetary policy, the central bank would implement an ultra-expansionary policy, the State would gain some financial leeway, put an end to austerity and protect the banking system

and French industry, and capital controls would be re-established in order to avoid a bank run ... But once again, predicting how such a complex process would unfold amounts to astrology ... And if the example of Argentina [\[2\]](#) in late 2001 is cited to argue that it is possible to recover from a currency crisis, the context in which the end of the “currency board” took place there should not be forgotten[\[3\]](#): a deep financial, social and political crisis that does not really have a point of comparison, except perhaps Greece.

In these circumstances, we believe that attempting to assess the cost and benefits of leaving the euro leads to a sterile debate. The only question worth asking concerns the political and economic European project. The creation of the euro was a political choice – as would be its end. We must break with a sclerotic vision of a European debate that opposes proponents of leaving the euro to those who endlessly tout the success of European integration. There are many avenues open for reform, as has been demonstrated by some recent initiatives ([Manifesto for a euro political union](#)) as well as by the contributions collected in issue 134 of the *Revue de l'OFCE* entitled [“Réformer l'Europe”](#). It is urgent that all European institutions (the new European Commission, the European Council, the European Parliament, but also the Eurogroup) take up these questions and rekindle the debate about the European project.

[\[1\]](#) For a more detailed analysis of comparisons that can be drawn between the European Monetary Union and Austro-Hungary, see Christophe Blot and Fabien Labondance (2013): “Réformer la zone euro: un retour d'expériences”, *Revue du Marché Commun et de l'Union européenne*, no. 566.

[\[2\]](#) Note that Argentina was not in a monetary union but rather under what was called a “currency board”. [See here](#) for a classification and description of various exchange rate

regimes.

[3] See Jérôme Sgard (2002): "L'Argentine un an après: de la crise monétaire à la crise financière", *Lettre du Cepii*, no. 218.

What options for the European Central Bank?

By [Paul Hubert](#)

All eyes are now on the ECB, whose recent statements indicate that it is concerned about the risk of deflation in the euro zone. The further downturn in inflation in May to 0.5% year on year is a reminder that this risk [is increasing](#). This could lead the ECB to take action at the monthly meeting of the Board of Governors being held today, or in the months to come. This post provides a brief summary of the possible options available to the ECB.

1. To lower the key interest rate (main refinancing operations rate, the MRO rate), which is currently 0.25%. The consensus in the financial markets is for a reduction of around 10 to 15 percentage points, which would further cut financing costs for banks that are still dependent on ECB liquidity. However, this would have a marginal impact on the rates of refinancing operations (MRO and long-term refinancing operations, or LTRO), which would not have much influence on financing conditions and thus not much benefit for Spanish and Italian banks (the main users of this option).

2. To lower the deposit facility rate from zero to a negative rate (again by 10 to 15 percentage points). This option has been largely anticipated by the financial markets. A negative interest rate on deposits should also be accompanied by a change in the policy on the ECB's excess reserves by capping the amount of commercial banks' excess reserves on the ECB's balance sheet or by applying the same negative rate to excess reserves. Otherwise the banks would simply transfer their funds from deposit accounts to excess reserves. A combination of these two policies should lead to a lower Euro OverNight Index Average (EONIA) rate of between zero and 0.05%. The incentive for banks to keep their cash at the ECB would thus be reduced, thereby stimulating the distribution of credit to the non-financial sector.

3. An extension of the policy of providing liquidity in unlimited amounts at a fixed rate (fixed-rate full allotment) from mid-2015 to late 2015 or even mid-2016 is considered by most to be an easy and quick option that would provide additional assurance on the markets before the LTRO deadlines in early 2015. This kind of measure would ensure the liquidity of the banking system but its impact on activity and inflation could be limited, in so far as the banks would prefer to place their cash with the central bank.

4. An ECB announcement of the end of sterilization through the Securities Markets Programme (SMP), a programme for purchasing the sovereign bonds of euro zone countries in difficulty. The markets seem divided on this issue. The ECB has not managed to attract sufficient demand to completely sterilize this operation in the last eight weeks. This would add 164.5 bn euros (the SMP target amount) of liquidity to the system and take the EONIA rate to zero or even into negative territory, and could reduce the volatility that has appeared in recent months. This measure would therefore also cut the interbank refinancing rate, which would more or less amount to the first option.

5. A conditional and targeted LTRO programme could see the light of day. This would consist of copying the Funding for Lending Scheme (FLS) set up by the Bank of England, in which cheap financing is arranged for banks in exchange for granting new loans to the real economy. However, it would take time to implement this, and even more before there is any real impact on the economy. It would nevertheless probably be the most effective way to stimulate activity, because it would go beyond interbank operations in influencing refinancing conditions.

In any event, the economic situation in the euro zone for both the business outlook as well as for the situation on the labour market calls for a strong response from the ECB so as to ensure that the euro zone does not incur deflation. The effect of the signal may be just as important as the measure actually implemented by the ECB. By demonstrating in today's meeting that it is active, the ECB would show its determination to fight against the risk of deflation, which could at least change agents' expectations. While any action by the ECB would be welcome, it is still the case that the current economic situation is also the result of the restrictive fiscal policies that have hit activity (see [here](#)).

Why read Piketty?

By [Jean-Luc Gaffard](#)

Thomas Piketty's book *Capital in the twenty-first century* has met with an extraordinary reception, one that is commensurate with both the empirical work performed and the political issue addressed, that is to say, the spectacular increase in inequality in the United States. Paul Krugman and Joseph

Stiglitz, both of whom are concerned about current trends in American society that they consider are threatening democracy, believe Piketty's work confirms their fears.

Armed with an impressive mass of data and a solid historical knowledge reinforced by a reading of the great novels of French and English literature, Piketty foresees the advent of a second *Belle Epoque*, the decades-long period preceding the First World War. This would mean a return to a patrimonial capitalism based on inheritance, when income and capital are concentrated in the hands of the top percentile of the population and the ratio of capital to income rises significantly. More fundamentally, Piketty highlights the existence of a longstanding trend towards stagnation and rising inequality, which is reflected in a rate of return on capital that is sustainably higher than the economy's rate of growth, a little like Marx insisted on the existence of a tendency for the rate of profit to fall. The twentieth century, and in particular the period following the Second World War, was characterized by strong growth associated with decreases in inequality and in the importance of capital relative to income – but this period was merely a parenthesis that is now closed. The thesis defended is that capitalist society has returned to low growth and rising inequalities fuelled more by the transmission of wealth than by the remuneration of individual talent.

The book is nevertheless ambivalent. There is a gap between the wealth of data collected and the simplicity of the theory that is supposed to account for it. On the one hand, an overly simple, essentially a-institutional model adopts a growth rate that is ultimately exogenous and ignores the heterogeneity of capital, making distribution a technical given that does not feed back into growth. On the other hand, the wealth of the data and the insights associated with it encourage reflection about the ins and outs of the distribution of income and wealth, returning it to its central place in economic theory

and restoring its social dimension.

A belief runs through the book: that, regardless of what economic policies are implemented, growth is again returning to a low level because there is no longer any catch-up going on and potential productivity gains are largely exhausted. Inheritance then begins to play a key role in the distribution of wealth and feeds the rise of inequality. This fundamental pessimism justifies the simplicity claimed for the theoretical explanation. If this pessimism is to be shared, however, the foundation needs to be improved by examining the causes and effects in the formation of rent and by breaking with a neo-classical analysis of growth that is without any real relevance to the subject at hand. There is nothing natural about the evolution of the distribution of income and wealth, which depend on political choices and social norms. The question, then, is whether the choices and norms of the years of the *Belle Epoque* still have any meaning, and whether policy can still counteract the forces of what must be called decline that threaten modern capitalist societies.

Reading Piketty thus gives rise to an implicit challenge: to develop an analysis that, following an intuition that we owe to the classical economists, is based on the idea that the growing importance of rent, as distinguished from profit, would fuel an increase in the purchase of nonperforming assets or luxury goods at the expense of the accumulation of capital, and would thereby constitute an obstacle to growth.

These various issues are examined in the *Note de l'OFCE*, no. 40 of 2 June 2014, "[Le capital au XXI^e siècle : un défi pour l'analyse](#)" [*Capital in the twenty-first century : a challenge for analysis*], which follows on from the previously published working document by Guillaume Allègre and Xavier Timbeau (see the blog [here](#)).

What is a weaker euro likely to mean for the French economy?

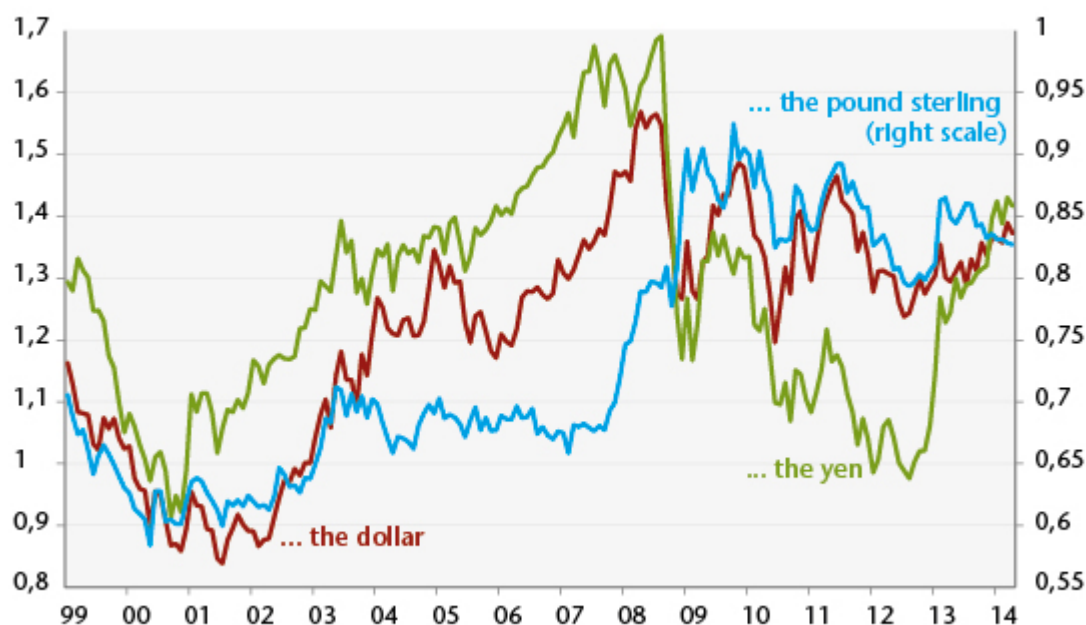
By [Bruno Ducoudré](#) and [Eric Heyer](#)

Faced with the rising risk of deflation in the euro zone, which has been reinforced since mid-2012 by the continued appreciation of the euro against other currencies, the heads of the European Central Bank have begun to change their tone in their communications with the financial markets: [they are now evoking the possibility of conducting a new round of quantitative easing](#). These measures are likely to lower the exchange rate of the euro. This would provide valuable support for the euro zone economies by shoring up their price competitiveness vis-à-vis competitors outside the zone, in a context where fiscal consolidation policies will continue to dampen [the growth expected in the zone in 2014 and 2015](#). What are the likely consequences for the French economy from reducing the euro's value against other currencies? We briefly review past episodes of exchange rate changes, and then present the impact expected from a 10% depreciation of the euro against other currencies using the *emod.fr* model. These effects are more moderate than those projected by the government.

Quantitative easing measures have been used extensively by the US Federal Reserve, the Bank of England and the Bank of Japan. Since mid-2012, the balance sheets of these three banks has continually increased, by respectively 6.5 percentage points of GDP, 1.3 GDP points and 15.3 GDP points. [During this same period, the ECB balance has on the contrary declined by 8.4](#)

GDP points. This difference in strategy has led to a continued rise in the strength of the euro: now at 1.38 dollars, the euro has seen its value against the dollar increase by 12% since June 2012. During the same period, the single currency has appreciated 49% against the yen and about 3% against the pound sterling (Figure 1).

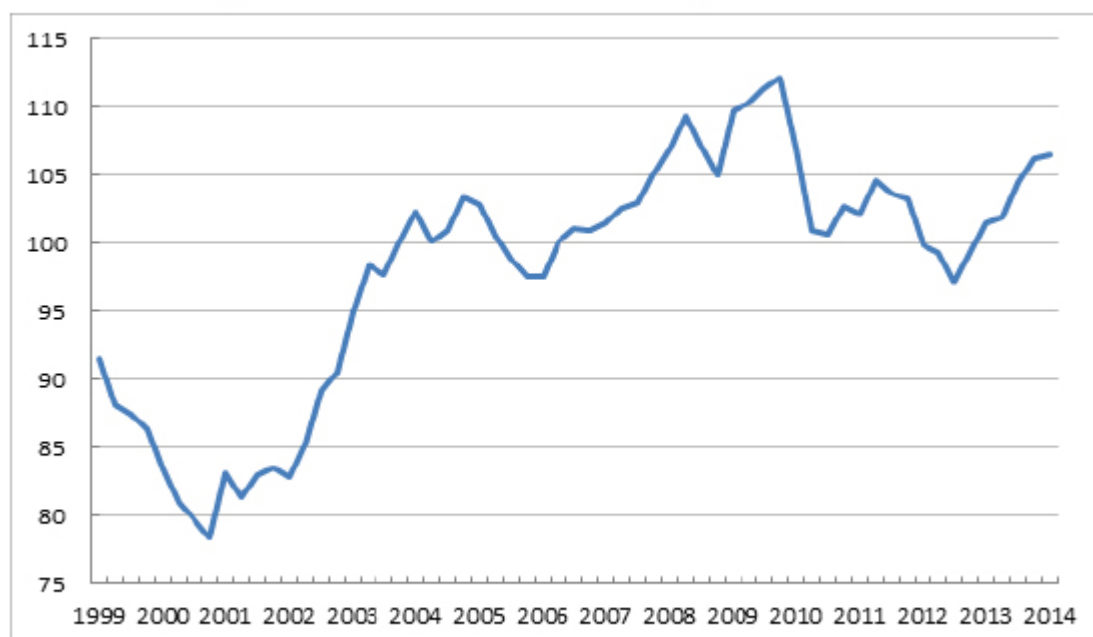
Figure 1. Exchange rate of the euro against...



Source : Datastream.

The nominal effective exchange rate of the euro, which weights the different exchange rates depending on the structure of trade in the euro zone, has thus appreciated by 9.5% since the third quarter of 2012 (Figure 2). This appreciation, combined with austerity policies and the competitive disinflation carried out within the euro zone, has held down GDP growth in the zone, which was negative in 2012 and 2013, as well as inflation. The absence of inflationary pressures and the past appreciation of the euro have now given the ECB leeway to try to influence the course of the euro against other currencies.

Figure 2. Nominal effective exchange rate of the euro



Source : OECD.

What would be the impact of a devaluation of the euro against all currencies?

The depreciation of the euro would have a dual effect:

- **An income effect:** a weak euro would increase the prices of imports. This would result in higher energy costs, a rise in companies' prices of production and a loss of household purchasing power;
- **A substitution effect:** a weak euro would decrease the prices of exports and increase their volume. Depreciation would also decrease the competitiveness of rival manufacturers, causing a decline in imports in favour of domestic production.

These opposite effects would apply only to trade outside the euro zone. Trade with our European partners would not be directly impacted, as the prices of imports and exports to and from this area would remain unchanged. On the other hand, intra euro zone trade would be impacted by a weaker euro. But this involves the channel of addressed demand.

Table 1. Impact on the French economy of a 10% depreciation in the exchange rate of the euro against all currencies combined

(Difference with the reference scenario in %)	n	n+1	n+2	n+8
GDP	0,3	0,4	0,5	0,0
Total waged employment (1000s)	22	53	74	34
Household consumer prices	0,9	1,4	1,9	3,9
Public financing capacity (% of GDP)	0,0	0,2	0,3	0,2

Note: The euro's depreciation would be favourable to short-term activity due to an improvement in France's price competitiveness relative to countries outside the euro zone. The positive impact of the euro's depreciation on the activity of our euro zone partners and the negative impact on our partners outside the zone are taken into account.

Source : *emod.fr*

As is summarized in Table 1, a 10% depreciation of the euro against all currencies leads to a gain in price competitiveness for French exports vis-à-vis the rest of the world. Other countries in the euro zone would benefit from the same gain in competitiveness across all export markets. In this case, the impact on activity would amount to 0.3% in the first year, 0.5% after three years, and none after nine years. The increase in demand due to this improvement in the activity of our European partners would be broadly offset by a reduction in demand addressed to France from the rest of the world. As for the labour market, this depreciation would create 22,000 jobs in the first year and 74,000 jobs after 3 years. The public deficit would in turn improve by 0.3 GDP point within 3 years.

These results, while more moderate than those [published by the DG Treasury\[1\]](#), are nonetheless significant and are welcome in an economic situation like today's that is marked by sluggish growth and the risk of deflation. A depreciation of the single currency would also undercut the process of competitive deflation engaged in by countries in the euro zone.

[1] The publication of the DG Treasury argues that a 10% decrease in the effective exchange rate of the euro (against all currencies) would do the following: increase our GDP by

0.6 percentage point of GDP in the first year and 1.2 GDP points after three years; create 30,000 jobs in the first year and 150,000 jobs within three years; and reduce the government deficit by 0.2 GDP point in the first year and 0.6 GDP point after three years.

Abenomics and the new monetary policy

This post summarizes a paper written by [Mahito Uchida, in Revue de l'OFCE, n° 135.](#)

With the arrival of Shinzo Abe at the end of 2012, Japan's economic policy started clearly focusing on the risk of deflation. This new policy combines a highly accommodative monetary policy with a fiscal stimulus based on public investment. In an article published by the OFCE, Mahito Uchida of SEIJO University, analyses the first stage of implementation of the new Japanese monetary policy. In that paper, Mahito Uchida investigates the Bank of Japan's (BOJ) monetary policy effects under Abenomics at the initial stage. First, he describes briefly what is "Abenomics" and "New monetary policy under Abenomics" since April 2013. He also examines the causes of the sharp response of the yen and Japanese stock prices, the increase in consumer price index and the change in public's expectations of the economic activity and prices from surveys. In the second part he explains why the new monetary policy was effective in 2013, comparing the previous policy until 2012. Although there is not much difference between monetary policies before and after

2012 theoretically, he points out the importance of the strong commitment by central bank, the cooperation with the government and “psychological impact” on public. The third part discusses the durability of the new monetary policy. The policy effects will be sustainable if a price becomes lastingly positive, which needs a durably positive output gap. Therefore, Abenomics’ growth strategy plays an important role. He also points out that the BOJ has to perform the policy over side effects such as the impact on the government bond markets, the impact on other financial markets and on capital flows overseas.

Elections and the (first) derivative of unemployment: the turnaround strategy

By [Guillaume Allègre](#), [g_allegre](#)

A ministerial adviser recently explained to me what he thinks is the strategy of the French President on macroeconomic management and unemployment, which could be called a turnaround strategy: “In relation to the presidential elections, the goal is to reduce unemployment in 2016-2017. The way people vote is based on the way unemployment has been changing just in the last year or even the last 6 months. Like for Jospin in 2002.” The belief that for unemployment and the economy in general what counts is the derivative, *i.e.* the recent evolution and not the actual level, has deep roots in the technocratic-political milieu: “it’s the derivative, stupid!” is the new “[it’s the economy, stupid!](#)” (the maxim of Bill Clinton’s election strategist in 1992).

This belief stems in part from an intuition confirmed by a well-known psychological experiment. Participants in the study were subjected to two painful experiences during which one of their hands is immersed in ice water. One version lasts 60 seconds and the other 90 seconds. In the second experiment, the first 60 seconds are the same as in the first, while the 30 added seconds are a bit less painful (the experimenter pours some warm water into the container). Later, the participants must choose which of the two experiments to repeat: 80% chose the longer one. This seems irrational, because in the longer experiment the total amount of pain is greater. To an objective observer, this is what should count ("the area under the curve, or the integral"). But the participants have a selective memory: they are more strongly influenced by the representative moments of the experience and in particular here by the improvement at the end of the test. Daniel Kahneman, the 2002 Nobel Prize-winner in economics for his work on biases in judgment, which is popularized in a book that can be found [here](#), distinguishes two representative moments during an unpleasant episode: the peak of suffering and the end [\[1\]](#).

Economists, especially in America, have developed econometric models of electoral forecasts to estimate the links between election results and the economy. The popularity of these models varies with their predictive power for the election: in 1992, half of the models predicted an easy re-election for George Bush; in 1996, the re-election of Clinton was reliably predicted; but in 2000, virtually all the models forecast a landslide victory for Al Gore ... And the model that had the closest forecast in that election (0.6%) was off by 5 points in the next one. Of course, thanks to the proliferation of predictions, it is always possible to find a model with a good record for the time-being, such as Paul the Octopus (see [Wiki](#)).

Despite this motley record, these politico-econometric models

have been imported into France. In their generic form, they attempt to explain the percentage of the vote going to a candidate or a party based on economic variables (GDP, unemployment, or levels or changes in income) and political variables (popularity of the President and the Prime Minister). The vast majority of models adopt as an economic variable changes in unemployment over a relatively short horizon, on average one year. The conclusion drawn from these empirical estimates is that French voters seem to have limited memories ([Dubois, 2007](#)).

But these studies are faced with a major problem: the low number of observations (nine presidential elections and thirteen legislative elections between 1958 and 2011). “We don’t vote often enough to suit the econometricians,” says Lafay (1995) [\[2\]](#). In other words, the law of large numbers cannot be applied in this type of configuration. This is compounded by the fact that the number of variables that change in the context of these elections is almost as high as the number of elections (the existence of a government of multiple party “cohabitation”; legislative elections on their own or coupled to the presidential elections; the presence or absence of an incumbent in the presidential election; parliamentary elections held before the deadline; the presence or absence of a leftist candidate in the second round of the presidential elections; the importance of tactical voting when there are three candidates in the second round of legislative elections [*triangulaires*]; etc.).

There are other technical problems confronting the econometricians. In a comprehensive review of the literature analyzing 71 political-economic studies on voting in France between 1976 and 2006, [Dubois](#) describes the way these problems are handled – “if at all” – as “relatively frustrating”. Just as in the United States, the predictions meet with “varied success”. There is also the problem of what econometricians call “endogeneity”: the politico-economic models attempt to

explain or predict the outcome of elections using economic variables (unemployment) and the popularity of the executive. However, there is little doubt that the popularity of the executive depends in part on unemployment levels and trends: given this, the lack of significance of changes in the longer-term economic variables may be explained by the fact that their impact is already included in the popularity of the executive. In short, these empirical studies are not sufficient to conclude that in economic terms, voters have short memories.

In the words of Kahneman, a machine for jumping to conclusions is at work: an intuition (the memory of voters is selective) that relies on psychological studies (whose object is distant) and is confirmed by econometric studies (not robust and therefore merely reproducing the researchers' *a priori* assumptions). The story told is consistent, and it seems to be supported by facts ... Upon reflection, it may seem scary that this kind of rhetorical cocktail is influencing the actions of politicians. This is even more frightening since, from an outside observer's viewpoint and from the perspective of social welfare and hence the goals of public policy, what matters is obviously the level of unemployment over several years (its integral) and not the way it has changed in the last year (its first derivative)!

Many rules have been implemented at the European level, and now the national level too, to prevent the politicians heading up government from trying to win elections by pursuing policies that, while they may reduce short-term unemployment, also build up long-term deficits. From the Maastricht criteria (government deficit of less than 3% of GDP) to the recent European multiannual financial framework, these rules are justified by the belief that politicians are encouraged to pursue a lax fiscal policy since it does not take into account future generations, who, by construction, don't vote. But if governments begin to believe that it is short-term economic

developments that count, then the incentives are reversed, especially if it is easier to reduce unemployment after having first increased it, which would lead to a trajectory of weak growth and of excessively high unemployment. [\[3\]](#) In this case, the solution cannot come from governance through new binding rules, which in any case have so far proved to be ineffective. It is necessary to rely on the fact that this kind of turnaround strategy can work in electoral terms only if the citizens fail to understand that they are being manipulated. Exposing the manipulation is then more efficient than implementing rules. Duly noted.

[\[1\]](#) Consequently, those who follow this theory today should also deal with unemployment at its peak, and not merely with the way it is changing at the end of their mandate.

[\[2\]](#) Lafay J.-D. 1995, "Note sur l'élection présidentielle de 1995 et les apports de l'analyse économétrique des comportements électoraux", mimeograph, LAEP, University of Paris 1. Cited by [Dubois](#).

[\[3\]](#) This post – [link](#) – emphasizes that it was possible to achieve the same ratio of debt to GDP in 2032 by taking a path that would have reduced unemployment in the euro zone by 3 points in 2013.