

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) [21]. 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.

What Reforms for Europe?

by [Christophe Blot](#) [1], [Olivier Rozenberg](#) [2], [Francesco Saraceno](#) [3] et [Imola Strehö](#) [4]

From May 22 to May 25 Europeans will vote to elect the 751 Members of the European Parliament. These elections will take place in a context of strong mistrust for European institutions. While the crisis of confidence is not specifically European, in the Old Continent it is coupled with the hardest crisis since the Great Depression, and with a political crisis that shows the incapacity of European institutions to reach decisions. The issues at stake in the next European elections, therefore, have multiple dimensions that require a multidisciplinary approach. The latest issue of the *Debates and Policies Revue de l’OFCE* series (published in [French](#) and in [English](#)), gathers European affairs specialists – economists, law scholars, political scientists – who starting

from the debate within their own discipline, share their vision on the reforms that are needed to give new life to the European project. Our goal is to feed the public debate through short policy briefs containing specific policy recommendations. Our target are obviously the candidates to the European elections, but also unions, entrepreneurs, civil society at large and, above all, citizens interested by European issues.

In the context of the current crisis, the debate leading to the next European elections seems to be hostage of two opposing views. On one side a sort of self-complacency that borders denial about the crisis that is still choking the Eurozone and Europe at large. According to this view, the survival of the euro should be reason enough to be satisfied with the policies followed so far, and the European institutions evolved in the right direction in order to better face future challenges.

At the opposite, the eurosceptic view puts forward the fundamental flaws of the single currency, arguing that the only way out of the crisis would be a return to national currencies. The different contributions of this volume aim at going beyond these polar views. The crisis highlighted the shortcomings of EU institutions, and the inadequacy of economic policies centered on fiscal discipline alone. True, some reforms have been implemented; but they are not enough, when they do not go in the wrong direction altogether. We refuse nevertheless to conclude that no meaningful reform can be implemented, and that the European project has no future.

The debate on Europe's future and on a better and more democratic Union needs to be revived. We need to discuss ways to implement more efficient governance, and public policies adapted to the challenges we face. The reader nevertheless will not find, in this volume, a coherent project; rather, we offer eclectic and sometimes even contradictory views on the direction Europe should take. This diversity witnesses the

necessity of a public debate that we wish to go beyond academic circles and involves policy makers and citizens. Our ambition is to provide keys to interpret the current stakes of the European debate, and to form an opinion on the direction that our common project should take.

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Recession and Austerity: Gender Equality Jeopardized

By Anne Eydoux, [\[1\]](#) Antoine Math, [\[2\]](#) and H el ene P erivier [\[3\]](#)

The crisis that began in 2008 has hit European countries diversely, causing economic and labour market disequilibria of more or less magnitude. As with past global crises, the current one has gendered implications. While women's employment is said to have been preserved relative to men's in the early stage of a recession, austerity plans implemented in several countries to limit public deficits and debts are deemed to affect female workers more deeply. How gendered are labour market changes in recession and austerity and how should cross-country differences be analysed? [This special](#)

[issue of the Revue de l'OFCE](#) notably points out the protective role of the gendered segregation of labour markets (i.e. the fact that women and men do not work in the same sectors or occupations): male-dominated sectors (construction, industry, etc.) are generally first hit in recession, while female-dominated sectors (services and the public sector) remain quite sheltered from a quick drop in the demand for labour – but are exposed to job losses at a later stage.

This collective publication aims to shed light on the differences in the gendered dimensions of past and/or present crises and related policies' impacts on European labour markets. The issue includes several comparative papers that either deal with gender at the European Union (EU) level, encompassing a variety of European countries, or that focus on more specific groups of countries, such as those most hit by the crisis and austerity (central and eastern European (CEE) countries, southern countries) or 'continental' countries (France, Germany). To complete the picture, a focus on specific country cases helps understanding the great variety of crises and how related policies impact on gender in labour markets. For instance, in Germany where female employment has apparently been spared the effects of recession in quantitative terms, the focus is on the low quality of women's jobs. In central and eastern Europe, as well as in southern countries such as Greece, Portugal and Spain, male and female employment has been so deeply affected in quantitative terms (both in the recession and in the austerity phase of policy) that poverty and material deprivation have increased for all. In the UK, the impact of the recession and austerity has been selective, increasing existing inequalities by gender and by ethnicity, as well as within each category. In Sweden, where the public sector is widespread and female-dominated, the impact of recessions on women's employment has been delayed, occurring in austerity phases through the downsizing of the local government sector.

Various approaches are developed in this issue. First of all, many papers show the importance of the timing of recessions and define several phases with different gender implications, often distinguishing the recession and the austerity phases or adding an intermediate phase of recovery. When it comes to the analysis of crisis related policies, the phases may however sometimes appear less sharply, overlapping instead of alternating, for instance when austerity measures were implemented prior to the crisis – eventually in line with the economic governance of the euro zone or with a previous downturn. Several papers cover the long-term changes in labour market or public policies, trying to identify the impact of recession and austerity on trends in female and male employment (or foregone employment growth), and/or to question the change in public policies from a gender perspective. Others rather focus on the short-term gender impact of recession and austerity, exploring the relevance of common hypotheses regarding the demand for labour (segregation or buffer effects) or the labour supply (discouraged-worker or added-worker effects).

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Rock around the Clock: an explanation of flash crashes

Sandrine Jacob Leal, [\[1\]](#) Mauro Napoletano, [\[2\]](#) Andrea Roventini, [\[3\]](#) Giorgio Fagiolo [\[4\]](#)

On May 6 2010, contemporaneously with the unprecedented price decrease of the E-Mini S&P500 [\[5\]](#), many US equity indices, including the Dow Jones Industrial Average, nosedived by more than 5% in few minutes, before recovering much of the loss. During this “flash crash”, most asset prices lost any informational role, as over 20,000 trades across more than 300 securities were executed at prices more than 60% away from their values just moments before. Many were executed at prices of a \$0.01 or less, or as high as \$100,000, before prices of those securities returned to their “pre-crash” levels ([CFTC and SEC, 2010](#)). Such a huge mispricing was associated with a sudden evaporation of market liquidity, swelled volatility and a prolonged crisis in [market confidence](#) (average daily volumes were down for several months after the crash). Furthermore, extreme asset misalignments could also be a source of [systemic crises](#) in light of mark-to-market financial accounting practices, according to which banks’ and other financial institutions’ assets are evaluated at current market prices.

The flash crash of May, 6 2010 widely reported in the [press](#) was not an isolated incident. Similar episodes have been observed since then [in many financial markets](#). Moreover, because of their disruptive consequences on the orderly functioning of markets, flash crashes attracted the attention of regulators, politicians and academic researchers. In the last four years, many conjectures have been advanced to clarify the origins of the phenomenon and to propose regulatory measures able to prevent its emergence and/or to mitigate its effects. Most theories focused on the role of high-frequency trading (HFT). Indeed, as suggested by a [SEC](#)

[report](#), high-frequency (HF) traders may have had a fundamental role in fueling the crash by increasingly selling their positions. However, [no convincing explanation has emerged yet](#) and the debate on the benefits and costs of HFT, and its role in flash-crash events, is still unsettled. Some studies suggest that HFT can negatively affect market efficiency, exacerbating market volatility, reducing market liquidity and possibly [fueling flash crashes](#). Others suggest that high-frequency traders are [“modern” market makers](#), who provide an almost continuous flow of liquidity, thus reducing transaction costs and fostering price discovery and market efficiency.

The lack of a consensus on the net benefits of HFT is not surprising, as the ultra-fast algorithms adopted by high-frequency traders represent a genuine financial innovation, whose social impacts are difficult to assess given [the legion of associated –often unintended– externalities](#) and the underlying complexity of financial markets. In such a context, [agent-based models](#) (ABMs) may represent a powerful tool to study the impact of financial innovations such as HFT on market dynamics. Indeed, ABMs allow the researcher to build artificial markets where price fluctuations can emerge from direct interactions occurring among heterogeneous traders, endowed with a repertoire of different trading strategies, ranging from simple to very sophisticated ones (as those employed by HF traders).

Following this intuition, in a [OFCE Working Paper n°2014-03](#), we develop an ABM of a limit-order book (LOB) market, wherein heterogeneous HF traders interact with low-frequency (LF) ones. Our main goal is to study whether HFT is responsible for the emergence of flash crashes and more generally for periods of higher volatility in financial markets. Furthermore, we want to shed some light on which salient features of HFT are relevant in the generation of flash crashes and in the process of price-recovery after a crash.

The model portrays a market wherein LF agents trade a stock,

switching between fundamentalist and chartist strategies according to their profitability. HF agents differ from LF ones not only in terms of speed, but also in terms of activation and trading rules. First, contrary to LF strategies, which are based on *chronological* time, the algorithmic trading required by HFT naturally leads HF agents to adopt trading rules which rest [on event time](#). As a consequence, LF agents, who trade at exogenous and constant frequency, co-evolve with HF agents, whose participation in the market is endogenously triggered by price fluctuations. Second, HF agents adopt *directional* strategies that exploit the price and volume information released in the LOB by LF traders. Finally, HF traders keep their positions open for very short periods of time and they typically display high order cancellation rates. To study the model, we run extensive numerical simulations. Our results show that flash crashes together with high price volatility occur *only* when HF agents are present in the market. Why do flash crashes occur in our model in presence of HF traders? We clearly show that the emergence of flash crashes is not only related to the faster trading speed of HF agents, but more important to the use of specific trading strategies which enable them both to siphon liquidity off the market, leading to high bid-ask spreads[\[6\]](#), and to synchronize on the sell-side of the LOB, when the market crucially needs liquidity.

Finally, we explore the effects of HF agents' order cancellation rate on market dynamics. [Order cancellation](#) has received much attention in recent public debates, because HF traders can use it strategically to move prices in the desired directions by filling the LOB with fake orders within few microseconds only to cancel them just as quickly. We find that high rates of order cancellations have an ambiguous effect on price fluctuations. Indeed, a larger rate of order cancellations leads to higher volatility and more frequent flash crashes, but also to faster price recoveries, which in turn reduce the duration of flash crashes. We therefore

suggest that order-cancellation strategies extensively employed by HF traders cast more complex effects than thought so far, and that [regulatory policies](#) aimed to curb these practices should take

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[5] A [futures contract](#) on the S&P 500 index.

[6] The difference between the highest price a buyer is willing to pay for an asset and the lowest price a seller is willing to sell this same asset.

France: gradual adjustments

(forecasts)

[2014-2015 outlook for the French economy](#)

By [Éric Heyer](#), Marion Cochard, [Bruno Ducoudré](#) and Hervé Péléraux

In 2013, the French economy grew at an annual average rate of 0.3%, which enabled it to return to the level it had reached six years ago, in early 2008. Between 2008 and early 2011, the economy had shown resilience in comparison with the performance of France's main partners. In the first quarter of 2011, the country's GDP had even come close to regaining its pre-crisis level, and lagged only slightly behind Germany and the United States. But the situation changed in the second quarter of 2011 as the austerity measures introduced in 2010 began to have an impact. The initial spurts of recovery seen after the recession were cut off. While the country did experience positive annual GDP growth, until 2013 this was close to zero. Ultimately, France is leaving this six-year period behind with an increased deficit that is still greater than the threshold of 3 GDP points. Fiscal consolidation has not proved very effective: the cost in terms of activity, unemployment and the financial situation for business has been disproportionate to the results.

In recent months, the economic situation in Europe has clarified considerably, with a return to growth and a strengthening of the main economic indicators. Business surveys also show a return of confidence in the productive sectors in France.

The relaxation of austerity should enable the French economy to continue along this path, with growth in GDP gradually picking up pace in 2014 and 2015.

For 2014, if we consider only the measures already approved, the French economy would grow by 1.2%, a level that is

insufficient to bring down unemployment or to hit the 3.6% deficit target. The announcement by Manuel Valls in his general policy (“DPG”) speech on 8 April 2014 of additional austerity measures of 4 billion euros through a supplementary budget prior to the summer should allow the government to meet its deficit commitment. But this will inevitably hurt activity and reduce the growth expected for the French economy to 1%, bringing the unemployment rate to 10.2% of the workforce by year-end.

Table 1. Measures announced in the General Policy (DPG) speech by Manuel Valls on 8 April 2014

		Date implemented	Amount in bn euros	Multiplier	Impact on growth (%)
	CICE tax credit yr 1	1Jan 2014	9	1,0	0,5
	CICE yr 2	1Jan 2015	7	0,8	0,3
	CICE yr 3	1Jan 2016	1	0,8	0,0
	CICE yr 4	1Jan 2017	2	0,8	0,1
	CICE yr 5	1Jan 2018	1	0,8	0,0
Responsibility Pact	Reductions on low wages	1Jan 2015	4,5	0,9	0,2
	Reductions wages > 1.6 SMIC	1Jan 2016	4,5	0,8	0,2
	Reductions free-lancers and artisans	1Jan 2015	1	0,8	0,04
	TOTAL		30		1,4
Solidarity Pact	Reductions social contributions < 1.3 SMIC	1Jan 2015	2,3	0,8	0,1
	Income tax reductions	2016-2017	2,7	0,7	0,1
	TOTAL		5		0,2
Tax base	Elimination of the C3S tax	2015	1		0,04
		2016-2017	4	0,8	0,16
	Elimination of the IS corporation surtax	2016	2,3	0,9	0,1
	Reduction in the IS corporation tax rate	Around 2020			

CICE = “Crédit d’impôt pour la compétitivité et l’emploi” (Tax credit for competitiveness and employment)

SMIC = French minimum wage

Sources: DPG speech, authors’ calculations.

The DPG speech is also upsetting expectations for 2015: prior to this announcement we had forecast GDP growth of 1.6%. Companies would benefit from this renewed growth to gradually restore their financial positions. This strategy is based primarily on increasing productivity, which would help to reabsorb marginal production capacity and restore business margins. In this scenario, the public finances would also

continue their gradual adjustment and the government deficit would come to 3% of GDP. As a corollary to the announced adjustment, the unemployment rate will continue to rise in 2015. The acceleration of the implementation of the Responsibility and Solidarity Pact promised in the DPG speech and the vagueness about how it will be funded may well affect the scenario set out above. Without new measures to cut public spending other than the 12 billion euros already included in our central scenario, the injection of 8.8 billion euros in new measures (Table 1) would allow the French economy to achieve 2% growth in 2015, as it did in 2011. This growth, combined with the impact of reductions in social security contributions on low wages, would by the end of 2015 push the unemployment rate down to its end 2013 level of 9.8% of the labor force. The reduction in the fiscal stimulus to -0.1% of GDP, although partly offset by the impact of growth on tax revenues, will nevertheless take the scenario off the path set out by Brussels, with a public deficit of 3.2% of GDP. If new cost-cutting measures are taken to finance these new measures *ex ante* in 2015, then, given the higher fiscal multipliers for government spending, the positive impact on growth would vanish, and the general government deficit would surpass 3% (3.1% of GDP) and the unemployment rate would hit 10% at end 2015. This scenario appears worse than the central scenario with respect to public finances and growth, with the slight fall in the unemployment rate being due simply to the impact of reducing social contributions on low wages, leading to a larger proportion of low-wage jobs in total employment (Table 2).

Table 2. Summary of the forecast for 2014 and 2015

	2013	2014		2015		
		Before DPG	After DPG	Before DPG	After DPG	
					Not funded	Funded*
GDP (%)	0,3	1,2	1,0	1,6	2,0	1,5
Public deficit (% of GDP)	-4,3	-3,7	-3,6	-3,0	-3,2	-3,1
Unemployment rate*	9,8	10,0	10,1	10,1	9,8	10,0
Fiscal impulse	-1,2	-0,7	-0,9	-0,6	-0,1	-0,6

* It is assumed that the 9.3 billion euros in measures to reduce social contributions and income tax are financed by a reduction by the same amount in public spending, which would be added to the 50 billion already announced by the government.

Sources: INSEE, national accounts, authors' calculations.

Euro zone: Recovery or deflation?

By [Céline Antonin](#), [Christophe Blot](#), Sabine Le Bayon and Danielle Schweisguth

This text summarizes the [OFCE's forecast for 2014-2015 for the euro zone economy](#)

Will the euro zone embark on the road to recovery, or will it sink into a deflationary spiral? The latest macroeconomic indicators are sending out conflicting signals. A return to growth is being confirmed, with three consecutive quarters of rising GDP. However, the level of unemployment in the euro zone remains at a historically high level (11.9% for the month of February 2014), which is fuelling deflationary pressures, as is confirmed by the latest figures on inflation (0.5% yoy for March 2014). While this reduction in inflation is partly due to changes in energy prices, the fact remains that underlying inflation has fallen under 1% (Figure 1). In these conditions, a turnaround in inflationary expectations cannot

be excluded, which would undoubtedly push the euro zone into deflation. The ECB has been concerned about this situation for several weeks and says it is ready to act (see [here](#)). However, no concrete proposal for a way to ease monetary policy and ensure that expectations are not anchored on a deflationary trajectory has been set out.

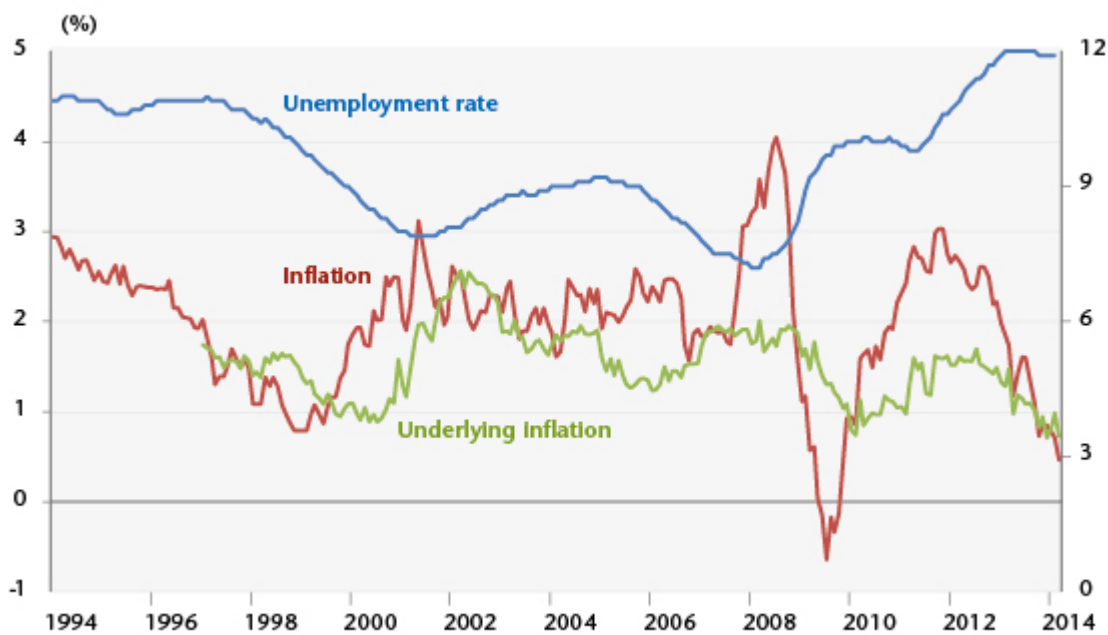
After a fall in GDP of 0.4% in 2013, the euro zone will return to positive growth: 1.3% in 2014 and 1.6% in 2015. Even so, at this rate of growth, there will still be an open output gap in most of the euro zone countries, reflecting the idea that the euro zone is only slowly pulling out of the crisis. Indeed, although efforts to reduce deficits will be curtailed, fiscal policies will still be pro-cyclical. Furthermore, financing conditions will continue to improve. The end of the sovereign debt crisis, thanks in particular to the announcements by the ECB in July and September 2012 [\[1\]](#), has reduced the risk premiums on the market for government bonds. The impact of lower long-term market rates has been partly reflected in bank interest rates, and credit supply conditions are generally less restrictive than they were between early 2012 and mid-2013. But there will still not be sufficient growth to trigger a recovery strong enough to lead to a rapid and significant reduction in unemployment. Indeed, the level will fall only very moderately, from 11.9% in the first quarter of 2014 to 11.3% at year end 2015. While Germany will enjoy almost full employment, mass joblessness in Spain and the other countries of southern Europe will persist (Figure 2). Unemployment should stabilize in Italy and continue to grow in France.

However, this continuing underemployment is giving rise to the risk of deflation. It is holding back growth in wages and contributing to the weakness of underlying inflation, which was in fact zero in Spain in March 2013 and negative in Greece and Portugal. For the euro zone as a whole, we do not expect deflation in the short term, but the weakness of growth is

increasing the likelihood that private agents' expectations are not anchored in a deflationary scenario.

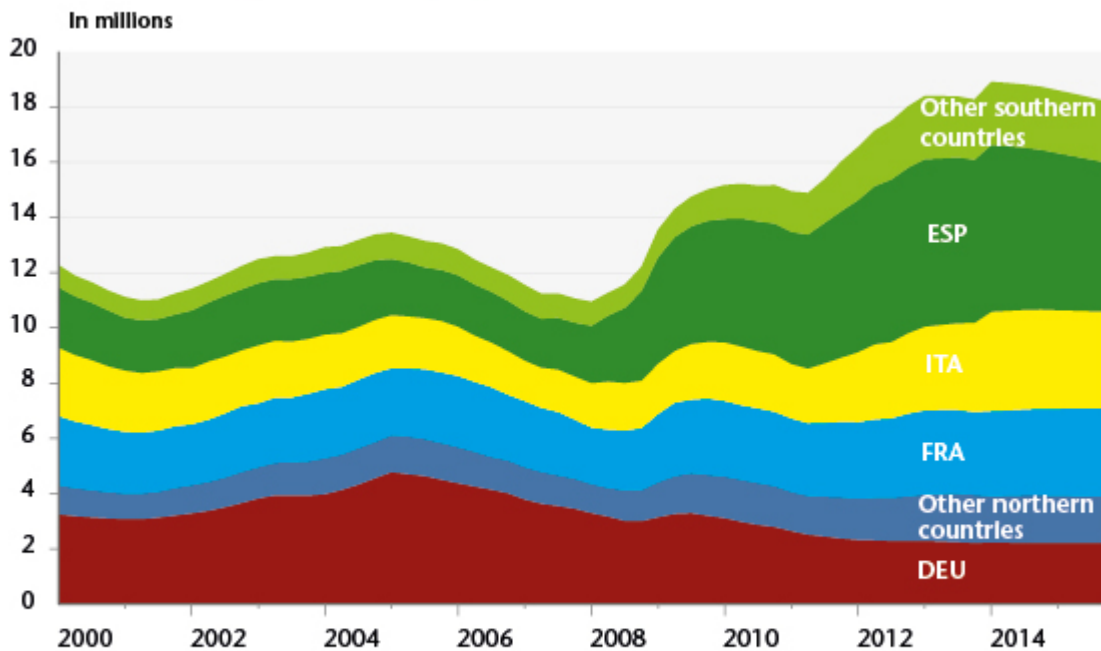
The situation in the euro zone is reminiscent of Japan in the 2000s. The country began to experience deflation in 1999 [2] following the recession associated with the Asian crisis. At that point, despite average growth of 1.4% between 2000 and 2006, prices failed to pick up, and the country's central bank did not find a way out of this trap, despite trying expansionary monetary policies. This is precisely the dynamic threatening the euro zone today, making it crucial to use all possible means to avoid this (monetary policy, fiscal policy and the coordination of wage policy [3]).

Figure 1. Unemployment rate and inflation rate in the euro zone



Source : Eurostat.

Figure 2. Unemployment in the euro zone countries



Note : The other southern countries are Portugal and Greece. The other northern countries are the Netherlands, Belgium, Ireland, Austria and Finland.

Sources : Eurostat, OFCE forecast April 2014.

[1] In July, ECB President Mario Draghi declared that the central bank would save the euro “whatever it takes”. In September, the ECB announced the creation of a new mechanism called Outright Monetary Transactions (see the post by [Jérôme Creel and Xavier Timbeau](#)), which enables it to engage in unlimited purchases of sovereign debt.

[2] It should be pointed out that there was an initial period of deflation in 1995 following three years of economic stagnation.

[3] All these elements are discussed in detail in the previous [iAGS](#) report (2014).

The ECB – or how to become less conventional

By [Jérôme Creel](#) and [Paul Hubert](#)

The gloomy economic situation in the euro zone and the deflationary risks it is facing are leading the members of the European Central Bank (ECB) to consider a new round of quantitative easing, as can be seen in [recent statements by German, Slovakian and European central bankers](#). What might this involve, and could these measures be effective in boosting the euro zone economy?

Quantitative easing (QE) includes several different types of unconventional monetary policy. To define them, it is necessary to start by characterizing conventional monetary policy.

Conventional monetary policy involves changing the key interest rate (the rate for so-called medium-term refinancing operations) by what are called open market operations so as to influence financing conditions. These operations can change the size of the central bank's balance sheet, including by means of money creation. So there is a stumbling block in distinguishing between conventional and unconventional policy: increasing the size of the central bank's balance sheet is not sufficient in itself to characterize an unconventional policy.

In contrast, strictly speaking an unconventional quantitative easing policy gives rise to an increase in the size of the central bank's balance sheet but without any immediate additional money creation: the extra liquidity provided by the central bank to the commercial banks serves to increase their reserves with the central bank, so long as these reserves are ultimately used for the subsequent acquisition of securities or to grant loans. These reserves, which are the commercial

banks' safe assets, help to consolidate their balance sheets: risky assets decrease in proportion, while safe assets increase.

Another type of unconventional monetary policy, qualitative easing, consists of modifying the structure of the central bank's balance sheet, usually on the assets side, but without changing the size of the balance sheet. This may mean that the central bank purchases riskier securities (not AAA rated) to the detriment of safer securities (AAA). In doing this, the central bank reduces the amount of risk on the balance sheets of the banks from which it has acquired these higher-risk securities.

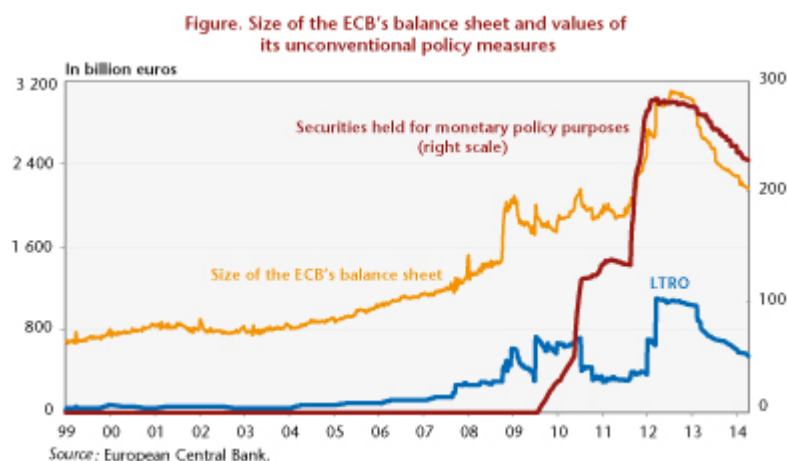
A final type of unconventional monetary policy involves conducting an easing policy that is both qualitative and quantitative: credit easing, *i.e.*, the size of the balance sheet of the central bank and the resulting risk increase in concert.

Unconventional monetary policies that are often attributed to the ECB include operations to provide long-term liquidity (3 years) at low interest rates, as was done in November 2011 and February 2012, and which were described as very long-term refinancing operations (VLTRO). But were these really unconventional large-scale operations? On the one hand, these operations involved not trillions of euros but an amount closer to 500 billion, which is not negligible after correcting for bank repayments to the ECB. On the other, the LTRO operations are part of the ECB's conventional policy arsenal. Finally, these operations were partially sterilized: the loans granted by the ECB to the commercial banks were offset by sales of securities by the ECB, thereby altering the structure of its assets. So we can conclude that the VLTRO operations were in part "conventional" and in part "unconventional".

The situation is different for the Securities Market Programme

mechanism, which consisted, on the part of the ECB, of purchasing government debt on the secondary markets during the sovereign debt crisis. This mechanism led to increasing the size of the ECB's balance sheet, but also the risk involved: the policy of credit easing has indeed been an unconventional policy.

Given the different definitions of unconventional policy in current use, it is helpful to recall that the ECB explicitly indicates the amounts it has agreed within the framework that it sets for its unconventional policies, which are called Securities held for monetary policy purposes. These amounts are graphed in the figure below. They show the frequency and magnitude of the monetary activities that the ECB itself defines as unconventional.



The three different measures shown in the figure (size of the ECB's balance sheet, LTRO amounts, and amounts of Securities held for monetary policy purposes) are expressed in billions of euros. The first two went up in the fourth quarter of 2008 after the bankruptcy of Lehman Brothers, whereas the third measure of unconventional policy started only in June 2009. We then see a new joint deepening of these measures at end 2011. Following this episode, the amount of LTRO operations came to 1090 billion euros, which represented about 50% of euro zone GDP (2,300 billion euros), i.e., about one-third of the ECB's balance sheet, while the amount of Securities held for monetary policy purposes was only 280 billion euros, or 13% of

euro zone GDP, about a quarter of the LTRO operations. It is interesting to note that the ECB's monetary policy, which depends on the banks' demand for liquidity, changed in 2013. One can interpret the reduction in the balance sheet size as a sign of a less expansionary policy or as a reduction in the demand for liquidity from the banks. In the first case, this would indicate that the strategy for ending the monetary easing policy probably came too early in terms of the European economy – hence the recently evoked recourse to new unconventional measures.

Until then, these measures had been formally introduced to restore the channels for transmitting the ECB's monetary policy to the real economy, channels that in some euro zone countries have been scrambled by the financial crisis and the euro zone crisis. The way to restore these channels was to inject liquidity into the economy and to increase the reserves of the banking sector in order to encourage banks to start lending again. Another objective of these policies was to send a signal to investors about the central bank's ability to ensure the stability and sustainability of the euro zone, as reflected in Mario Draghi's famous "whatever it takes" [\[1\]](#) statement on 26 July 2012.

In a recent working paper with Mathilde Viennot, we consider the effectiveness of conventional and unconventional policies during the financial crisis. We estimate how much the conventional instrument and the purchases of securities held for monetary policy purposes under the ECB's unconventional policies have affected interest rates and the volumes of new loans granted in various markets: loans to non-financial corporations, to households and on the sovereign debt market, the money market and the deposit market.

We show that unconventional policies have helped to reduce interest rates on the money market, on the government securities market and on loans to non-financial companies. These policies have not, however, affected the volume of loans

granted. At the same time, it turns out that the conventional instrument, whose lack of effectiveness was one of the justifications for implementing unconventional measures, had the expected impact on almost all the markets surveyed, and more so in the southern euro zone countries than in the northern ones on the market for 6-month sovereign debt and for real estate loans to consumers.

So it seems that unconventional policies have had a direct impact on the sovereign debt market as well as indirect effects, helping to restore the effectiveness of the conventional instrument on other markets. One of the reasons that helps to explain the weak impact of both instruments on the volumes of loans granted is the need facing the commercial banks [2] to shed debt and reduce the size of their balance sheets by adjusting their portfolio of risk-weighted assets, which has pushed them to increase their reserves rather than to play their intermediation role and to demand relatively higher compensation for each exposure taken.

Though legitimate, this behaviour is affecting the transmission of monetary policy: interest rates fall but lending doesn't restart. It thus seems important that monetary policy is not based exclusively on the banking sector. If there is a new round of unconventional operations, it should be focused directly on the acquisition of sovereign or corporate debt in order to bypass the banking sector. This workaround would undoubtedly lead to amplifying the transmission of monetary policy to the real economy. And it would be welcomed for helping to avoid the risk of deflation in the euro zone. [3]

[1] "The ECB is ready to do whatever it takes to preserve the euro. And believe me, it will be enough."

[2] The reasoning behind unloading debt also applies to their customers: the non-financial agents.

[3] See the [post](#) by Christophe Blot on this subject as well as the recent [Council of Economic Analysis \(CAE\) report](#) by Agnès Bénassy-Quéré, Pierre-Olivier Gourinchas, Philippe Martin and Guillaume Plantin.

Towards a better governance in the EU?

By [Catherine Mathieu](#) and [Henri Sterdyniak](#)

The 10th EUROFRAME Conference on economic policy issues in the European Union was held on 24 May 2013 in Warsaw on the topic, “Towards a better governance in the EU?” Revised versions of twelve of the papers presented at the Conference are included in issue 132 of the “Debates and Policies” collection of the *Revue de l’OFCE* entitled “[Towards a better governance in the EU?](#)”. The papers are organized around four themes: fiscal governance, analysis of fiscal policy, bank governance, and macroeconomic issues.

The global financial crisis of 2007 and the sovereign debt crisis in the euro area that began in 2009 have highlighted shortcomings in EU governance. The intense debate that has been going on among economists over how to analyze these shortcomings and proposals for improved governance also marked the EUROFRAME Conference.

How can the Economic and Monetary Union be strengthened

between countries that are still fundamentally different? How can we get out of the financial and economic crisis, the sovereign debt crisis, fiscal austerity and depression? Is it possible to develop a governance of the euro area that ensures the strength of the single currency, that avoids widening the disparities between Member States, and that gives the Members the flexibility needed, while forbidding non-cooperative policies, whether that means the excessive pursuit of competitiveness and trade surpluses or the irresponsible swelling of their public or foreign debt?

The articles in this issue provide readers with various viewpoints on possible pathways that Europe could take:

– Some authors think that we should stick to the original Treaty, abolish solidarity mechanisms, prohibit the Central Bank from buying the debt of member countries, and make it compulsory for them to find financing on the financial markets, which, stung by the Greek experience, will now be more vigilant and impose risk premiums on countries they consider lax. But is this compatible with the single currency? Are the markets really competent in macroeconomic matters? And will the euro zone members accept being reduced to the rank of countries without monetary sovereignty, whose public debt is considered risky and who do not control their interest rates?

– Other authors believe that we should gradually move towards a federal Europe, where the European authorities would be responsible for the fiscal policy of each Member State; this would need to be accompanied by a democratization of EU institutions, perhaps including even some form of political union. But can there be centralized management of countries in different economic circumstances with different economic and social structures, and which thus need differentiated strategies? Isn't the euro zone just too heterogeneous for this? Would every country agree to submit its social and economic choices to European trade-offs?

– Other authors believe that such heterogeneous countries cannot share a single currency; that the Northern countries will refuse to give an unconditional guarantee of public debt, even though this is a prerequisite for maintaining the euro zone's unity; that Europe is incapable of organizing a common but differentiated strategy; and that the differentials accumulated in terms of competitiveness require large exchange rate adjustments in Europe. Exchange rates need to be allowed to reflect the Members' different situations, *i.e.* sharp exchange rate falls in the Southern countries, and sharp rises in the Northern countries, by returning to the European Monetary System, or even to flexible exchange rates. Each country would then have to face up to its responsibilities: the Northern countries will have to boost domestic demand, while the Southern ones will have to use their gains in competitiveness to rebuild their export sectors. But no country is demanding this leap into the unknown – the financial consequences could be terrible.

– Finally, some authors, including ourselves, believe that public debts should once again be risk-free assets, guaranteed by the ECB, as part of a process of genuine coordination of economic policy by the Member States, while explicitly targeting full employment and the coordinated reduction of imbalances in the zone. But isn't such coordination a myth? Is a country going to agree to change its economic policy objectives to help the situation of its partners? Don't the European countries today mistrust each other too much to agree to guarantee the public debt of their partners?

These are the questions addressed in this issue, which, as the European elections draw near, we hope will make a useful contribution to the debate on EU governance.

[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).

[\[2\]](#) This issue is published in English.

Europe's control of public aid: good or bad for industry?

By [Sarah Guillou](#)

Following a meeting of the Ministers of Industry in Brussels on 20 February 2014, Arnaud Montebourg criticized the European Commission's control of aid, which he considers too strict at a time when industry needs assistance. He wants aid for energy-intensive industries to receive an exemption due to competition from US companies that have much lower energy costs (estimated, on average, at one-third of the cost in Europe). More generally, Arnaud Montebourg was very critical of Joaquin Almunia, the European Commissioner for Competition. So is the Minister of Industrial Renewal (*Redressement productif*) right to castigate the control of State aid by the European Commission?

What does public aid for business entail?

"A transfer of wealth, directly or indirectly, from a public entity to an autonomous economic entity" – public aid to business can take a variety of forms. In France, half of State

aid is made up of tax expenditures (tax credits or various exemptions), a third of financial support (loans, guarantees, capital), and the rest consists of direct and indirect subsidies.

A recent report by the General Inspectorate of Finance (IGF 2013) estimated the amount of public aid granted by the central government and local authorities to economic actors at 110 billion euros. Included in this total are measures such as reduced VAT rates (18 billion), reductions on social security contributions on low wages (21 billion), the CIR research tax credit (3.5 billion), as well as more than 600 State schemes and even more under local authorities.

The report highlights the complexity of the system of aid, which is the result of a kind of sedimentation of successive measures, sometimes with intervention levels intermingled, and with many programmes involving small amounts. Criticizing the goals and effectiveness of this system, the report's authors lament that industry is not a bigger target: ultimately it receives only 2 billion euros (excluding CIR and relief from social security contributions and VAT), while agriculture receives 4 billion.

What justifies the European Commission's control of public aid?

A direct consequence of the implementation of the single market, Europe's control over State aid is a tool of European competition policy that is intended to ensure the existence of fair competition and to fight against distortions created by advantages granted by a State to its own companies. The fight against a "race to the top" in terms of aid is thus subject to control. Under [Article 87, paragraph 1, of the Treaty establishing the European Community](#), State aid is deemed incompatible with the common market, and Article 88 gives a mandate to the Commission to control such aid. But Article 87 also specifies the criteria that make aid "controllable" by

the Commission.

A policy of support comes under the control of the Commission if it involves 1) specific aid (aid not paid to all firms or households, such as a general tax reduction), 2) the support policy involves a commitment of the State's public finances, whether direct grants, soft loans, tax credits, the supply of equipment, etc. 3) the support provides a specific advantage to companies, an industry, or a region (which they would not have received without the State's intervention) 4) the support distorts competition and may affect trade between the Member States – the [*de minimis rule*](#) exempts small amounts of aid.

What aid requires notice to the European Commission?

Aid to companies is subject to approval by the European Commission when it exceeds 200,000 euros over three years and it is not covered by arrangements for exemptions decided by Europe. In theory, aid may be granted only once the Commission's approval has been obtained. This is binding at a time of emergency measures and undeniably affects economic sovereignty. The interval between notification and a decision can range from 2 months to 20 months, or even more if an investigation is needed. The Commission has the power to require the reimbursement of aid that has been already paid and is deemed illegal; the EU Directorate-General for Competition exercises this control, with the exception of aid for agriculture and fisheries, which is under the control of their respective directorates. Legislation is constantly being adjusted to the economic situation, as happened at the time of the financial crisis in order to support the banking sector.

In an effort to simplify the controls and reduce administrative burdens, a general regulation on block exemptions, adopted in 2008, has clarified cases where no notification is necessary. There are numerous exemptions, which revolve around the following five themes: the Lisbon strategy, sustainable development, the competitiveness of EU

industry, job creation, and social and regional cohesion. This system of exemptions shows that control is also an expression of European policy choices that are guiding State aid, and therefore public resources, towards uses that accord with these choices.

Is aid often refused?

According to Mr. Almunia, 95% of the aid examined is authorized. The statistics provided by the 2000-2013 Scoreboard ([DC, Europa Scoreboard](#)) show that 88% of notifications related to industry and services lead to the conclusion that the support measure in question does not fall within the definition of public support, hence there is no objection. Another 5% of decisions are positive, and 1% are conditional. This comes close to the 95% cited. The remaining 5% consist of support measures that have been rejected by the Directorate for Competition, part of which (4%) will be recovered. Since 2000, this amounts for all the Member States to 251 refusals, the equivalent of an annual average of 22 refusals from 2000 to 2007, and 12 from 2008 to 2013.

The notifications from the French State overwhelmingly concern regional aid, especially for the DOM-TOM overseas territories, aid for certain agricultural sectors, and aid for R&D. For example, aid to Renault's HYDIVU project from the Agency for the environment and energy, notified in March 2013, resulted in a decision in October 2013 that the measure did not raise any objections. The aid to R&D for innovative young companies notified in December 2013 led to a decision in February 2014 by the Directorate for Competition that the measure did not raise any objections and was covered by the exemptions for support for R&D.

More recently, the Commission agreed to the State's entry into PSA's capital after having accepted the need for the company's restructuring in July 2013 (decision [SA.35611](#)). This capital acquisition was not found to constitute State aid. The French

State was considered a private investor, just like the Chinese company Donfeng.

In 2013, the French government issued 47 notifications, none of which raised objections. To date only one is under investigation: the alleged subsidies to public transport in the Ile-de-France region around Paris.

What is France's position with regard to State aid?

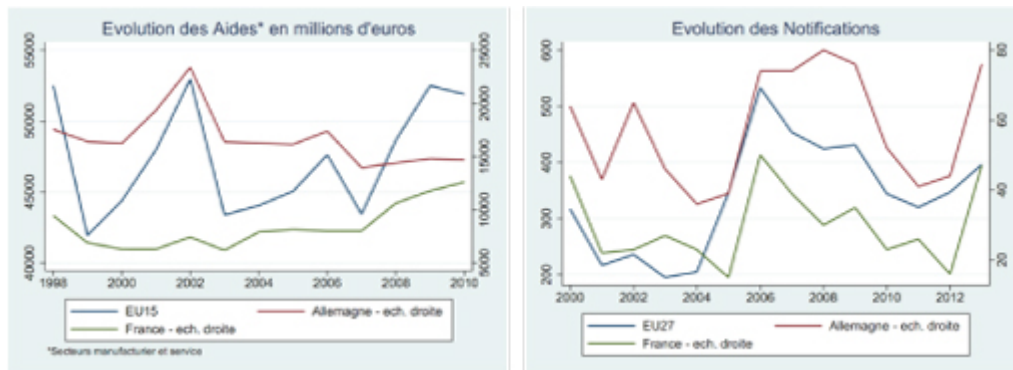
Of all the notifications addressed by Member States to the Directorate for Competition from 2000 to 2013 – i.e. 4765 in the field of industry and services – France sent 8.8%, compared with 10% for Italy and Spain, 17% for Germany and 6.4% for the UK. The French State, so often accused of a Colbertist tendency, on average gave notice over the period of about half as much aid as Germany. The statistics provided by the “Scoreboard on State aid” ([DC, Aid in volume and as a % of GDP](#)) can be used to see France's position in the EU15 in terms of the volume of aid granted relative to GDP. Table 1 shows that France is about average: higher than the group of countries with a free market tradition (UK, Netherlands, Belgium, Austria, Luxembourg) but below countries with a social-democratic tradition (Denmark, Finland, Sweden, Germany). With regard to the volume of aid relative to its purpose, it is customary to distinguish sectoral aid that benefits a particular sector, an “old version” brand of industrial policy, from horizontal aid that caters to all businesses, a “modern” brand of industrial policy, such as support for R&D. Once again, France occupies a middle position in terms of the percentage of sectoral aid relative to the EU15 group.

Table 1. Average public aid per country in the EU15 from 2000 to 2012

Country	Total		Service and Manuf.		% total aid	
	Millions of €	% GDP	Millions of €	% GDP	Sect. aid	Horiz. aid
Austria	1688,0	0,59	1214,3	72	27	73
Belgium	1567,4	0,44	1117,3	71	24	76
Denmark	2091,9	0,87	1719,6	82	17	83
Finland	2347,2	1,29	628,2	27	68	32
France	13495,8	0,69	8480,4	63	40	60
Germany	18130,5	0,75	16635,3	92	30	70
Greece	1462,8	0,68	841,3	58	36	64
Ireland	1193,7	0,79	684,8	57	54	46
Italy	7094,7	0,44	5232,7	74	32	68
Luxembourg	111,1	0,28	63,6	57	35	65
Netherlands	2429,8	0,43	1331,8	55	43	57
Portugal	2217,0	1,32	1462,5	66	80	20
Spain	6196,7	0,63	4833,1	78	47	53
Sweden	2751,5	0,74	2036,5	74	19	81
United Kingdom	4659,2	0,26	3201,5	69	29	71

Source : European Scoreboard Statistics, author's calculations.

Both the volume of aid and the notifications are very sensitive to a country's economic and institutional environment and to shocks to this environment (German reunification, industrial restructuring, etc.). France is among the countries that have granted more aid in the recent period (2010-2012) than in the beginning of the crisis period (2007-2009). Countries that are comparable to it (Germany, Italy, Spain) have instead reduced their aid payments. The following graphs show changes in the volume of aid (constant euros). While the amount of aid clearly increased in 2007, the crisis does not seem to have fundamentally altered behaviour in terms of notifications. Aid for the banking industry is the subject of a specific legal system and separate accounting. The amounts described therefore do not include aid to the banking sector.



Source: DC, Europa State Aid Scoreboard Statistics.

There is nothing to show that the European Commission's controls on aid have hurt industry

This brings us to the question that concerns our Minister. If the level of public aid is positively correlated with manufacturing's share in the economy (see [Guillou S., 2014](#)), this is mainly because the characteristics of the manufacturing industry – regional imbalances, R&D, environmental investment – correspond more to the criteria for the authorized payment of aid. The manufacturing sector has also been characterized historically by lobbying, a potential trigger for aid, and is also the sector most exposed to international competition. There is no evidence that the causality would run from State aid to manufacturing's share of value added. The reverse is much more likely.

Moreover, a careful analysis of the European Commission's control of aid shows that negative decisions are relatively rare. But a strong inhibitory effect cannot be excluded, in the sense that governments might exercise self-censorship in light of their knowledge of the case record of Europe's Directorate for Competition. This kind of censorship is difficult to quantify, but it is detectable for all the Member States in the decrease in notifications since controls were implemented.

There is however much room for exemptions, spaces in which aid to industry may be authorized. If indeed it is not possible to

envisage a "CICE" tax credit that would be reserved for companies in the manufacturing industry alone, as this would be too selective, any measure is acceptable that is considered support for innovation and R&D, the development of renewable energies, the handling of regional and major sectoral imbalances, or job creation.

Moreover, a judgment on aid's legality is based on an economic cost-benefit analysis, which is sometimes not exempt from criticism or debate, but is undeniably based on an economic assessment of the allocation of public funds and of any distortions in competition that this allocation could create. There are *a priori* rules mandating rejection or acceptance, but most cases are subject to a reasoned economic analysis. This consists of a "balancing" between "the contribution to the attainment of an objective of well-defined common interest", such as efficiency or equity, and "the resulting distortion of competition and trade". The measure is also reviewed in order to determine its appropriateness, its effectiveness as an incentive and its proportionality. Finally a comparative scenario, a sort of counterfactual that envisages no implementation of the aid, is also used to help reach a decision.

On the question of support for energy-intensive industries, firms that consume electricity intensively have generally negotiated preferential rates with energy providers. This was the case in France with the Exeltium consortium, but it is also the case in Germany. Whether this involves preferential tariffs granted by a State-owned company (historical supplier) or a tax exemption or reduction, these measures have been analyzed by the Directorate for Competition. To date, these special rates have not encountered systematic opposition, but the process of deregulating Europe's electricity market and the new regulation on aid for the environment and energy – scheduled for the first half of 2014 – should not necessarily work in their favour. It is still the case that the best

support for industries that intensively consume energy, and not just electricity, remains the appreciation of the euro vis-à-vis the dollar, which is reducing the cost of imported energy, even though this is rather debilitating for exporters, as our Minister frequently points out. In addition, the cost of energy is an incentive (among others) to invest in energy-saving technologies. This perfectly illustrates the economic adage that any choice (aid) is also a renunciation (of another use of resources). The competitiveness of energy-intensive industries or a policy to reduce fossil fuels – this is the choice at the heart of the European Commission's decisions.

Control on aid is aimed at a different type of objective

It is because the control of State aid is consistent with European objectives (Lisbon Objectives, 2008 Climate and Energy Package, and now the 2030 Climate and Energy Framework) that it might be possible to develop a coherent European economic policy.

The regulatory system and the jurisprudence on public aid have proven to be relatively flexible and adaptive. This should not prevent us from discussing and commenting on the decisions of the Directorate General for Competition, particular as competition policy does not need to resemble a doctrine to be effective. It does, of course, entail some loss of economic sovereignty. But it needs to be recognized that control over aid is a major element in European economic cohesion, in the convergence of economic levels, and most of all in democracy. This reporting requirement generates valuable information for citizens about the use of public funds. Furthermore, it facilitates the readability of industrial policy and more generally of public aid from States, which citizens and the media have an interest in assessing on the eve of the upcoming European elections.