

# Manic-depressive austerity: let's talk about it!

By [Christophe Blot](#), [Jérôme Creel](#), and [Xavier Timbeau](#)

*Following discussions with our colleagues from the European Commission [1], we return to the causes of the prolonged period of recession experienced by the euro zone since 2009. We continue to believe that premature fiscal austerity has been a major political error and that an alternative policy would have been possible. The economists of the European Commission for their part continue to argue that there was no alternative to the strategy they advocated. It is worth examining these conflicting opinions.*

In the [iAGS 2014](#) report (as well as in the [iAGS 2013](#) report and in [various OFCE publications](#)), we have developed the analysis that the stiff fiscal austerity measures taken since 2010 have prolonged the recession and contributed to the rise in unemployment in the euro zone countries, and are now exposing us to the risk of deflation and increased poverty.

Fiscal austerity, which started in 2010 (mainly in Spain, Greece, Ireland and Portugal, with a fiscal impulse [2] for the euro zone of -0.3 GDP point that year), and then was intensified and generalized in 2011 (a fiscal stimulus of -1.2 GDP point across the euro zone, see table), and then reinforced in 2012 (-1.8 GDP point) and continued in 2013 (-0.9 GDP point), is likely to persist in 2014 (-0.4 GDP point). At the level of the euro zone, since the start of the global financial crisis of 2008, and while taking into account the economic recovery plans of 2008 and 2009, the cumulative fiscal impulse boils down to a restrictive policy of 2.6 GDP points. Because the fiscal multipliers are high, this policy explains in (large) part the prolonged recession in the euro zone.

The fiscal multipliers summarize the impact of fiscal policy on activity [3]. They depend on the nature of fiscal policy (whether it involves tax increases or spending cuts, distinguishing between transfer, operating and investment expenditure), on the accompanying policies (mainly the ability of monetary policy to lower key rates during the austerity treatment), and on the macroeconomic and financial environment (including unemployment, the fiscal policies enacted by trading partners, changes in exchange rates and the state of the financial system). In times of crisis, the fiscal multipliers are much higher, *i.e.* at least 1.5 for the multiplier of transfer spending, compared with near 0 in the long-term during normal times. The reason is relatively simple: in times of crisis, the paralysis of the banking sector and its inability to provide the credit economic agents need to cope with the decline in their revenues or the deterioration in their balance sheets requires the latter to respect their budget constraints, which are no longer intertemporal but instantaneous. The impossibility of generalizing negative nominal interest rates (the well-known “zero lower bound”) prevents central banks from stimulating the economy by further cuts in interest rates, which increases the multiplier effect during a period of austerity.

**Table. Fiscal impulses in the euro area**

In GDP points

	2010	2011	2012	2013	2014
DEU	1,3	-1,1	-1,2	0,2	0,1
FRA	-0,5	-1,8	-1,2	-1,4	-0,7
ITA	-0,7	-0,4	-3,0	-1,5	-0,6
ESP	-1,4	-1,3	-3,4	-1,6	-1,0
NLD	-1,1	-0,5	-1,4	-1,5	-1,0
BEL	-0,1	0,1	-0,6	-1,0	-0,5
IRL	-4,2	-1,5	-2,0	-1,7	-1,7
PRT	-0,3	-3,7	-3,9	-1,5	-1,5
GRC	-7,6	-5,5	-3,9	-3,3	-1,7
AUT	0,5	-1,4	-0,3	-0,9	-0,4
FIN	1,3	-0,7	-0,3	-1,4	-0,3
EA (11)	-0,3	-1,2	-1,8	-0,9	-0,4

Sources: Eurostat, National accounts.

If the fiscal multipliers are higher in times of crisis, then a rational reduction in the public debt implies the postponement of restrictive fiscal policies. We must first get out of the situation that is causing the increase in the multiplier, and once we are back into a “normal” situation then reduce the public debt through tighter fiscal policy. This is especially important as the reduction in activity induced by tightening fiscal policy may outweigh the fiscal effort. For a multiplier higher than 2, the budget deficit and public debt, instead of falling, could continue to grow, despite austerity. The case of Greece is instructive in this respect: despite *real* tax hikes and *real* spending cuts, and despite a partial restructuring of its public debt, the Greek government is facing a public debt that is not decreasing at the pace of the budgetary efforts – far from it. The “fault” lies in the steep fall in GDP. The debate on the value of the multiplier is old but took on new life at the beginning of the crisis.[\[4\]](#) It received a lot of publicity at the end of 2012 and in early 2013, when the IMF (through the voice of [O. Blanchard and D. Leigh](#)) challenged the European Commission and demonstrated that these two institutions had, since 2008, systematically underestimated the impact of austerity on the euro zone countries. The European Commission recommended remedies that failed to work and then with each setback called for strengthening them. This is why the fiscal policies pursued in the euro zone reflected a considerable error of judgment and are the main cause of the prolonged recession we are experiencing. The magnitude of this error can be estimated at almost 3 percentage points of GDP for 2013 (or almost 3 points of unemployment): If austerity had been postponed until more favourable times, we would have reached the same ratio of debt-to-GDP by the deadline imposed by treaty (in 2032), but with the benefit of additional economic activity. The cost of austerity since 2011 is thus almost 500 billion euros (the total of what was lost in 2011, 2012 and 2013). The nearly 3 additional points of unemployment in the euro zone are now exposing us to the risk of deflation, which will be very

difficult to avoid.

Although the European Commission follows these debates on the value of the multiplier, it (and to some extent the IMF) developed another analysis to justify its choice of economic policy in the euro zone. This analysis holds that the fiscal multipliers are *negative* in times of crisis *for the euro zone*, and for the euro zone alone. Based on this analysis, austerity should *reduce* unemployment. To arrive at what seems to be a paradox, we must accept a particular counterfactual (what would have happened if we had not implemented austerity policies). For example, in the case of Spain, without an immediate fiscal effort, the financial markets would have threatened to stop lending to finance the Spanish public debt. The rise in interest rates charged by the financial markets to Spain would have pushed its government into brutal fiscal restraint, the banking sector would not have survived the collapse of the value of Spain's sovereign notes, and the increased cost of credit due to the fragmentation of the financial markets in Europe would have led to a crisis that spiralled way beyond what the country actually experienced. In this analytical model, the austerity recommended is not the result of dogmatic blindness but an acknowledgement of a lack of choice. There was no other solution, and in any case, delaying austerity was not a credible option.

Accepting the European Commission's counterfactual amounts to accepting the idea that the fiscal multipliers are negative. It also means accepting the notion that finance dominates the economy, or at least that judgments on the sustainability of the public debt must be entrusted to the financial markets. According to this counterfactual, quick straightforward austerity would regain the confidence of the markets and would therefore avoid a deep depression. Compared to a situation of postponed austerity, the recession induced by the early straightforward budget cuts should lead to less unemployment and more activity. This counterfactual thesis was

raised against us in a seminar held to discuss the iAGS 2014 report organized by the European Commission (DGECFIN) on 23 January 2014. Simulations presented on this occasion illustrated these remarks and concluded that the austerity policy pursued had been beneficial for the euro zone, thereby justifying the policy *a posteriori*. The efforts undertaken put an end to the sovereign debt crisis in the euro zone, a prerequisite for hoping one day to get out of the depression that began in 2008.

In the [iAGS 2014](#) report, publically released in November 2013, we responded (in advance) to this objection based on a very different analysis: massive austerity did not lead to an end to the recession, contrary to what had been anticipated by the European Commission following its various forecasting exercises. The announcement of austerity measures in 2009, their implementation in 2010 and their reinforcement in 2011 never convinced the financial markets and failed to prevent Spain and Italy from having to face higher and higher sovereign rates. Greece, which went through □□an unprecedented fiscal tightening, plunged its economy into a deeper depression than the Great Depression, without reassuring anyone. Like the rest of the informed observers, the financial market understood clearly that this drastic remedy would wind up killing the patient *before* any cure. The continuation of high government deficits is due largely to a collapse in activity. Faced with debt that was out of control, the financial markets panicked and raised interest charges, further contributing to the collapse.

The solution is not to advocate more austerity, but to break the link between the deterioration in the fiscal situation and the rise in sovereign interest rates. Savers need to be reassured that there will be no default and that the state is credible for the repayment of its debt. If that means deferring repayment of the debt until later, and if it is credible for the State to postpone, then postponement is the

best option.

Crucial to ensuring this credibility were the intervention of the European Central Bank during the summer of 2012, the initiation of the project for a banking union, and the announcement of unlimited intervention by the ECB through Outright Monetary Transactions ([Creel and Timbeau \(2012\)](#)), which are conditional upon a programme of fiscal stabilization. These elements convinced the markets almost immediately, despite some institutional uncertainty (particularly concerning the banking union and the state of Spain's banks, and the judgment of Germany's Constitutional Court on the European arrangements), and even though OMT is an option that has never been implemented (in particular, what is meant by a programme to stabilize the public finances conditioning ECB intervention). Furthermore, in 2013 the European Commission negotiated a postponement of fiscal adjustment with certain Member States ([Cochard and Schweisguth \(2013\)](#)). This first tentative step towards the solutions proposed in the two IAGS reports gained the approval of the financial markets in the form of a relaxation of sovereign spreads in the euro zone.

Contrary to our analysis, the counterfactual envisaged by the European Commission, which denies the possibility of an alternative, assumes an unchanged institutional framework [\[5\]](#). Why pretend that the macroeconomic strategy should be strictly conditioned on institutional constraints? If institutional compromises are needed in order to improve the orientation of economic policies and ultimately to achieve a better result in terms of employment and growth, then this strategy must be followed. Since the Commission does not question the rules of the game in political terms, it can only submit to the imperatives of austerity. This form of apolitical stubbornness was an error, and in the absence of the ECB's "political" step, the Commission was leading us into an impasse. The implicit pooling of the public debt embodied in the ECB's

commitment to take all the measures necessary to support the euro (the “Draghi put”) changed the relationship between the public debt and sovereign interest rates for every country in the euro zone. It is always possible to say that the ECB would never have made □□this commitment if the countries had not undertaken their forced march towards consolidation. But such an argument does not preclude discussing the price to be paid in order to achieve the institutional compromise. The fiscal multipliers are clearly (and strongly) positive, and it would have been good policy to defer austerity. There was an alternative, and the policy pursued was a mistake. It is perhaps the magnitude of this error that makes it difficult to recognize.

---

[\[1\]](#) We would like to thank Marco Buti for his invitation to present the iAGS 2014 report and for his suggestions, and also Emmanuelle Maincent, Alessandro Turrini and Jan in’t Veld for their comments.

[\[2\]](#) The fiscal impulse measures the restrictive or expansionary orientation of fiscal policy. It is calculated as the change in the primary structural balance.

[\[3\]](#) For example, for a multiplier of 1.5, tightening the budget by 1 billion euros would reduce activity by 1.5 billion euros.

[\[4\]](#) See [Heyer \(2012\)](#) for a recent review of the literature.

[\[5\]](#) The institutional framework is here understood broadly. It refers not only to the institutions in charge of economic policy decisions but also to the rules adopted by these institutions. The OMT is an example of a rule change adopted by an institution. Strengthening the fiscal rules is another element of a changing institutional framework.

---

# The Barnier proposal on banking regulation: whence the wrath?

By Jean-Paul Pollin (Université d'Orléans) and [Jean-Luc Gaffard](#)

This time the evidence is there and it's irrefutable: the reaction of the French "authorities" to the proposed [structural reform of Europe's banking sector](#) proves that their law on the so-called "separation of banking activities" was nothing but a false pretence, a ruse to head off the European Commission's initiatives in this field (see this [OFCE blog](#)). It was also an occasion for them to smoothly undercut the report by Bourget, whose most striking passage was the denunciation of finance as the "invisible enemy", followed by its promise to create distance between deposit banks and trading banks (finance and investment banks). At the time this declaration was well received – the innumerable eccentricities of deregulated finance were held, rightly, to be responsible for the "Great Recession" and it was considered necessary to prevent the predatory and destabilizing dynamics of the financial markets from returning to pollute the traditional activities of lending and managing means of payment, whose impact on the economy is significant and lasting.

But these ambitions were buried a few months later by legislation that separates almost nothing, as was agreed by the bankers themselves: virtually all trading activities thus remain closely linked to the commercial bank operations which serve to strengthen them. During the debate on this law, one of the arguments in defence of its feeble character was that



our banking system should not be put at a disadvantage relative to the Anglo-American institutions. MPs, including [Karine Berger, the law's rapporteur](#), pretended to believe that to preserve the City the British government would never dare implement the recommendations of the Vickers report, which advocated a strict separation of activities. It is curious to see now that the UK has actually legislated in the manner recommended, resisting the pressure of the financial lobbies, whereas the French government not only capitulated to the "invisible enemy" but now is battling against a less stringent proposal than that adopted across the Channel.

Thus the Minister of the Economy expressed his wrath (cf. [Le Monde of 30 January 2014](#) and [Le Monde of 5 February 2014](#)) at European Commissioner Michel Barnier, whose fault was to propose a text that intends to follow the conclusions of the Liikanen report and the recommendations of a report of the European Parliament approved by a large majority last July. But there is nothing shocking about this text: it merely prohibits trading for own account (directly, or indirectly through exposure to the entities doing this) and imposes the separation of trading activities (with the specific exception of transactions in government securities) in institutions for which these activities reach a certain absolute and / or relative size (as a percentage of assets). This should affect only some thirty European banks which, it is true, include the four largest French groups. In the end, France has become one of the most determined opponents of a reform that was the subject, less than two years ago, of one of the main campaign promises of the President-elect.

Equally shocking is the incongruous intervention of the Governor of the Bank of France, Mr. Noyer, who took it upon himself to label [Mr. Barnier's project as irresponsible](#) and assert that it ran counter to the interests of the European economy. It is rather improper to label the European Commissioner as irresponsible, when he has actually

demonstrated a great deal of prudence in this matter. This criticism is also indirectly targeted at the Working Group chaired by the Governor of the Bank of Finland and composed of well-known figures (including Mr. Louis Gallois) who could be said, with due respect to Mr. Noyer, to be no less competent or less familiar with the state of European interests than he is. In reality their report offers a serious analysis and thoughtful conclusions. It is an example of a well-documented work, clearly argued and non-partisan, which should be a source of inspiration for the administration, and in particular the Bank of France. Yet Mr. Barnier's recommendations largely reflect the proposals in this earlier report, while leaving even broader margins of appreciation to the supervisor about possibilities for the separation of the main trading activities, with the exception of own account trading. This should not displease Mr. Noyer.

Nor are there any grounds to claim that the Barnier proposal could undermine the financing of the European economies or otherwise damage them. Nobody can seriously believe that this financing can be performed efficiently only by universal banks – particularly since we took so much pleasure recently in recalling the importance of bank credit for the economies of continental Europe. What actually worries Mr. Noyer (as well as Mr. Mestrallet, the head of Paris Europlace) is the future of trading, and more specifically the potential role of the French banks. But the separation principle obviously does not imply the disappearance of the finance and investment banks. What Mr. Noyer needs to explain is why he believes that, to be competitive, the finance and investment banks should not be separated from commercial banking, including through subsidiarization:

- – Is it because this allows for possible economies of scale? The existence of synergies between the different types of activities is not proven, but even if it exists, then subsidiarization should preserve them. For

example, information that is useful for financing trading or for bank loans to finance a company can easily circulate between the separate entities of a banking group. More generally, to market a range of services that customers consider complementary, there is no need to produce these within the same entity.

- – Is it because the existence of cross-subsidies between activities helps to build a more profitable and more robust model? But this would mean that the strength of universal banking resides in the violation of the rules on competition. This is of course unacceptable, and it should not be forgotten that what defines efficiency is not that one or another product or service has a lower price, but that all these products and services have a “fair price”. The subsidizing of trading operations by commercial banks can lead to excessive risk-taking, with the reverse true as well. In this sense, if separation leads to a differentiation in ratings between group entities, this should benefit the commercial bank and therefore the cost of credit. On the other hand, it may be that this would increase the cost of market transactions and thus reduce the volume of transactions. But is it reasonable to manipulate the relative prices of financial services in order to stimulate activity on Europe’s financial markets?
- – Is it because the possibility of transferring cash or equity between activities also helps to make the bank more stable and reduce its operating costs? But in part this would be covered by what has just been raised about competition and efficiency, since this assumes that transfer prices would differ from market prices. Above all, it is likely to endanger the commercial bank when losses or liquidity problems occur on the markets. It would no longer be possible to guarantee the protection of lending or the management of payments. The decrease

in the commercial banks' equity could constrain the flow of credit, and the investment of deposits in market transactions could subject them to excessive risk.

- – Or finally is it because the constitution of banks that are “too big to fail” and / or “too interconnected to be subject to an orderly resolution” would protect the national champions? But this would end up perpetuating the implicit subsidy that benefits these institutions – which once again poses the problem of distorting competition and encouraging the growth of these institutions, and hence the concentration of the industry, thus continuing to endanger the public finances. As for the entanglement of activities, this would prohibit the establishment of a credible resolution mechanism. In this sense the separation of activities is an essential complement to the provisions envisaged under the European Banking Union.

It is really important that this type of question be answered precisely and consistently, otherwise the French protests will remain ineffective because they will appear to be based solely on defence of the interests of the national financial lobbies, as if this would be worth the sacrifice of the efficiency and stability of the financial systems; this is not in the interests of Europe's economies.

In fact, the many arguments from a variety of backgrounds (including the OECD Secretariat in 2009) in favour of separation have never been convincingly refuted. Without going into detail (*cf.* [OFCE Note no. 36/November 2013](#)), it seems that separation is the best if not the only solution to the problems to be solved: to protect commercial banking activities, which have the character of a public service; to avoid distortions of competition; to control systemic risk; to ensure the efficient governance and management of the large banking groups in a transparent manner; and to provide for a possible orderly “resolution” –all of which generally

corresponds to the explicit list of the Barnier proposal's objectives.

While awaiting these explanations, the remarks by the Minister of the Economy and the Governor of the Bank of France only reinforce suspicions of the possible complicity in our country between the banking sector and part of the high public financial administration. It also demonstrates how the argument often heard in France that what is needed is to focus on supervision rather than regulation is full of ulterior motives and devoid of all credibility. Even if the supervision of the large banks must now be entrusted to the European Central Bank, it is evident that some work will still be carried out at the national level. And following the declarations by the Governor of the Bank of France, who is also President of the ACPR, France's Prudential Control and Resolution Authority, who can seriously believe that the supervision of our institutions will be carried out with the rigor and independence needed?

---

# **Regulating the financial activities of Europe's banks: a fourth pillar for the banking union**

By [Céline Antonin](#), [Henri Sterdyniak](#) and [Vincent Touzé](#)

At the impetus of EU Commissioner Michel Barnier, on 29 January 2014 the European Commission proposed new regulations

aimed at limiting and regulating the commercial activities of banks “of systemic importance”, that is to say, the infamous “too big to fail” (TBTF).

### **Regulating proprietary activities: a need born of the crisis**

Due to banks’ particular responsibility in the 2008 economic and financial crisis, many voices have been raised demanding stricter regulation of their financial activities. This has led to two approaches: prohibition and separation.

In the United States, the “Volker rule” adopted in late 2013 prohibits banks from engaging in any proprietary trading activities as well as taking holdings of greater than 3% in hedge funds. The banks can nevertheless continue their own market-making and hedging activities. Obviously, this rule does not prohibit banks from investing their own funds in financial assets (equities, government and corporate bonds). The purpose of the rule is to prevent a bank from speculating against its customers and to minimize the use of the leveraging that proved so costly to the financial system (banks using their clients’ money to speculate on their own behalf).

The European approach is based on the Vickers Report (2011) for the United Kingdom and the Liikanen Report (2012) for the European Union. These reports recommend some separation between traditional banking activities on behalf of third parties (management of savings, provision of credit, simple hedging operations) and trading activities that are for the bank’s own account or bear significant risk, although the activities can be maintained in a common holding company. The Vickers Report proposes isolating traditional banking activities in a separate structure. In contrast, according to the Liikanen report it is proprietary trading and large-scale financial activities that need to be isolated in a separate legal entity.

The idea of separating banking activities is not new. In the past, many countries enacted legislation to separate commercial banks from investment banks (Glass-Steagall Act in 1933 in the United States, the 1945 Banking Act in France). These laws were revoked in the 1980s due to a growing belief in the superiority of the “universal bank” model, which allows a single bank to offer a full range of financial services to individuals (loans, deposits, simple or complex financial investments) and especially to business (loans, hedging, issuance of securities, market-making activities). The crisis exposed two defects in this model: the losses incurred by a bank on its proprietary trading and other activities on the markets led to a loss in its equity capital, thereby calling into question the bank’s lending activities and requiring the State to come to its rescue in order to ensure that bank credit didn’t dry up. The universal bank, backed by the State’s guarantee and sitting on a mass of deposits, did not have sufficient vigilance over its proprietary trading activities (as was shown by the cases of Kerviel, Picano-Nacci and Dexia).

### **An ambitious European regulatory proposal**

This proposal for bank reform is coming in a situation that is complicated by several factors:

1) The Basel 3 regulations currently being adopted already impose strict rules on the quality of counterparties of the equity capital. Speculative activities must be covered by substantial levels of common equity.

2) The banking union being developed provides that in case of a crisis creditors and large deposit holders could be called upon to save a bank facing bankruptcy (principle of “bail in”), so that taxpayers would not be hit (end of “bail out”). But there are doubts about this mechanism’s credibility, which could cause a domino effect in the event that a TBTF bank faces bankruptcy.

3) Some European countries have anticipated reform by adopting a separation law (France and Germany in 2013) or setting prohibitions (Belgium). In the United Kingdom, a separation law inspired by the Vickers Report (2011) is to be adopted by Parliament in early 2014.

The regulatory proposal presented on 29 January is more demanding than the Liikanen Report. Like the “Volker rule” in the US, it prohibits speculation on the bank’s own account through the purchase of financial instruments and commodities, as well as investments in hedge funds (which prevents banks from circumventing the regulation by lending to hedge funds while holding significant shares in these funds, thereby taking advantage of the greater leverage).

Moreover, in addition to this prohibition the European legislator provides for the possibility of imposing a separation on an independent subsidiary for operations that are considered too risky, that is to say, that would result in taking positions that are too large. The aim is to address the porous border between proprietary trading and trading for third parties, as bankers could take risks for themselves while not covering the positions sought by their clients. With these new regulations, the legislator hopes that in the event of a bank crisis public support for the banks will benefit only depositors, not the bankers, with as a consequence an overall reduced cost.

Compared to French regulations, the regulatory proposal is more restrictive than the [law on the separation and regulation of banking activities](#) of 26 July 2013. Indeed, French law provides for the legal compartmentalization only of certain proprietary activities and highly leveraged activities in an independently financed subsidiary; strict prohibition concerns only high-frequency trading activities and speculation in agricultural commodities. And there are numerous exceptions: the provision of services to clients, market-making activities, cash management, and investment transactions and



hedging to cover the bank's own risks. In contrary, the prohibitions are broader in the regulatory proposal, as it applies to all proprietary trading. In addition, the regulatory proposal prohibits investment in hedge funds, whereas the French law permits it provided that such activities are compartmentalized.

The regulatory proposal nevertheless concerns only banks of a systemic size, *i.e.* 30 out of the 8000 found in the European Union, representing 65% of banking assets in the EU. It will not be discussed until the election of the new Parliament and the establishment of a new Commission.

### **A reform that doesn't have a consensus**

Michel Barnier's proposed reform has already provoked sharp criticism from certain member countries and the banking community. Some have reproached it for intervening in an area where it has no jurisdiction, which clearly indicates the current complexity of the legislation governing the European banking system.

France, Germany, Belgium could object, "Why are you interfering? We have already enacted our banking reform." But the logic of the banking union is that the same laws apply everywhere. These countries have chosen to carry out a minimal banking reform in order to pre-empt the content of European law. This is hardly acceptable behaviour at European level. There is also the case of the United Kingdom (for which Barnier's proposal opens the exit door: the regulations will not apply to countries whose legislation is more stringent).

The banking union provides for the European Central Bank to oversee the large European banks and for the European Banking Agency to set the regulations and rules on supervision. The Commission can therefore be reproached for intervening in a field for which it is no longer responsible. On the other hand, the crisis clearly showed that banking concerns more

than just the banks. It is legitimate for EU political institutions (Commission, Council, Parliament) to intervene in the matter.

The proposal has encountered two contradictory criticisms. One is that it doesn't organize a genuine separation of deposit-taking banks and investment banks. From this perspective, deposit or retail banks would be entrusted with specific tasks (collecting and managing deposits; managing liquid savings and risk-free savings; lending to local government, households and businesses); they would not have the right to engage in speculative activities or trading activities or to lend to speculators (hedge funds, arranging LBO transactions). These banks would be backed fully by a government guarantee. In contrast, market or investment banks would have no government guarantee for their market interventions and equity and other above-the-line operations. Since these transactions are risky, the absence of a public guarantee would lead them to set aside a greater amount of capital and to bear a high cost for attracting capital. This would reduce their profitability and thus the development of hedging and other speculative activities. A company that was in need of a hedging operation would have to have it carried out by an investment bank and not by its regular bank, so at a higher cost. Conversely, this would reduce the risk that banks suck their clients (banks and companies) into risky investments and operations. A reform like this would greatly increase the transparency of financial activities, at the cost of diminishing the importance of the banks and financial markets. Michel Barnier did not dare take the principle of separation to this, its logical conclusion. He remains instead within the logic of the universal bank, which uses its massive size as a deposit bank to provide financial intermediary services to its customers (issuance of securities, coverage of risk, investment in the markets, etc.), to intervene in the markets (market-making for foreign exchange and public and private securities) and to underwrite speculative activities.

The reform is nevertheless facing stiff opposition from the banking community, who would have preferred the status quo. Hence Christian Noyer, a member of the ECB Governing Council, has labelled the proposals “irresponsible”, as if the ECB had acted responsibly before 2007 by not warning about the uncontrolled growth of banks’ financial activities.

The European Banking Federation (EBF) as well as the French Banking Federation (FBF) are demanding that the universal banking model be preserved. The banks are criticizing the obligation to spin off their market-making operations (including for corporate debt). According to the FBF, this regulation “would lead to making this operation considerably more expensive,” which “would have a negative impact on the cost of financing companies’ debts and hedging their risks”. However, this obligation may be waived if the banks demonstrate that their market interventions do not require them to take on any risk. The banks could therefore continue to act as market makers provided that they set strict limits on their own positions; they could provide simple hedging operations by covering these themselves.

### **A fourth pillar for the banking union?**

European banks have of course rightly pointed out that this reform comes in addition to the establishment of the SSM (single supervisory mechanism), the SRM (single resolution mechanism), and the ECB exercise assessing the banks (launched in November 2013). The overall system does lack cohesion; a well thought-out schedule should have been set.

However, the separation advocated by the Barnier proposal lends credibility to the banking union and its three pillars (SSM, SRM and deposit insurance). This project does contribute to convergence in banking regulations, from both a functional and a prudential perspective. The establishment of a consistent framework simplifies control by the European supervisor under the SSM (the ECB will monitor the banks’

normal activities and ensure that they are not affected by speculative activities). The separation recommended by the Barnier proposal enhances the credibility of the SRM; there will no longer be any banks that are too big to go bankrupt, and investment bank losses will not rebound onto the lending activities of deposit banks and will not have to be borne by the taxpayer. By reducing the risk that deposit banks might fail, the risk of a costly rescue plan for investors (bail-in) is also lowered, as is the risk of needing recourse to deposit insurance. In this sense, the draft regulations can be considered a fourth pillar of the banking union.

For more information:

- Antonin C. and V. Touzé V. (2013), [The law on the separation of banking activities: political symbol or new economic paradigm?](#), OFCE Blog, 26 February 2013.
- Avaro M. and H. Sterdyniak H. (2012), [Banking union: a solution to the euro crisis?](#), OFCE Blog, 10 July 2012.
- Gaffard J.-L. and J.-P. Pollin (2013), [Is it pointless to separate banking activities?](#), *OFCE Blog*, 19 November 2013.

---

## **Croatia under the Excessive Deficit Procedure: which**

# measures should be implemented?

By [Sandrine Levasseur](#)

How to put public finances on a good track when (almost) all measures regarding spending cuts and tax increases have been already exhausted? Croatia's government has been seeking to solve this tricky problem since mid-November when [an excessive deficit procedure \(EDP\) was launched](#) against the country. Let us explain what an EDP means: the public deficit of Croatia currently exceeds 3% of GDP; the breach is neither exceptional nor temporary; consequently, the government of Croatia has to curb its public deficit in a lasting way.

On 28 January 2014, the EU Council will propose (1) the time limits within which Croatia must reduce its deficit below 3% of GDP and (2) the average annual amounts of deficit reduction during the period. Yet, (3) the EU council will invite *formally* the government of Croatia to propose concrete measures towards reducing the deficit-to-GDP ratio below 3%.

The problem facing the government of Croatia is not straightforward since the proposed measures should not further depress the economy. Currently, only modest signs of recovery are in sight in Croatia, and its unemployment rate stands at a high level (16.5%). The country is among the poorest EU members: its GDP per capita is 62% of that of the EU-28.

**Briefing Paper n° 6** aims at proposing a list of measures that an EU country under EDP such as Croatia could envisage. For each measure, we present the main arguments "in favor of" it and "against" it in general terms. Then, we discuss the relevance of every measure for Croatia. Note that our list of measures is suitable for both advanced and less advanced EU countries. More generally, our list could be used for any

country facing public finance problems and looking for solutions.

Three measures (out of seven) seem to us particularly relevant in the case of Croatia:

- the use of service concession contracts;
- the privatization of some state-owned enterprises;
- the improvement of tax collection and compliance.

The first two measures are related to the need to restructure state-owned enterprises that are inefficient due to poor management. In particular, state-owned enterprises which are neither natural monopolies nor of strategic importance (*i.e.* in the tourism and agriculture sectors) should be privatized. Privatization of other state-owned enterprises should be envisaged more carefully, but not excluded. Croatia is the first country to join the EU with such a high share of state-owned enterprises (25%), and the slow pace of privatization has hindered growth. More privatizations will result in (long-run) gains even if causing (short-run) pains, in particular layoffs among the workforce. Service concession contracts are another way of restructuring the state-owned sectors. The impact on public finances is different, though. Services concession contracts provide a regular source of revenues for the government (through receipts of concession fees) and/or of savings (through lower payments of government subsidies). By contrast, immediate and potentially large amounts of cash can be obtained from the proceeds of privatization.

Recommending a restructuring of state-owned enterprises in Croatia is not a novelty. The [International Monetary Fund](#), the [World Bank](#) and the European Commission have repeatedly stated that the pace of privatization or service concessions should be accelerated to raise the efficiency of the economy. Currently, the government of Croatia is actively engaged in accelerating such a process, in particular for service

concessions. A few recent concessions include [Zagreb's airport](#) and [Rijeka's port](#), while [motorways](#) and [Brijuni's island](#) have also been proposed to bidders.

Croatia's citizens do not always support the restructuring process. To obtain greater public acceptance of privatization and service concessions, communication should be improved and intensified. In particular, the budgetary authorities should explain *what* they are doing, *why* they are doing it, and what the long-run benefits of their actions will be. Otherwise, the restructuring of state-owned enterprises will be perceived as a gift to the private sector. Last but not least, the process of privatization and service concessions should be more controlled to prevent misguided choices, abuse or conflicts of interest. That also means fighting corruption.

The improvement of tax collection is the third measure that we advocate to curb Croatia's public deficit. According to the [Institute of Public Finance](#), the cumulated uncollected tax revenues in Croatia would amount to HRK 40bn, which represents more than twice the projected public deficit for 2014 (HRK 19.3bn). Should the government be capable of collecting at least a portion, it would give a little breathing room to the public finances. In Croatia, increasing the tax collection means several interrelated things: fighting the grey economy (since unreported incomes are untaxed incomes) and prosecuting tax fraud (otherwise, rules and procedures are useless). Again, tighter control means fighting corruption.

By contrast, other measures such as wage cuts in the public sector or low corporate tax rates do not appear suitable to put the public finances of Croatia on track.

Further details can be found at <http://www.ofce.sciences-po.fr/pdf/briefings/2014/briefing6.pdf>.

---

# Does financial instability really undermine economic performance?

By [Jérôme Creel](#), [Paul Hubert](#) and Fabien Labondance

What relationship can be established between the degree to which an economy is financialized (understood as the ratio of credit to the private sector over GDP), financial instability and economic performance (usually GDP per capita) in the European Union (EU)? [A recent working paper \[1\]](#) attempts to provide a few answers to this question.

Two major competing approaches can be found in the economic literature. On the one hand, an approach inherited from Schumpeter emphasizes the need for entrepreneurs to access sources of credit to finance their innovations. The financial sector is thus seen as a prerequisite to innovative activity and a facilitator of economic performance. On the other hand, financial development can be viewed instead as the result or consequence of economic development. Development implies increased demand for financial services on the part of households and businesses. There is therefore a source of endogeneity in the relationship between financial development and economic growth, as one is likely to lead to the other, and vice versa.

Until recently, analytical studies that attempted to disentangle and quantify these causalities showed a positive significant link between an economy's financial depth and its economic performance ([Ang, 2008](#)). However, the onset of the international financial crisis led to nuancing these



conclusions. In particular, [Arcand et al. \(2012\)](#) showed that beyond a certain level the impact of increased financialization becomes negative [2]. The relationship between financialization and economic performance can be represented by a bell curve: positive at the beginning and then, from a level of 80%-100% for the private credit to GDP ratio, fading to zero or turning negative.

Unlike other works that include both developed and emerging or developing countries, our study focuses on the EU Member States from 1998 to 2011. The advantage of this sample is that we include only economies whose financial systems are developed or at least in advanced stages of development [3]. Moreover, it is a relatively homogeneous political space that permits the establishment of common financial regulations. We adopt the methodology of [Beck & Levine \(2004\)](#) who, using a panel and instrumental variables, are able to resolve the endogeneity issues discussed above. Economic performance is explained by the usual variables in endogenous growth theory, namely initial GDP per capita, the accumulation of human capital over the average years of education, government expenditure, trade openness and inflation. In addition, we include the aforementioned financialization variables. We show that, contrary to the usual results in the literature, an economy's financial depth does not have a positive impact on economic performance as measured by GDP per capita, household consumption, business investment or disposable income. In most cases, the effect of financialization is not different from zero, and when it is, the coefficient is negative. It is therefore difficult to argue that financial and economic development go hand in hand in these economies!

In addition, we included in these estimates different variables quantifying financial instability so as to check whether the results set out above might be due simply to the effects of the crisis. These financial instability variables (Z-score [4], CISS[5], bad debt rate, the volatility of stock

market indices and an index reflecting the microeconomic characteristics of Europe's banks) usually seem to have a significant *negative* impact on economic performance. At the same time, the variables measuring the *degree* of an economy's financialization show no obvious effects on performance.

These various findings suggest that it is certainly unrealistic to expect a positive impact of any further increase in the degree of financialization of Europe's economies. It is likely that the European banking and financial systems have reached a critical size beyond which no improvement in economic performance can be expected. Instead, there are likely to be negative effects due to the financial instability arising out of a financial sector that has grown overly large and whose innovations are insufficiently or poorly regulated.

The findings of this study suggest several policy recommendations. The argument of the banking lobbies that regulating bank size would have a negative impact on growth finds absolutely no support in our results—quite the contrary. Furthermore, we show that financial instability is costly. It is important to prevent it. This undoubtedly requires developing a better definition of micro- and macro-prudential standards, together with effective supervision of Europe's banks. Will the forthcoming banking union help in this regard? There are many sceptics, including the economists of [Bruegel](#), the [Financial Times](#) and the [OFCE](#).

---

[1] Creel, Jérôme, Paul Hubert and Fabien Labondance, "Financial stability and economic performance", *Document de travail de l'OFCE*, 2013-24. This study was supported by funding from the European Union Seventh Framework Program

(FP7/2007-2013) under grant agreement no. 266800 (FESSUD).

[2] We consider this work in an earlier [post](#).

[3] In addition to the ratio of private sector credit to GDP, the depth of financialization is also indicated by the turnover ratio, which measures the degree of liquidity of financial markets, measured as the ratio of the total value of shares traded to total capitalization.

[4] Index measuring the stability of banks based on their profitability, their capital ratio and the volatility of their net income.

[5] Index of systemic risk calculated by the ECB and including five components of the financial system: the banking sector, non-bank financial institutions, money markets, securities markets (stocks and bonds) and foreign exchange markets.

---

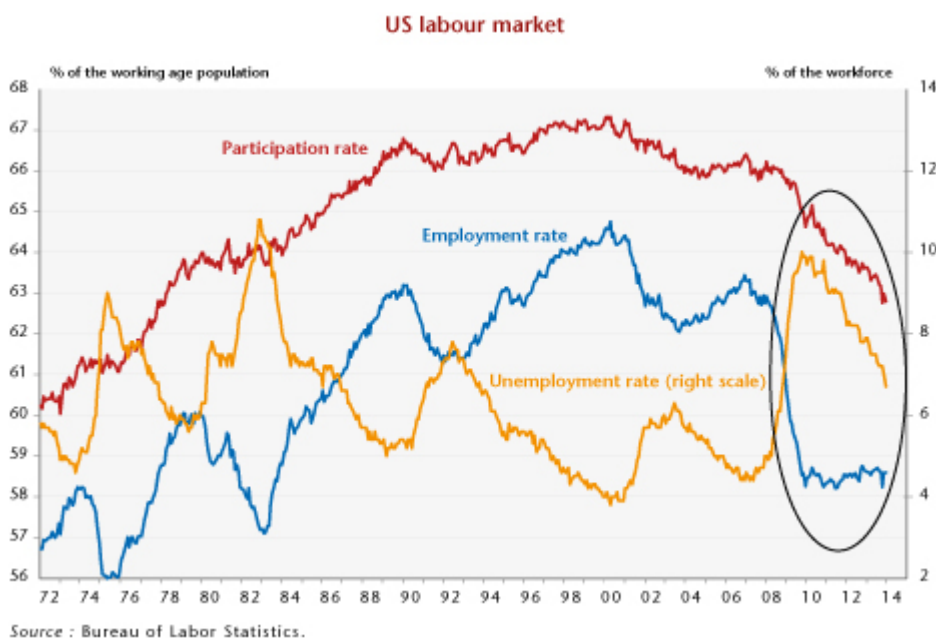
## What's masked by the fall in US unemployment rates

By Christine Riffart

Despite the further decline in the US unemployment rate in December, data from the Bureau of Labor Statistics released last week confirms paradoxically that the American labour market is in poor health. The US unemployment rate fell by 0.3 percentage point from November (-1.2 points from December 2012) to end the year at 6.7%. The rate has fallen 3.3 percentage points from a record high in October 2009, and is coming closer and closer to the [non-accelerating inflation](#)

[rate of unemployment](#) (NAIRU), which since 2010 has been set by the OECD at 6.1%. However, these results do not at all reflect a rebound in employment, but instead mask a further deterioration in the economic situation.

While the unemployment rate is the standard indicator for summarizing how tight a labour market is, this can also be considered using two other indicators, *i.e.* the employment rate and the labour force participation rate – in the US case, these give a different view of the state of the labour market (see chart).



After falling nearly 5 percentage points in 2008 and 2009, the employment rate has been constant for 4 years, at the level of the early 1980s (58.6%, following a peak of 63.4% at end 2006). Since then, the decline in the unemployment rate has reflected the decline in the participation rate, a trend that is confirmed by the figures for December. Over the period 2010-2013, the participation rate lost a little more than 2 percentage points, to wind up at end December at its lowest level since 1978 (62.8%, following a peak of 66.4% at end 2006).

This poor performance is due to insufficient job creation, which has a threefold impact. Despite positive GDP growth –

which contrasts with the recession in the euro zone – demand is far from sufficient to reassure business and revitalize the labour market. After four years of recovery, at end 2013 employment has still not returned to its pre-crisis level. Net creation of salaried jobs in the private sector has not even been sufficient to absorb the demographic increase in the working age population. As a result, the employment rate is not improving from where it bottomed out.

Moreover, the difficulty in finding employment is encouraging the exit or delaying the entry or return of people who are old enough to participate in the labour market. This effect, familiar to economists, is called *effet de flexion* (“bending effect”) in French: young people are encouraged to study longer, women stay at home after raising their children, and unemployed people become discouraged and stop looking for work. Despite the resumption of economic growth and job creation, this effect continued to be felt in full in 2013. While the reduction in the participation rate slowed in 2011 and 2012 – the growth of the labour force was once more positive but remained lower than that of the working-age population – it accelerated in 2013 with the decline in the labour force. During the second half of 2013, 885,000 people were in effect diverted away from the labour market, due in particular to the more difficult economic and social conditions.

Companies seem reluctant to rehire in the particularly difficult economic context. The fiscal shock in early 2013 depressed activity: GDP growth fell from 2.8% in 2012 to an expected level of about 1.8% in 2013. There will be additional fiscal adjustments in 2014. Beyond drastic cuts (related to sequestration [\[1\]](#)) in state spending, some exceptional measures that have been in force since 2008-2009 for the poorest households and the long-term unemployed (3.9 million out of the 10.4 million unemployed) are coming to an end and have not been renewed. According to estimates by the [Centre on](#)

[Budget and Policy Priorities \(CBPP\)](#), 1.3 million unemployed who have exhausted their entitlement to basic benefits (26 weeks) and who have enjoyed an exceptional extension will find themselves without support as of 1 January 2014 due to the non-renewal of the measure, and nearly 5 million unemployed will be affected by the end of the year.

There is a risk of growing numbers of people falling into poverty in this situation. According to the Census Bureau, since 2010 the poverty rate has been about 15%. However, again according to the [CBPP](#), unemployment benefits would have prevented 1.7 million people from falling below the poverty line. The greater difficulties facing the long-term unemployed and the withdrawal of part of the population from the labour market are the direct result of a morose labour market, which is not indicative of a continuous decline in the unemployment rate.

---

[1] See [America's fiscal headache](#) written 9 December 2013.

---

## **Important change of course at the Elysée Palace. Austerity is no longer the priority**

By [Xavier Timbeau](#), Twitter: @XTimbeau

(published in [Le Monde on Thursday 16 January 2014](#), p. 17)

When he was elected François Hollande made fiscal discipline his main goal. The 2008 crisis was continuing to have an impact on the developed economies; in the face of a sovereign debt crisis, Europe's governments had been implementing austerity measures that were to cause a second recession, a "double dip", to use the language of economists. For example, when François Hollande came to power, the situation in France seemed disastrous: the public deficit was 5.2%, with a rise in the public debt of more than 600 billion euros since 2008 along with a 2-point rise in unemployment (to 9.6% of the workforce). The pressure was intense, and, the euro zone states were falling like dominos, with Spain and Italy in danger of following Greece, Portugal and Ireland. In this context, it seemed that only budgetary discipline could help Germany to support a faltering euro zone.

Yet the worst was still to come. By underestimating the magnitude of the fiscal multipliers (the impact of fiscal policy on activity), as was eventually recognized by the International Monetary Fund (IMF) and the European Commission, and as we had pointed out in July 2012, the consequences of generalizing this unprecedented fiscal effort throughout the European Union were dismissed.

What François Hollande had presumed would be a painful recovery preceding a rebound that would open up new possibilities proved instead to be a period of economic stagnation, where rising unemployment went in hand with bad fiscal news. When the fiscal multiplier is high, nothing works. The budget efforts were weighing down economic activity, and there was no real re-absorption of the government deficits. If this infamous multiplier had been low, François Hollande's strategy – and that of the euro zone as a whole – would have worked. But the multiplier is not at our beck and call; it was the result of an economic situation in which the balance sheets of agents were degraded, with the banks suffocating and expectations dire.

The second part of François Hollande's five-year term, which the press conference of 14 January 2014 was to launch, is now much more complicated than expected. Instead of a recovery in public finances, the debt has barely been stabilized despite an incredible effort. Instead of a strong recovery, what we have is, in the understated language of the INSEE, a "sluggish recovery", which really amounts to continuing recession, with unemployment rising relentlessly. Our businesses are anaemic, and to try to restore their margins, the tax credit for competitiveness and employment (the "CICE"), inspired by the Gallois report, has not really injected new blood.

To lower the cost of labour without increasing the deficit, households, though exhausted, have to be hit again. The fiscal multiplier is still high, and growth, along with a reversal in the trend in unemployment, is being postponed. Worse, the commitment to Brussels to reduce the public deficit (a structural effort of 0.8 GDP point by the end of the five-years, *i.e.* 50 billion euros in total) will postpone a reduction in unemployment until after 2017. The patient may well die from the cure, and at best it will be Hollande's successor in the 2017 elections, which he's lost in advance, who might hope to reap the benefits of a policy that prioritized deficit reduction at the worst possible time.

The responsibility pact now proposed by François Hollande is setting out a different path, a different choice. Instead of austerity, a reduction in the cost of labour is to be financed not by taxes but by fiscal spending (amounting to 1 GDP point). The bet is that the growth stimulated will bring in additional revenue to meet the commitments on the public deficit. A reduction in social charges of thirty billion euros was announced, replacing the current CICE (20 billion). This means an additional 10 billion euros that can be obtained by companies that are to engage in collective bargaining under the watchful eye of a bipartisan watchdog. While this does not simplify the complex CICE, it will promote social dialogue.



On the other hand, François Hollande confirmed that the target for cutting public expenditure remains, *i.e.* 16 billion euros in 2015 and 18 billion in 2016 and 2017, for a total of 50 billion, with no increase on previous announcements. The CICE was partially funded by an increase in VAT (6 billion euros from 2014) and environmental taxes (4 billion). Replacing the CICE with cuts in social charges gives room for finesse: if companies benefit from the lower labour costs to boost their profits, then taxes on these profits will reduce the bill for the state by 10 billion euros (one-third of 30 billion). If, however, they increase employment and wages or lower their prices or invest, then there will be an increase in activity and the financing will come through growth.

Compared with France's budget commitments to Brussels (an 0.8 point reduction in the structural deficit every year), there will be a 20 billion euro fiscal stimulus based on lowering labour costs by 2017. This GDP point could lead to the creation of 250,000 jobs by 2017 and allow a one-point drop in unemployment. This is a substantial change of course from the priority given up to now to deficit reduction. A choice has been made to focus on business and push companies to create new activity or jobs through a pact. This is a significant step, but there is still more to be done to put an end to austerity, to repair the social damage done and to take radical action to reduce unemployment.

---

**The war between taxis and  
chauffeur-driven private**

# **cars: everyone has their reasons**

By [Guillaume Allègre](#)

*Editor's note:* This post was first published on the OFCE blog on 21 October 2013, when the issue of car with driver services was a subject of intense debate. Given the recent events in France, it seemed appropriate to republish this text by Guillaume Allègre.

*"What's worse is that everyone has their reasons"*

Jean Renoir, *La Règle du jeu*

In the war between taxis and chauffeur-driven private cars (*voitures de tourisme avec chauffeur* – VTCs), everyone has their reasons. We noted in [a previous post](#) that the discourse on innovation masked a classic conflict over distribution between producers, who want to defend their incomes, and consumers, who want an inexpensive quick-response taxi service including at peak times. This conflict is coupled with another no less classic one between holders of licenses with a scarcity value and new entrants, who support opening up the market.

In this conflict the current regulatory system is absurd. Limiting the number of taxi licenses was intended to support the income of independent taxis and prevent them from working too many hours per day to achieve a decent income. However, the authorities have committed two errors. First, by allowing the transfer of licenses, they transferred the benefit of quotas on taxi drivers to the license owners: a taxi driver now must either rent their license or buy it at a price reflecting its scarcity value (230,000 euros in Paris in 2012!). The current situation is even more absurd given that new licenses are [allocated free of charge](#) (to a waiting

list): if the *préfet* allocates 1000 new licenses for free, then a value of 230 million euros at market prices will be transferred to the fortunate winners (who may subsequently rent out the licenses)!

The second error is that the government has allowed the taxi license bubble to expand. The high price of licenses clearly reflects that supply is too low relative to demand. But it would now be unfair to penalize those who have just spent a fortune acquiring a license by, for example, massively increasing their number: why should recent purchasers pay for the shilly-shallying of the regulatory authorities?

### **What's the solution?**

It would be preferable to put an end to a system that generates constant worry about the value of licenses issued for free. But redeeming all the licenses at their market price would be costly and would result in the unjust enrichment of those who received a license for free.

One solution, which was proposed in the [previous post](#), is to buy the current licenses over time (as taxi drivers retire), not at their market value but at their acquisition value plus interest, and to assign new licenses that are free but not transferable. This system would compensate recent purchasers, without contributing to the unjust enrichment of those who have obtained a license for free or at a very low price. It would allow a transition from a system of transferable licenses to a system of non-transferable licenses in which the number of licenses in circulation and the division of the market between chauffeured cars and taxis would depend on the demand for services and not on the nuisance power of one or the other party. This system is of course complex, but it would help to overcome past mistakes in the fairest way possible.

For further information: [Chauffeur-driven private cars:](#)

[Victory of the anti-innovation lobby?](#)

To contact the author: [guillaume.allegre@sciencespo.fr](mailto:guillaume.allegre@sciencespo.fr)

To follow the author on Twitter: [@g\\_allegre](#)

---

# **TOFLIT18: for a better understanding of the French economy**

By Loïc Charles and [Guillaume Daudin](#)\*

Recurrent questions on our economies are, to quote a few: Which factors and actors are key for economic development? What private and public behaviors are particularly growth-enhancing? How important are institutions and policies in shaping trade, in promoting innovations and then growth?...There are different ways of enhancing our knowledge to answer these questions. The first way consists in laboratory experiments where a small-scale environment is created in order to understand “how the different pieces of the system work and interact” This is particularly appropriate for learning on social preferences and dealing with welfare issues. But, as soon as questions related to growth – such those mentioned above – are concerned, laboratory experiments do not appear very suitable. One other way of enhancing our knowledge consists in analyzing what happens today in our country and, possibly, to carry out international comparisons in order to disentangle between what is “good” and what is “bad” for the economy. Once one is engaged in that direction, why stop at comparison across space? Analyzing what happened several decades or centuries ago and to learn from these past

experiences for the current period can also be very fruitful.

The project “Transformations of the French Economy through the Lens of International Trade, 1716-1821” ([TOFLIT18](#)) follows this direction. The 4-year project, granted funding by [ANR](#), was launched on the 1<sup>st</sup> January 2014.

In few words, the project aims at analyzing the French economy during the period that laid the economic ground for the entry of France and Europe in the modern industrial era. Its main tools are the retranscription, the use and the diffusion of French international trade statistics.

The French administrative trade statistics are the most comprehensive and coherent source of quantitative information available for the French economy at that time. These data were produced locally and aggregated at the national level by the Bureau de la Balance du Commerce from 1716 on ([Charles and Daudin ,2011](#)). Despite several administrative reshufflings, the techniques of gathering and presenting the statistics on French foreign trade went almost unchanged up to the 1820s: they provided the total value, and sometimes the unit values, of merchandise and partner-specific trade flows; we have already photographed an almost complete series of yearly statistics. These documents are unique as they provide quantitative information on several geographical levels. As such, they can be used to study the economic effects of international trade on the French economy as a whole, on the economy of a single region, of a port town as well as on the economic behaviors of individual agents, e.g. a merchant or a community of merchants from a single town/region. They can also be used to get a more accurate understanding of the interplay that existed between these different geographical levels.

The volume and dispersion of primary sources makes the process of collecting and putting them into a usable form both time-consuming and costly. Our [team](#) includes therefore social

scientists with consolidated experience in the construction and management of large databases (notably [MARPROF](#), [NAVIGOCORPUS](#), [RICardo](#) and [SoundToll Registers Online](#)). They will bring their expertise to cross-test our dataset with other types of information on trade (shipping and merchants accounts). The collaboration of researchers who are currently working on similar set of foreign trade statistics for important economic partners of France at that period— Great-Britain and the Austrian Netherlands – will allow both crosschecking and building comparative studies.

The result database will include the bilateral value (with 20-30 different partners) of trade flows at the national level from 1716 to 1821, a merchandise (600-1000 different goods) and partner breakdown from at least 1750 onward, unit values and quantities from 1771 to 1792 and regional trade data. The project will transfer this database in the public domain and make it easily useable by the research community. The collected data can partly substitute for the lack of domestic macroeconomic series.

We will use the data to improve our knowledge of the French economy and our understanding of the economic mechanisms at work, both at the national and regional level. Two main avenues of research will be privileged. First, we will investigate the evolution of French specialization, both across French regions and in comparison to other countries. How was it linked to the contrasted economic development of France and Britain? What does it tell us on the determinants of international trade? Second, we will study the effects of policy choices on the French economy: France went through several wars and politic upheavals. It also went through stark changes in its commercial policies: from mercantilism to mitigated free trade in the 1760s with its colonial empire, to a number of free-trade treaties in the 1780s, followed by the closing up of the economy under the Empire. What were the effects of these policy choices?

All these questions resonate particularly to our contemporary ears. More importantly, the answer to these questions can provide a renewed glance on the functioning of the (French) economy, both then and now.

For more details, please contact [Guillaume Daudin](#)

—

*\*Guillaume Daudin est chercheur associé à l'OFCE.*

---

# Latvia: goodbye lats, hello euro!

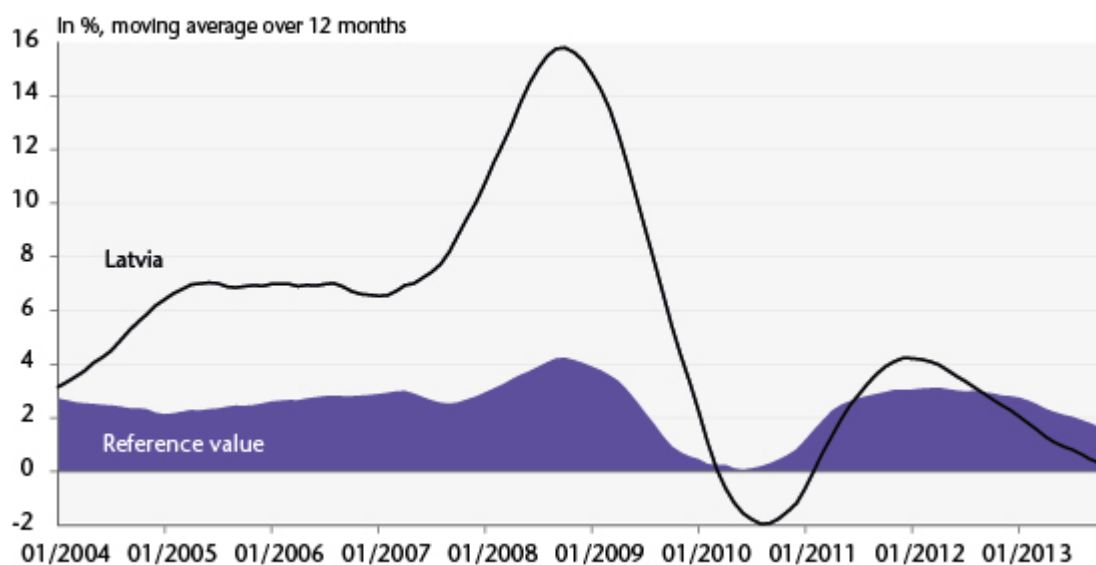
By [Céline Antonin](#)

On 1 January 2014, Latvia will become the 18th member of the euro zone, two years after its Estonian neighbour. From a European perspective, Latvia's entry into the "euro club" may seem of merely incidental importance. The country accounts for only 0.2% of euro zone GDP, and its integration is above all politically symbolic – it represents the culmination of the fiscal and monetary efforts undertaken by the country, which was hit hard by the crisis in 2008-2009 that slashed its GDP by almost a fifth.

At the end of 2008, facing an emergency situation, the country requested international assistance from the IMF and the European Union, which granted this in return for a drastic austerity plan. The aid came to some 7.5 billion euros, about one-third of the country's GDP. The national debt thus rose sharply between 2007 and 2012, from 9% of GDP to 40%. Latvia undertook a fiscal purge in order to boost its competitiveness

and reduce its public deficit by drastically lowering public spending, wages and pension payments. This internal devaluation strategy led to sharp disinflation, which allowed Latvia to meet the ERM II goal for price stability (see chart). In accordance with IMF advice, the country has stuck to its goal of joining the euro zone quickly while categorically refusing to use the weapon of an external devaluation to get out of the crisis. It has for instance adhered to its policy of maintaining a fixed exchange rate against the euro without interruption since 1 January 2005.

Figure : Price stability in Latvia with respect to inflation criteria



Sources : Eurostat, author's calculations.

2011 saw the country's return to growth, which was driven mainly by external demand from the Nordic countries and Russia. As for the public deficit, it rose from 9.8% of GDP in 2009 to 1.3% in 2012. Sovereign bond rates have fallen, which enabled the country to borrow only 4.4 billion euros (instead of the 7.5 billion planned) and to repay its debt to the IMF (three years in advance). Public debt has stabilized at around 40%. In addition, Latvia has met its inflation target over the reference period used to decide the issue of its euro zone membership. These various factors led the European Union to give it the green light in June 2013.

So is the entry of Latvia of merely incidental importance? Not



entirely. First, Latvia has still not erased the scars of the crisis; in 2012, GDP was below its 2007 level in real terms. Furthermore, while the unemployment rate has been cut almost in half since 2009, it still represents 11.9% of the workforce, and most importantly, this reduction has been due in part to high emigration. But above all, as was pointed out by the European Central Bank in its Convergence Report, nearly one-third of bank deposits (a total of 7 billion euros) are held by non-residents, particularly from Russia. As with Cyprus, this poses a high risk to banking stability in a crisis situation, with the potential for capital flight. At a time when the proposed banking union is stumbling up against the heterogeneity of the euro zone's banking systems, this illustrates yet again that it is very difficult to reconcile the logic of economic integration with the political choice of enlargement. Whether at the level of the euro zone or at the level of the European Union, it is time for Europe to make a clear choice between these two opposing logics.