“Buy French”: From the slogan to the reality

By Jean-Luc Gaffard, Sarah Guillou, Lionel Nesta

The current election campaign is lending weight to simplistic proposals like the slogan “buy French”, which evokes the need for France to re-industrialize. And to accomplish this, what could be simpler than to convince the population to buy native products designated with a special label? This is also more politically correct than advocating a straightforward return to protectionism. Employment is expected to benefit, along with the balance of trade. But if we look more closely, not only is it difficult to identify the geographical origin of products, but even if that were possible, any preference that these products might enjoy could well wind up in job losses. This solution for dealing with the need for re-industrialization ultimately reflects a refusal to get to the bottom of the problem.

Can we really define what it means to “buy French”? Does it mean buying the products of French companies? What about buying products made in France by foreign companies instead of buying products made abroad by French companies? These simple questions show that it is not so easy to pin down what is “Made in France”. One major difficulty is that the final goods produced in a country usually incorporate intermediate goods manufactured abroad. It may even happen that the components of a final product are manufactured by a competitor in another country. The iPhone is emblematic of this fragmentation. Should we refrain from purchasing intermediate goods from low-wage countries even though this makes it possible to produce final goods at a lower cost and boost exports by being more competitive on price? Those who think so should no longer be touting German industry as an example, since everyone knows about the growing share of imported

inputs in the production of the final goods Germany exports (OECD, *Measuring Globalisation: OECD Economic Globalisation Indicators 2010*, p. 212).

Imagine, nevertheless, domestic consumers who are able to identify products with a high labour content and are ready to make sacrifices out of a spirit of economic patriotism. Don't the polls tell us that over two-thirds of consumers would be willing to pay more for French goods? While there are doubts about whether they would actually do this, it would be risky to ignore the opportunity cost of such a choice. Buying more expensive products simply because they are French reduces purchasing power. Other goods and services would not be purchased or would be bought for less abroad. The balance sheet for employment is far from certain.

Should this exercise in economic patriotism actually materialize, it would be a way that consumers form attachments to certain types of products, in this case based on their place of manufacture, which would in turn reduce the intensity of competition. This could lead the companies concerned to cut back on their efforts to become more competitive on price and other factors. Why, indeed, should they shell out for expensive and risky investments when have a guaranteed customer base? It's a safe bet that they will not do this much, if at all. The national economy would then be locked in a low technology trap, doomed to slower growth, obviously with damaging consequences for employment in the medium and long term. This would also deprive the economy of the means to innovate and improve the competitiveness of its products.

Finally, it is likely that the willingness to buy French products would benefit products that replace goods made elsewhere in Europe rather than goods made in developing countries, either because the latter are no longer manufactured at all in France or because the price differences with French products would still be prohibitive. Ultimately it would not be possible to avoid further shifts in production to

low-wage countries, with the consequent job losses. Furthermore, from a European perspective the non-cooperative character of this kind of measure could lead our European partners to adopt reciprocal measures, which would be detrimental to exports and employment.

The slogan "buy French" masks a refusal to see that the downturn is a global phenomenon which calls for a comprehensive response at the European level, and a refusal to consider a proactive industrial policy that takes into account the realities of supply as well as demand.

This is not just a matter of looking the other way. France is undergoing a deindustrialization process that threatens its capacity for growth. But who can deny that this phenomenon has accelerated with the crisis and that this acceleration is set to increase as the general austerity measures and restrictions on bank credit further undermine domestic and European demand for consumer durables? Unless we are willing to accept that an entire segment of industry in France and elsewhere in Europe is destroyed, with no hope of ever returning, and with as a consequence still greater disparities between countries and sharper conflicts of interest, it is clearly urgent to support this kind of demand.

Is this kind of support "the solution"? Of course not: propping up demand will not be enough, as an industrial policy aimed at strengthening the supply side is also needed. The point is not to protect domestic production nor to promote the conquest of foreign markets through competition on taxation or social charges, but to stimulate investments designed to produce new goods and services, which is the only way to create stable jobs. Rather than try to rely on dubious slogans, the goal should be to consolidate production that has the advantage of being high quality in terms of design, safety and reliability, and which corresponds to what French and European consumers genuinely want.

What employment policy during a crisis?

By Marion Cochard

After a lull of only a year, unemployment figures started to rise again in April 2011. We are seeing a replay of the dynamics of the 2008 recession: a hiring freeze and the non-renewal of temporary and fixed-term ("CDD") contracts, with redundancies to follow later in the year. The reason, of course, is the current economic downturn, which is hitting while French business margins are still in bad shape after the shock of 2008-2009, particularly in industry. The weakened companies no longer have the strength to cushion the fall as they did four years ago. The French economy is thus expected to slide into recession in the fourth quarter of 2011, and we foresee a fall in activity of 0.2% in 2012. Given that annual growth of 1.1% is needed to kick-off job creation, the resumption of job losses seems inevitable. If we add the existence of a growing workforce to this bleak picture, the number of unemployed will surpass the 3 million threshold by year end.

On the eve of a tense social summit, what are the options for cushioning the impact of the crisis on the labor market? Given the urgency of the situation, the government has two main levers that are responsive and inexpensive: partial unemployment and subsidized jobs in the non-profit sector.

Partial unemployment can cushion the economic hardships faced by business and retain skills in the companies. There is substantial room to expand its use. By way of comparison, in 2009 maximum compensation for partial unemployment was extended to 24 months in Germany, versus 12 months in France. In addition, the greater level of state coverage in Germany partly explains how extensively it is taken up there: partial unemployment affected 1.5 million people at the peak of the crisis, but only 266,000 in France. Nor does this put much of a burden on public finances, as the 610 million euros disbursed by the States on partial unemployment in 2009 were offset by savings on unemployment benefits and the preservation of human capital.

But partial unemployment benefits workers in stable industrial jobs above all, while the brunt of the crisis is being borne by those in precarious employment and young people. These are the sections of the population targeted by subsidized employment. Again, the government has some leeway, because 70,000 subsidized non-profit contracts were eliminated since end 2010 and 300,000 since the early 2000s, and it is also not a very expensive scheme. The creation of 200,000 jobs would for instance cost the state 1 billion euros – contrast this with the shortfall of 4.5 billion euros due to the tax exemption of overtime, which, furthermore, is inconsistent with the logic of partial unemployment. These programs are targeted at those among the unemployed who are most isolated from the labor market – the long-term unemployed and unskilled – and would lower their risk of dropping out of the labor market.

However, even though these tools should be used immediately, they are still just stop-gaps. Partial unemployment remains confined to 80% of industry and designed for short-term use. If today’s dire economic situation continues, we know that this approach will only delay layoffs. Similarly, subsidized jobs are not intended to be long-term. These are low-paid

part-time jobs intended to deal with reintegration into the labor market, and not a long-term approach.

The biggest challenge is really a correct diagnosis of the current economic situation. By focusing negotiations on the issue of partial unemployment and subsidized jobs, the government seems to be betting on a quick recovery. Yet it is precisely the combined effect of austerity plans throughout Europe that will weigh on growth in the years to come. Furthermore, the policy of reducing public deficits, which will cost 1.4 percentage point of growth in France in 2012, is expected to continue at least into 2013. It is difficult in these circumstances to expect to pull out of the stagnant situation quickly enough to avoid the looming social catastrophe. Unless there are plans for a new permanent reduction in working hours and the creation of public sector jobs, the best employment policy remains growth. It is thus the issue of macro-economic governance that is posed above all today in France and throughout the euro zone.

In defense of France's "family quotient"

By Henri Sterdyniak

At the start of 2012, some Socialist Party leaders have renewed the claim that the "family quotient" tax-splitting system is unfair because it does not benefit poor families who do not pay taxes, and benefits rich families more than it does

poor families. This reveals some misunderstanding about how the tax and social welfare system works.

Can we replace the family quotient by a flat benefit of 607 euros per child, as suggested by some Socialist leaders, drawing on the work of the Treasury? The only justification for this level of 607 euros is an accounting device, *i.e.* the total current cost of the family quotient uniformly distributed per child. But this cost stems precisely from the existence of the quotient. A tax credit with no guarantee of indexation would see a quick fall in its relative purchasing power, just like the family allowance (*allocation familiale* – AF).

With a credit like this, taking children into account for taxation purposes would lose all sense. As shown in Table 1, families with children would be overtaxed relative to childless couples with the same income (per consumption unit before tax), and their after-tax income would be lower. The Constitutional Council would undoubtedly censor such a provision.

France is the only country to practice a family quotient system. Each family is assigned a number of tax parts or shares, P, based on its composition; the shares correspond roughly to the family’s number of consumption units (CU), as these are defined by the OECD and INSEE; the tax system assumes that each family member has a standard of living equivalent to that of a single earner with revenue R/P; the family is then taxed like P single earners with income R/P.

The degree of redistribution assured by the tax system is determined by the tax schedule, which defines the progressivity of the tax system; it is the same for all categories of households.

The family quotient (QF) is thus a logical and necessary component of a progressive tax system. It does not provide any

specific support or benefit to families; it merely guarantees a fair distribution of the tax burden among families of different sizes but with an equivalent standard of living. The QF *does not* constitute an arbitrary support to families, which would increase with income, and which would obviously be unjustifiable.

Let's take an example. The Durand family has two children, and pays 3358 euros less than the Dupont family in income tax (Table 1). Is this a tax benefit of 3358 euros? No, because the Durands are less well off than the Duponts; they have 2000 euros per tax share instead of 3000. On the other hand, the Durands pay as much per share in income tax as the Martins, who have the same standard of living. The Durands therefore do not benefit from any tax advantage.

The family quotient takes into account household size; while doing this is certainly open for debate, one cannot treat a tax system that does not take into account household size as the norm and then conclude that any deviation from this norm constitutes a *benefit*. There is no reason to levy the same income tax on the childless Duponts and the two-child Durands, who, while they have the same level of pay, do not enjoy the same standard of living.

Table 1. Family size and income taxation in euro

		Monthly wages / by tax share	Annual income taxation	Disposable income by consumption unit
Dupont	Couple	6 000/ 3000	8 472	2 526
Martin	Couple	4 000/ 2000	3 409	1 858
Durand	Couple + 2 children	6 000/ 2000	5 114	1858
Durand*	Couple + 2 children	6 000/ 2000	7 258	1798

* with a uniform tax credit.
Source: author calculations.

In addition, capping the family quotient [1] takes into account that the highest portion of income is not used for the consumption of the children.

Society can choose whether to grant social benefits, but it has no right to question the principle of the fairness of

family-based taxation: each family should be taxed according to its standard of living. Undermining this principle would be unconstitutional, and contrary to the Declaration of the Rights of Man, which states that “the common taxation … should be apportioned equally among all citizens according to their capacity to pay”. The law guarantees the right of couples to marry, to build families, and to pool their resources. Income tax must be family-based and should assess the ability to pay of families with different compositions. Furthermore, should France’s Constitutional Council be trusted to put a halt to any challenge to the family quotient? [2]

The only criticism of the family quotient system that is socially and intellectually acceptable must therefore focus on its modalities, and not on the basic principle. Do the tax shares correspond well to consumption units (taking into account the need for simplicity)? Is the level of the cap on the family quotient appropriate? If the legislature feels that it is unable to compare the living standards of families of different sizes, then it should renounce a progressive system of taxation.

Family policy includes a great variety of instruments [3]. Means-tested benefits (RSA, the “complément familial”, housing benefit, ARS) are intended to ensure a satisfactory standard of living to the poorest families. For other families, universal benefits should partially offset the cost of the child. The tax system cannot offer more help to poor families than simply not taxing them. It must be fair to others. It is absurd to blame the family quotient for not benefitting the poorest families: they benefit fully from not being taxed, and means-tested benefits help those who are not taxable.

Table 2 shows the disposable income per consumption unit of a married employed couple according to the number of children, relative to the income per consumption unit of a childless couple. Using the OECD-INSEE CUs, it appears that for low-income levels families with children have roughly the same

standard of living as couples without children. By contrast, beyond an earnings level of twice the minimum wage, families with children always have a standard of living much lower than that of childless couples. Shouldn’t we take into account that having three or more children often forces women to limit their work hours or even stop work? It is the middle classes who experience the greatest loss of purchasing power when raising children. Do we need a reform that would reduce their relative position still further?

Table 2. Living standard of a family according to the number of children and employment status relatively to a couple without children

In euro per month by CU in 2009

Adult 1	MI	MW	MW	MW	2 MW	3 MW	6 MW
Adult 2	Inactive	Inactive	½ MW	MW	1 MW	2 MW	4 MW
1 child	99.9	99.4	89.9	85.0	84.9	85.5	85.2
2 children	102.6	97.5	87.1	79.9	77.1	76.2	75.7
3 children	105.8	98.4	93.6	84.0	75.7	70.6	70.5

MI: minimum income; MW: minimum wage.
Source: author’s calculations.

The standard of living of the family falls as the number of children rises. Having children is thus never a tax shelter, even at high income levels. So if a reform of family policy is needed, it would involve increasing the level of child benefit for all, and not the questioning of the family quotient system.

Overall, redistribution is greater for families than for couples without children: the ratio of disposable income between a couple who earns 10 times the minimum wage and a couple who earns the minimum wage is 6.2 if they have no children; 4.8 if they have two children; and 4.4 if they have three. The existence of the family quotient does not reduce the progressivity of the tax and social welfare system for large families (Table 3).

Table 3. Income distribution is more equal between families

	10*minimum wage/ minimum income	10*minimum wage/ 1*minimum wage
0 child	9.2	6.2
1 child	7.8	5.3
2 children	6.8	4.8
3 children	6.0	4.4
4 children	5.7	4.2

Source: author's calculations.

Consider a family with two children in which the man earns the minimum wage and the wife doesn't work. Every month the family receives 174 euros in family benefits (AF + ARS), 309 euros for the RSA and 361 euros in housing benefit. Their disposable income is 1916 euros on a pre-tax income of 1107 euros; even taking into account VAT, their net tax rate is negative (-44%). Without children, the family would have only 83 euros for the PPE and 172 euros in housing benefit. Each child thus "brings in" 295 euros. Income is 912 euros per CU, compared with 885 euros per month if there were no children. Family policy thus bears the full cost of the children, and the parents suffer no loss of purchasing power due to the presence of the children.

Now consider a large wealthy family with two children where the man earns 6 times the minimum wage and the woman 4 times. Every month this family receives 126 euros in family benefits and pays 1732 euros in income tax. Their disposable income is 7396 euros on a pre-tax income of 10,851 euros; taking into account VAT, their tax rate is a positive 44%. The French system therefore obliges wealthy families to contribute, while financing poor families. Without children, the wealthy family would pay 389 euros more tax per month. Its income per CU is 4402 euros per month, compared with 5819 euros if there were no children. The parents suffer a 24.4% loss in their living standard due to the presence of the children.

Finally, note that this wealthy family receives 126 euros per month for the AF, benefits from a 389 euro reduction in income tax, and pays 737 euros per month in family contributions.

Unlike the poor family, it would benefit from the complete elimination of the family policy.

It would certainly be desirable to increase the living standards of the poorest families: the poverty rate for children under age 18 remains high, at 17.7% in 2009, versus 13.5% for the population as a whole. But this effort should be financed by all taxpayers, and not specifically by families.

No political party is proposing strong measures for families: a major upgrade in family benefits, especially the "complément familial" or the "child" component of the RSA; the allocation of the "child" component of the RSA to the children of the unemployed; or the indexation of family benefits and the RSA on wages, and not on prices.

Worse, in 2011, the government, which now poses as a defender of family policy, decided not to index family benefits on inflation, with a consequent 1% loss of purchasing power, while the purchasing power of retirees was maintained. Children do not vote …

I find it difficult to believe that large families, and even families with two children, especially middle-class families with children, those where the parents (especially the mothers) juggle their schedules in order to look after their children while still working, are profiting unfairly from the current system. Is it really necessary to propose a reform that increases the tax burden on families, especially large families?

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[1] The advantage provided by the family quotient is currently capped at 2585 euros per half a tax share. This level is justified. A child represents on average 0.35 CU (0.3 in the range 0 to 15 year old, and 0.5 above). This ceiling corresponds to a zero-rating of 35% of median income. See H. Sterdyniak: "Faut-il remettre en cause la politique

familiale française?" *[Should French family policy be called into question?], Revue de l'OFCE*, no. 16, January 2011.

[2] As it has already intervened to require that the Prime pour l'emploi benefit takes into account family composition.

[3] See Sterdyniak (2011), *op.cit.*

AAA, AA+: much Ado About no+hing?

by Jérôme Creel

The loss of France's AAA rating on Friday the 13th ofJanuary 2012 was a historic event. It poses three questions: should the austerity measures announced in autumn 2011 be strengthened? Why has Germany been singled out? And what is to be done now?

The loss of the AAA rating on French government bonds is not surprising – far from it. The sovereign debt crisis that has shaken the euro zone for over two years, starting in the autumn of 2009, was not managed properly because it occurred during a recession, at a time when all the EU Member States had their eyes glued to their own economic difficulties. In the absence of a concerted response that included immediate solidarity and mutual guarantees by the euro zone Member States of the zone's entire public debt, with the support of the European Central Bank (cf. Catherine Mathieu and Henri Sterdyniak, here), the foreseeable contagion occurred. The objective public finance mistakes committed by successive

Greek governments followed by the vagaries of the Irish banks have now led to a systemic crisis in Europe.

By implementing austerity measures simultaneously, Europe's governments have magnified the economic difficulties: economic stagnation and even recession are now on the agenda for the euro zone (cf. Xavier Timbeau *et al.*, here). A downgrade of debt ratings in the euro zone was thus to be expected. It does, however, raise three questions.

1. Should the austerity measures be strengthened? In a commentary on the supplementary 7 billion euro French austerity plan announced in November 2011, Mathieu Plane (see in French here) pointed out that the race for the AAA rating had already been lost. The impact of this austerity plan on economic growth was objectively inconsistent with the fiscal consolidation target – and Standard & Poor's was surely not unaware of this argument.
2. Why did S&P single out Germany and Slovakia, the only economies in the euro zone not downgraded on Friday 13 January? While their commercial links are undeniable (cf. Sandrine Levasseur, 2010, here), which could justify their comparable treatment, the main markets for both of these economies, and particularly Germany, lie in the euro zone. Slowing growth in the euro zone outside Germany will not leave the other side of the Rhine unaffected (cf. Sabine Le Bayon, in French here). It is difficult to see how the contagion of the crisis could stop at the borders of Germany and Slovakia. The recent take-up of German government 6-month bonds at a negative interest rate could even be interpreted to reflect extreme distrust of Germany's commercial banks. In any case, its economy, situated in the euro zone, is no less fragile than that of France.
3. What should be done now in France? The loss of the AAA rating reflects a negative outlook both for the state of

public finances and for economic growth. While Germany has not been downgraded, it is possible that this is because S&P takes a positive view of its non-cooperative strategy in the past. From this perspective, the principle of a social VAT measure can be considered a way to help France catch up with Germany in terms of competitiveness, as Jacques Le Cacheux points out (here): if the Germans did it, why can't we? This would help boost tax revenue by increasing the competitive advantage of businesses established in France. If such a measure were to be adopted, Germany and France would be on equal footing. The two countries could then sensibly consider a cooperative policy for a recovery in Europe. Some possible focuses include: industrial policy (cf. Sarah Guillou and Lionel Nesta, in French here); social policy; an ambitious climate and energy policy (cf. Eloi Laurent, here); and a financial policy that includes a common tax on financial transactions, with the revenue raised being used to ensure that the taxpayer would never again need to bail out the private banks, which would free up additional maneuvering room for the first three policies. The policy outlines would of course need to be defined, but it is crucial to recognize that policy action is urgently needed.

"Social VAT": Is it anti-social?

by Jacques Le Cacheux

The prospect of a "social" value added tax, which was raised anew by the President of France on December 31 during his New

Year speech, is once again provoking controversy. While the French employers association, the MEDEF, has included this measure in a series of proposed tax changes designed to restore France's competitiveness, the Left is mostly opposed. It views the "social VAT" as an oxymoron, an antisocial measure that is designed to cut the purchasing power of consumers and hits the poorest among them disproportionately and unfairly. But what exactly are we talking about? And from the viewpoint of taxes on consumption, what is the situation in France relative to its main European partners?

The proposal to establish a social VAT represents, in fact, a combination of two measures: raising the VAT rate and allocating the additional revenue obtained to finance social welfare, while lowering – in principle by the same amount – social contributions. The way that these two operations are conducted can differ greatly: the rise in VAT could involve the standard rate (currently 19.6%), the reduced rate (currently 5.5%, but recently increased to 7% for a range of products and services), the creation of an intermediate rate, a switch to the standard rate of certain products or services currently at the reduced rate, etc., while the reduction in social contributions could cover employer contributions or employee contributions, be uniform or targeted on low wages, etc. Many policy choices are available, with distributional impacts that are not identical.

France now has one of the lowest rates of implicit taxation on consumption in the European Union (Eurostat). Its standard VAT rate was reduced to 19.6% in 2000 after having been raised to 20.6% in 1995 to help ensure compliance with the Maastricht criteria, as the recession of 1993 had pushed the budget deficit significantly higher. This rate is now slightly lower than the rate applied by most of our partners, particularly as the deterioration of public finances has recently prompted several European countries to raise their standard rate of VAT. The reduced rate, at 5.5%, was, until the increase

decided in December 2011 on certain products and services, the lowest in the EU.

What can we expect from a social VAT? Let's consider in turn the effects on competitiveness and then on purchasing power, while distinguishing the two aspects of the operation. A VAT hike has a positive impact on the competitiveness of French business, because it increases the price of imports without burdening exports, which are subject to the VAT of the destination country. In this respect, a VAT increase is equivalent to a devaluation. In so far as most of France's trade is conducted with our European partners within the European single market, this could be deemed a non-cooperative policy. Fine, but if all our partners were to use this type of "internal euro zone devaluation" – recall that in 2007 Germany increased its standard VAT rate from 16% to 19% – and we didn't, this would actually amount to a real appreciation of the "French euro". It would undoubtedly be better to aim for improved fiscal coordination in Europe, and to work for more uniform rates. But current circumstances are hardly favourable for that, and the threat of a VAT increase may be one way to encourage our main partner to show more cooperation on this issue.

Allocating the revenue raised to reduce social contributions will, in turn, have an additional positive impact on competitiveness only if it leads to a real reduction in the cost of labour to firms located in France. This would be the case if the reduction targeted employer contributions, but not if it were on employee contributions.

Can we expect a positive effect on employment? Yes, at a minimum thanks to the impact on competitiveness, but this would be small, unless we were to imagine a massive increase in VAT rates. The effect of lowering labour charges is less clear, because the employers' social contributions are already zero or low on low wages, which, according to the available studies, is precisely the category of employees for which

demand is sensitive to cost.

Isn't the decline in the purchasing power of French households likely to reduce domestic consumption and cancel out these potential gains? In part perhaps, but it's far from certain. Indeed, the rise in VAT is unlikely to be fully and immediately reflected in selling prices: in the case of Germany in 2007, the price increase was relatively small and spread over time –meaning that the margins of producers and distributors absorbed part of the increase, thus reducing the positive impact on business somewhat. In France, empirical work on the increase in 1995 shows that it too was not fully and immediately reflected in prices; and, although one cannot expect symmetrical results, it's worth recalling that the cut in VAT in the restaurant business was not passed on much in prices.

Would the rise in VAT be "antisocial" because it winds up hitting the poorest households disproportionately? No! Don't forget that the minimum income, the minimum wage (SMIC) and pensions are indexed to the consumer price index. So unless these indexes were somehow frozen – which the government has just done for some benefits – the purchasing power of low-income households would not be affected, and only employees earning above the minimum wage, together with earnings on savings, would suffer a decline in purchasing power, if consumer prices were to reflect the rise in VAT. It should also be noted that, if there is a positive impact on employment, some unemployed workers would find jobs and total payroll would increase, meaning that the depressive impact on consumption often cited by opponents of this measure would only be minor, or even non-existent.

In short, "social VAT" should be neither put on a pedestal nor dragged through the dirt. As with any tax reform, we should certainly not expect a panacea against unemployment, or even a massive shift in our external accounts, even though it should help to improve our external price-competitiveness. But

rebalancing our tax burden to focus more on consumption and less on the cost of labour is a worthy goal. In the context of globalization, taxing consumption is a good way to provide resources for the public purse, and VAT, a French innovation that has been adopted by almost every country, is a convenient way of doing this and of applying, without explicitly saying so, a form of protectionism through the de-taxation of exports. VAT is not, on the other hand, a good instrument for redistribution, since the use of a reduced rate on consumer products ultimately benefits the better-off as much or more than it does the poor. Most of our European partners have understood this, as they either do not have a reduced rate (as in Denmark) or have one that is substantially higher than ours (often 10% or 12%). It would be desirable to make the French tax system fairer, but this requires the use of instruments that have the greatest and best-targeted potential for redistribution: direct taxes – income tax, CSG-type wealth taxes, property tax – or social transfers, or even certain government expenditures (education, health). What is missing in the proposed "social VAT" is making it part of a comprehensive fiscal reform that restores consistency and justice to the system of taxes and social contributions as a whole.

Monetary policy: Open-Market Operations or Open-Mouth Operations?

By Paul Hubert

Can the communications of a central banker influence agents'

expectations in the same way as they change interest rates? To believe Ben Bernanke, the answer is yes.

In a speech on 18 October 2011, Ben Bernanke, governor of the US central bank, highlighted his interest in finding new tools to help businesses and consumers anticipate the future direction of monetary policy. Thus we learn that the bank's Federal Open Market Committee (FOMC) is exploring ways to make its macroeconomic forecasts more transparent. Indeed, if the publication of the forecasts influences the formation of private expectations about the future, then this could be treated as another tool of monetary policy.

It is worth pointing out that the impact of communicating the central bank's forecasts depends on the bank's credibility. Any impact that the publication of the forecasts has on the economy is neither binding nor mechanical, but rather is channelled through the confidence that businesses and consumers place in the statements of the central bank. So if a statement is credible, then the action announced may not be needed any more or its amplitude may be reduced. The mechanism is straightforward: publishing the forecast changes private expectations, which in turn modifies decision-making and therefore the economic variables. Ben Bernanke's determination to implement what he calls "*forward policy guidance*" and the emphasis he is giving to the importance of the central bank's forecasts suggest that the Fed is seeking to use its forecasts as another instrument to implement its monetary policy more effectively.

Based on the inflation expectations of private agents collected through quarterly surveys called the Survey of Professional Forecasters (available here), it appears that the FOMC inflation forecasts, published twice yearly since 1979, have a persistent positive effect on private expectations (see the working document). Expectations rise by 0.7 percentage point when the Fed increases its forecast by one percentage point. Two interpretations of this effect could be offered: by

raising its forecast, the Fed influences expectations and in a certain sense creates 0.7 percentage point of inflation. The effectiveness of such an announcement would therefore be questionable. In contrast, it is conceivable that an increase of 1 percentage point of inflation will occur and that by announcing it, the Fed sends a signal to private agents. They then expect a response from the Fed to counter the increase, and so reduce their expectation of the increase. The Fed's communication would therefore have succeeded in preventing a 0.3 percentage point increase in future inflation, meaning that the announcement has been effective.

This last mechanism, called "Open-Mouth Operations" in an article published in 2000 dealing with the central bank of New Zealand, would therefore act as a complement to the bank's open market operations that are intended to modify the central bank's key rates so as to influence the economy.

In order to shed light on the reasons why private expectations have increased, it would help to characterize the mechanisms underlying the influence of the FOMC forecasts. If the FOMC forecasts are a good leading indicator of the Fed's future key rates, they provide information about future decisions. It appears from this study that an increase in the FOMC forecasts signals that there will be an increase in the Fed's key rates 18 to 24 months later.

Furthermore, the FOMC forecasts do not have the same impact as the bank's key rates on macroeconomic variables, nor do they respond in the same way to macroeconomic shocks: the responses of key rates to macroeconomic shocks are substantial and rapid in comparison with the responses of the forecasts. This suggests that the FOMC forecasts are an *a priori* instrument intended to implement monetary policy over the long term, whereas the key rates are an *a posteriori* instrument that responds to shocks to the economy, and thus to the short-term cycle.

The very great recession

Economic outlook updated for the major developed countries in 2012

OFCE Department of Analysis and Forecasting, under the direction of Xavier Timbeau

The growth outlook for the developed countries, in Europe in particular, have deteriorated dramatically in recent weeks. The "voluntary and negotiated" devaluation of Greek sovereign debt securities, which is really nothing but a sovereign default, the wave of budget cuts being announced even as budget bills are still debated, the inability of the European Union to mobilize its forces to deal with the crisis – all these factors render the forecasts made two months ago obsolete. For many European countries, including France, 2012 will be a year of recession.

The growth figures for the second quarter of 2011 in the developed countries, published in August 2011, put the positive signals from early 2011 into perspective. In the third quarter of 2011, the national accounts were better than expected, but the respite was short-lived. The economic indicators for most of the developed countries (see below and a companion note) heralded a reduction in activity in the fourth quarter of 2011 and early 2012. The euro zone will be stagnant in 2012, with GDP growth of 0.4% and Germany recording the "best" performance in the euro zone (Table 1).

Tableau 1. prévisions pour 2012

		2011				2012				2011	2012
		t1	t2	t3	t4	t1	t2	t3	t4		
Allemagne	PIB	1,3	0,3	0,5	-0,1	0,1	0,1	0,1	0,1	3,0	0,4
	Taux de chômage	6,1	5,9	5,7	5,7	5,7	5,7	5,7	5,7	5,8	5,7
	Solde public*									-1,2	-1,4
France	PIB	0,9	-0,1	0,4	-0,2	-0,1	0,0	0,0	0,0	1,6	-0,2
	Taux de chômage	9,2	9,1	9,3	9,6	9,9	10,2	10,5	10,7	9,5	10,5
	Solde public*									-5,8	-5,3
Italie	PIB	0,1	0,3	0,1	-0,2	-0,4	-0,4	-0,3	-0,3	0,7	-0,9
	Taux de chômage	8,2	8,1	8,2	8,4	8,6	8,8	8,9	9,0	8,2	8,8
	Solde public*									-3,9	-2,3
Espagne	PIB	0,4	0,1	0,0	-0,1	0,0	0,0	0,0	0,0	0,7	0,0
	Taux de chômage	20,6	21	22,2	22,6	22,8	23	23	23	21,6	23,0
	Solde public*									-7,4	-5,4
Zone euro	PIB	0,8	0,2	0,2	-0,1	-0,1	0,0	0,0	0,0	1,6	0,0
	Taux de chômage	10,0	10,0	10,6	10,8	10,9	11,0	11,1	11,2	10,3	11,1
	Solde public*									-3,5	-2,9
Royaume-Uni	PIB	0,4	0,1	0,5	-0,1	0,0	0,2	0,2	0,2	0,9	0,5
	Taux de chômage	7,7	7,9	8,3	8,5	8,6	8,7	8,8	8,8	8,1	8,7
	Solde public*									-9,1	-8,5
États-Unis	PIB	0,1	0,3	0,6	0,4	0,4	0,1	0,2	0,3	1,7	1,4
	Taux de chômage	8,9	9,1	9,1	8,7	8,7	8,7	8,7	8,7	9,0	8,7
	Solde public*									-9,2	-9,2
Japon	PIB	-0,7	-0,3	1,5	0,7	0,6	0,6	0,4	0,4	-0,1	2,4
	Taux de chômage	4,7	4,6	4,4	4,5	4,5	4,6	4,7	4,7	4,5	4,6
	Solde public*									-8,8	-9,4

* En points de PIB.
Sources : Comptes nationaux, prévisions OFCE décembre 2011.

The first phase of the great recession, in 2008-2009, led to the swelling of public debt (about 16 points in the euro zone, more than 30 points in the US and UK, see Table 2). Phase II will be determined by how the public debt caused by the crisis has been digested: either low interest rates will make it possible to postpone the adjustment of public deficits and the economies can bounce back, thus easing the necessary adjustment, or the adjustment will be immediate, amplified by higher public interest rates and the persistence of under-employment (Table 3). Gripped by the fear of default, Europe is transforming the *great* recession that began in 2008 into a *very great* recession.

Tableau 2. Besoins de financement, dettes publiques et caractéristiques de ces dettes

	All	Fra	Ita	Esp	RU	USA	JPN	ZE 4
Besoin de financement sur les marchés en 2012								
En milliards	255 Md€	295 Md€	391 Md€	175 Md€	257 Md£	3151 Md$	226 tn ¥	1116 Md€
En point de PIB	9,8	14,1	24,4	15,8	16,5	19,8	47,4	13,1
dont déficit public financé par appel au marché en 2012								
En milliards	20 Md€	78 Md€	31 Md€	57 Md€	134 Md£	910 Md$	32 tn ¥	186 Md€
En point de PIB	0,8	3,7	1,9	5,1	8,6	5,7	6,7	2,5
dont dette arrivant à maturité financée par appel au marché en 2012								
En milliards	235 Md€	217 Md€	360 Md€	118 Md€	122 Md£	2241 Md$	194 tn ¥	930 Md€
En point de PIB	9,0	10,4	22,5	10,6	7,8	14,1	40,7	12,6
Dette publique totale - 2011								
En milliards d'euros	2 082	1 693	1 884	568	1 381	11 064	9 516	6 207
En milliards de dollars	2 795	2 294	2 553	770	1 871	14 994	12 896	8 412
En milliards d'euros PPA 2010	2 051	1 825	1 869	500	1 283	10 210	11 144	6 216
En dollars par tête	34 181	35 238	42 109	16 695	29 972	46 510	101 136	35 171
En point de PIB	80,3	83,7	118,7	52,4	78,3	98,1	213,4	83,5
Variation par rapport à 2007	15,4	19,9	15,1	16,5	34,0	33,5	46,5	16,8
Dette publique de marché estimée au 31 décembre 2011								
En milliards d'euros	1 108	1 315	1 571	558	1 526	7 297	6 727	4 553
En milliards de dollars	1 502	1 782	2 129	756	1 797	9 890	9 116	6 168
En milliards d'euros PPA 2010	1 102	1 416	1 558	490	1 809	9 890	11 568	4 538
En point de PIB	43,1	65,0	99,0	51,6	75,4	64,8	150,8	62,7
En dollars par tête	18 368	27 385	35 116	16 572	28 786	30 678	71 505	24 122
Caractéristiques de la dette de marché								
Taux d'intérêt moyen sur la dette en 2011	nd	3,1	nd	4,0	2,2	3,1	1,0	nd
Taux d'intérêt moyen sur les émissions en 2011	nd	nd	3,5	nd	2,8	nd	0,5	nd
Taux d'intérêt moyen sur les émissions en 2012	0,9	1,5	4,5	5,0	2,0	1,4	0,5	2,9
Taux d'intérêt sur les émissions à 10 ans en 2012	2,8	3,2	6,5	5,5	2,5	2,2	1,1	4,5

Note : la PPA est calculée par rapport à la zone euro, et tient compte des différentiels de niveaux de prix entre pays de la zone euro.
Source : calculs OFCE décembre 2011, Eurostat, Agences du trésor nationales.

Tableau 3. Évolution de la situation des chômeurs entre 2007 et 2010

En points de population active

Évolution entre 2007 et 2010	Allemagne	Espagne	France	Italie	RU
chômage	-1,6	11,9	1,3	2,4	2,6
chômage de longue durée	-1,5	5,7	0,5	1,2	1,3
chômage non indemnisé	-0,3	5,7	0,5	2,0	4,3

Source : Eurostat.

After the “voluntary” Greek default, the euro zone countries have inflicted on themselves not only an adjustment that was even more brutal than that required by the Stability and Growth Pact, but also contagion and a general collapse in sovereign debt. The measures proposed by the European Union, from the EFSF to the adoption of the “golden rule”, have not been persuasive of its ability to solve the public finance problems of the euro zone members either in the short or long term, especially as Europe seems to have forgotten that growth and the restoration of full employment are fundamental to the sustainability of public debt and to the European project more generally.

Faced with the risk of insolvency on sovereign debt, creditors are demanding higher risk premiums to continue to fund both new debt and the renewal of the fraction of old debt that is expiring. The hardening of financing conditions, even as business prospects are deteriorating as a result of budget cuts, is nipping attempts at fiscal consolidation in the bud. The result: a downward spiral. The rising cost of debt adds to interest charges, which undercuts deficit reduction and leads to additional fiscal discipline to reassure donors. The added restrictions weigh on activity and wind up augmenting the cyclical deficits – at which point the governments, panicked at the stubborn resistance of the deficits and the prospect of a downgrade in their sovereign rating, respond with even greater rigor.

Because the economies of the European countries are so closely intertwined, the simultaneous implementation of restrictive fiscal policies leads to magnifying the global economic slowdown by undercutting foreign trade (we developed this point in our previous forecasting exercise). Restrictive

policies hit domestic demand in whichever countries implement them and thus reduce their output, but also their imports. This dynamic decreases the exports of their trading partners, and therefore their activity, regardless of their own fiscal policies. If these partners also implement a restrictive policy, then an external impact has to be added to the internal restriction (an indirect effect). The magnitude of these effects depends on several factors. The direct effects are mainly linked to negative impulses within each country. The indirect effect is more difficult to measure, since it depends on the degree of openness of each country, the geographical distribution of its exports and the elasticity of imports to GDP of the countries that are tightening their policy. Thus, a very open country for which the majority of exports are going to a country undertaking severe budget cuts will suffer a strong indirect effect. In this respect, the highly integrated countries of the euro zone will suffer more from the restrictive policies of their partners than will the United States or Japan. Their growth will be seriously curtailed, pushing back deficit reduction. In many countries, the coming recession is the result of the increasingly restrictive measures being taken to try to stabilize their debt / GDP ratio as soon as possible in an increasingly unfavourable economic environment.

The race to tighten up to try to bring public deficits below 3% of GDP and to stabilize debt ratios is aimed as much at meeting the requirements of European agreements as it is at reassuring the rating agencies and financial markets. The latter, among them the European banks, hold at least 50% of the public debt of the developed countries in the form of securities issued by the national debt agencies. This percentage varies from 77% of the public debt held by financial institutions in France to 97% for Spain.

In the euro zone, between 9 and 23 percentage points of GDP of public debt, depending on the country, needs to be renewed in

2012 (see Table 2). Outside of Japan, it is Italy, which combines a high debt with a large proportion of short-dated securities, which will have the largest financing requirement. If requirements related to the financing of the public deficit in 2012 are added to this, then the potential for total issues in the euro zone ranges between 10% of GDP in Germany to 24% in Italy.

These high levels are posing problems for countries that have lost the confidence of the markets. If the interest rates at which these countries are financed in 2012 remain at their average levels for the last quarter of 2011, Spain would borrow at 5% and Italy at 4.3%. France and Germany, however, would continue to benefit from low interest rates (1.5% and 0.9% respectively). The issue rates in December 2011 for these two countries have up to now been little affected by the threats to downgrade the sovereign debt of the euro zone countries. Even though the financing need from the markets was greater in 2012 for the United Kingdom, the United States and Japan than for the euro zone, their rates have remained low. Paradoxically, the downgrading of the US sovereign rating in August 2011 was accompanied by a decrease in 10-year rates and short-term rates in the United States. Within this context of a flight to safety, the programs of massive purchases of government securities on the secondary market that were implemented by the Federal Reserve (FED), the Bank of England (BoE) and the Bank of Japan have been keeping public long-term rates low. Monetary policy is also affecting short-term interest rates as well as long-term rates. The role of lender of last resort being adopted by these central banks is thus reassuring the markets and avoiding higher interest rates during Treasury auctions. In contrast, the ECB’s mandate and the strict supervision of Europe’s legal scaffolding limit ECB action. The relatively low amounts of government bonds purchased since 2010 (2.3% of euro zone GDP compared with 11% of US GDP for the Fed and 13% of UK GDP for the BoE) and tension between euro zone countries concerning the role of the

central bank is fueling demands by investors to protect their risks by raising premiums.

To stop the collapse of European sovereign debt, we must rule out any possibility of a sovereign default, public interest rates must be reduced to the maximum by all means possible, and a European strategy for stabilizing the public debt needs to be implemented, first by dealing with under-employment, thereby renewing growth, followed by an adjustment of public finances.

Post-Durban: For a Sino-European axis

By Eloi Laurent

The European Union absolutely must stay the course at the Durban conference and afterwards, not only by reaffirming its climate goals but even more by consolidating these through the improved control of its carbon linkages (see the OFCE note in French: *The European Union in Durban: Hold the course*), that is to say, the overall impact of its economic growth. This requires moving – on its own if necessary – from a target for 2020 of a 20% reduction in its greenhouse gas emissions to a target of 30% of its emissions, which is more in synch with the goal that it has endorsed of limiting global warming to 2°C compared to the pre-industrial era.

The possibility of transitioning the global economy towards a low-carbon economy depends on Europe's determination. As the largest market in the world, the EU possesses great power over the environmental policies of the world's other countries: the more ambitious it is in terms of the climate, the more its

influence and leadership will spur the ambitions of other countries too.

But the pursuit of the de-carbonization of the European economy requires the reform and coherent articulation of EU and national economic policy tools.

For France, this means achieving its climate targets (the division of its emissions by four by 2050, called the "factor 4" approach) by introducing a price signal to contain emissions from diffuse greenhouse gas emissions (*i.e.* from housing and transport) that are not included in the European carbon market. To be clear, it will be necessary to introduce a carbon tax that spells out how it will be integrated into the French tax system. A recent study by the OFCE shows that this may well generate a dual dividend, both social and environmental. The Perthuis report is quite clear on this point: with the support of a price signal, the French climate transition will generate jobs. This transition should not, however, neglect issues of social justice, starting with the urgent problem of fuel poverty.

The European Union must also speed up the reform of its carbon markets, whose price signal is now almost inoperative (a tonne of CO2 has fallen to 7 euros). These markets could be significantly affected by the outcome of the Durban conference, as was the case after the summit in Copenhagen. Various options exist, such as to establish a Europe-wide central carbon bank.

Finally, the introduction of a carbon tariff at the borders of the European Union could restore coherence to the region's climate policy by addressing the problem of carbon leakage and imported emissions and by providing a source of funding for the Green Fund, whose architecture might be the only genuine accomplishment of Durban.

There are, ultimately, three fundamental reasons why the EU

needs to confirm and reinforce its climate goals at Durban and especially “post-Durban”:

1. The first concerns the human security of Europeans: the EU needs to reduce its emissions of greenhouse gases because, as is shown by a recent report by the IPCC, these are at the origin of the proliferation of extreme weather events on our planet, and this will be even more the case in the future. The European Union has experienced nearly 350 of these events during the Noughties alone, almost four times more than in the 1980s. The heat wave of summer 2003, alone, cost the lives of 70,000 Europeans.
2. The second reason relates to the economic prosperity of Europeans. The EU needs to strengthen its comparative environmental advantage and free itself as soon as possible from the fossil fuel trap. Europe’s dependence on carbon has only increased over the past two decades. The rate of energy dependence of the EU member countries rose by an average of about 10 percentage points over the last fifteen years, to 53% in 2007, including 82% for oil and 60% for natural gas, which between them account for 60% of all energy consumed in the EU. Conversely, the short-term economic cost (not including the longer-term benefits) of switching from a 20% target for the reduction of emissions to a 30% reduction by 2020 is minimal, on the order of about 0.6% of the EU’s GDP per year (estimated by the European Commission).
3. The third reason, and perhaps the most fundamental, concerns the need today for the political cohesion of the European Union. What is necessary now is nothing less than rebuilding the European Union, which has been devastated economically and politically by the global crisis. The prospect of the coordinated economic depression currently being proposed to European citizens

> by their governments will signal the breakup of the euro zone but also in turn, it can be feared, a halt to the construction of Europe and even its unraveling. The ecological transition may indeed "save the climate", but it can also save Europe by giving it a future once again.

The best hope for what is already being called "post-Durban" may well lie in the establishment of a Sino-European axis on the climate: China is becoming aware that its impact on climate change is matched only by the impact of climate change on it (the world's largest emitter, it will in turn be the first victim of its emissions). As a result of the desertion by the US, Europe can confirm its role as global leader on the climate.

Europe's leaders sometimes seem annoyed to be alone among the developed countries to assume this responsibility, and they are tired of suffering the criticisms reserved for the one who wields the baton, even though the EU is the only region in the world to have met its Kyoto commitment, the only one to have set itself interim targets on the reduction of greenhouse gas (GHG) emissions, and the only one capable of meeting these goals. This European annoyance is misplaced: given the disasters that science is warning us of, the fight against climate change could be Europe's greatest contribution to the future of humanity. Holding the course on the climate is a compelling duty. It also just happens to be in Europe's interest.

Regaining confidence in the

euro: Three pressing issues

By Jérôme Creel

In a communication on European economic governance before the European Parliament's ECON Committee on Monday, 17 October 2011, three pressing issues were identified in order to save the euro and improve its management.

Saving the euro without further delay is the priority. To do this, it is necessary to provide the EFSF with sufficient funds and to require the ECB to continue intervening in the market for government bonds, so as to resolve the difference between the long-term rates of the peripheral countries and those in the countries in the heart of the euro zone (Germany, France, Netherlands), where these rates are falling and thus benefiting these countries, whereas the rise in the periphery is placing a heavy burden on the public finances of Greece, of course, but also of Portugal and Spain.

Second, the new legislation amending the Stability and Growth Pact and setting up a symmetrical device for monitoring macroeconomic imbalances needs to be implemented as soon as possible. This second priority is urgent, too: it should in the future allow the euro zone to avoid a new crisis, or at least to protect itself with proper instruments and surveillance. In this context, the European Parliament is being asked to "check the checkers" so as to give a real boost to Europeans' trust in their institutions.

Finally, it is necessary to ensure the proper functioning of European governance. Nothing has been lost, intelligent rules do exist: they must be applied after consultation. Inflation targeting on the monetary side and a genuine golden rule of public finances on the budget side both need to emerge.

Communication to the European Parliament ECON Committee, 17 October 2011

Dear Honorable Members,

After almost two years of European turmoil related to the bad management of public finances in a few Eurozone countries, and more than four years after a deep worldwide crisis, time is certainly ripe for reaching European solutions to cure the crisis. Two emergencies are at stake: first, stopping distrust's contagion vis-à-vis Eurozone members; second, stopping misbehaviors' contagion among Eurozone members in the future. By the way, this second emergency certainly necessitates a separation between two periods: the short run and the longer run.

1. Short run emergency 1: improving trust in the Euro

In order to cope with the first emergency, Eurozone countries need a more automatic solidarity mechanism. There have been different options discussed and implemented so far at the Eurozone level, from the EFSF (then future ESM) to Eurobonds, or the intervention of the ECB on secondary markets. They all need to be enforced and implemented as soon as possible without limitations, otherwise discrepancies in long-term yields on public bonds will continue to grow across Eurozone members, at the expense of countries with twin deficits and at the benefit of countries which are closer to twin balance. Without strong automatic interventions, Eurozone countries take the risk of feeding distrust in their ability to support the Euro. The consequence might be distrust in the future of the Euro, distrust in the future of the EU project.

2. Short run emergency 2: enforcing the "6-pack" with improvement in its democratic content

In order to cope with the second emergency, the European Commission, the President H. van Rompuy and the European Parliament have dealt with the EU governance of the near future through a "6-pack" of legislative amendments which were adopted on 25 September 2011.

A major step has been made in the good direction: macro imbalances are no longer automatically related to deficits as they may also refer to surpluses; and a macro imbalance can be considered "excessive" only to the extent that it "jeopardizes or risks jeopardizing the proper functioning of the EMU". This is clear understanding that provided Eurozone countries are primarily partners rather than competitors, their trade links shall not be automatically confounded with risky imbalances for they do not impinge on the common currency, the Euro.

The "6-pack" also deals with the better enforcement of the Stability and Growth Pact, introducing earlier sanctions, and a more comprehensive fiscal surveillance framework. This is certainly necessary to make sure that the risk of moral hazard in the Eurozone is reduced to a minimum. However, the overall '6-pack' must pass beforehand criteria for the effectiveness of a fiscal rule.

There have been different ways to assess reform proposals for economic policies. A well-known and convenient one is a set of criteria first developed by George Kopits and Steven Symansky at a time when both were working at the IMF. According to them, a fiscal rule is effective if it is well-defined, transparent, simple, flexible, adequate relative to goal, enforceable, consistent and efficient. In an amendment by the European Parliament related to macro imbalances, one can read that the indicators in the scoreboard must be relevant, practical, simple, measurable and available; moreover, flexibility is advocated in the assessment of macro imbalances. The Kopits-Symansky criteria are thus still relevant, and only their seventh criterion, consistency, seems to have been forgotten from the list. Does it reveal that through the current reform proposals, no one wishes to deal with monetary policy, which consistency with fiscal policies might well be assessed, and the other way round?

I have written elsewhere my own views on Kopits and Symansky's set of criteria (Creel, 2003; Creel and Saraceno, 2010), but I

think I need to insist on the simplicity one. I fear the existence of a so-called “simplicity” criterion when complex problems are arising. For instance, a strong public deficit may be due to ‘bad times’ (recession, slow GDP growth), interest rates hikes, wrong policies, a non-existing tax system, etc. A simple rule cannot handle the multiplicity of the causes for a deficit. I also fear that such a criterion is simply disrespectful towards the people: well-informed people can certainly approve complex rules if they believe that those who implement them target the common interest.

It leads me to propose that the “simplicity” criterion is changed into a “democratic” criterion. That change would not be substantial as regards Kopits and Symansky’s justification of their criterion: simplicity is required, they say, to enhance the appeal of the rule to the legislature and to the public. Changing “simplicity” into “democratic” would thus be consistent with their view. It would add two advantages. First, there would be no need to target simple or simplistic rules, if more complex ones are required. Second, to enhance their appeal to the public, these rules should be endorsed and monitored by a Parliament: as their members are the representatives of the public, the latter would be fully informed of the nature and properties of the rule.

What would be the main consequences of assessing reform proposals through the lens of democratic content in the current context? First, the now-complex setting of fiscal rules in the EU, under the amendments of 25 September 2011, is well-defined but it is no longer simple. That should not lead us to assume that these rules will not be efficient. Second, if all European authorities, including the European Parliament, approved a stricter surveillance mechanism for fiscal policies, macro imbalances, and employment guidelines, control over the misbehaving countries should be shared with all these authorities, hence also including the European Parliament. The implication of the latter, with that of the

European Council, would enhance the appropriation of rules by the public, and the trust of the public in their institutions. Third, another consequence would be that automaticity in sanctions should not be an option for automaticity is contradictory with the essence of a democracy: contradictory debates.

Are the current reform proposals respecting the “democratic” criterion? The implication of the EP in these reforms already calls for a positive answer. Nevertheless, the implication of the EP in “checking the checkers” is necessary to achieve a definite positive answer. This implication might be very productive in reassessing the effectiveness of the policies which are undertaken in a country where suspicion of misbehavior is developing. The implication of the Economic Dialogue and the European Semester should also be used to improve trust in the EU institutions and the Eurozone governments, with due respect to the subsidiarity principle. Sharing information, analyses, data should be viewed by all partners as a way to achieve cooperation, keeping in mind that John Nash showed through his solutions that cooperative equilibria always lead to a win-win situation.

“Checking the checkers”, as I mentioned above, involves an informed assessment of the effectiveness of fiscal policies. Such an assessment is not dealt with in the current Stability and Growth Pact. During the procedure of fiscal surveillance, and before sanctioning a country, it is of the highest priority to gauge the effectiveness of a fiscal policy which has led to higher deficits and debts.

Discussions about fiscal policies are usually very pessimistic nowadays, as far as their effectiveness is concerned, but those endorsing these discussions take the risk that the people have finally no trust in their governments, for they are said to follow the wrong policies, and in the European institutions that are not able to stop these policies.

It may be useful to recall (once again?) that a consensus exists in the economic literature about the sign of the fiscal multiplier: it is positive. And because of that, the Chinese, US, German, French, etc. governments decided to increase their deficits through discretionary policies during the worldwide crisis: these governments were conscious that their policies were helpful. Why shouldn't they during other 'bad times'? Why should we all think that a contagion of fiscal restrictions in the EU will help us thrust again? Good policymaking requires that policies are contingent to the economic situation (GDP growth, inflation rate, level of unemployment, etc.).

In my view, at this stage, there are two important prerequisites to a rapid improvement in the EU governance, and I do not think they require a new Treaty. We all know that at the ECB and beyond, some argue that political pressures led this institution to buy public bonds, in contrast, they add, with the EU Treaty. Its independence would have been at stake. For this reason, the first prerequisite is in recalling the independence and mission of the ECB. The ECB is a young institution and it needs confidence in itself, as a teenager does. Once definitely adult, after full confidence is reached, the ECB will not fear coordination or cooperation with governments and the EP that fully respect its independence but may wish to improve the consistency of their policies with its.

The second prerequisite is in recalling the objectives of the EU, growth and stability, and in admitting that there is not a single way to achieve these objectives, for countries are still so different within the EU, even within the Eurozone. The 'one size fits all' is no longer an option, hence the necessity to complement fiscal rules with an assessment of macro imbalances and with regular, transparent, and democratically-controlled assessments of the relevance of the underlying analyses by governments on the one hand, and controllers on the other. There is a strong role for the EP in

acknowledging and managing this no ‘one size fits all’ way of dealing with fiscal rules.

3. Longer run emergency 2: more intelligent rules?

In the longer run, if improvements by the ECB in cooperating with governments have not materialized, a binding commitment to follow a cooperative behavior could be included in the statutes of the ECB. A change in its statutes might also be considered, with a view to adopting, for instance, a dual mandate similar to that of the Fed. That way, it would be clear that “if 5% inflation would have (Central bankers’) hair on fire, so should 9% unemployment” (Ch. Evans, 2011). Another possibility would be to urge the ECB to implement full inflation targeting. That would require the ECB to make public its forecasts and minutes of decisions, thus enhancing information and potentially influencing the private sector.

Lastly, the most important debate on fiscal policymaking is in wondering what governments are doing with tax and spending, and how they finance them. The European Semester and the monitoring of indicators of macro imbalances certainly go in the good direction, but rather than a global view on the evolution of deficits and debts, Eurozone countries should think about circumscribing the good and bad parts of taxes and spending and make sure they all target the good policy, at their benefit and at the benefit of others. Of course, this is not an easy task, but it is a task that would make the EU fiscal rules ever more “intelligent”.

Having common objectives within Europe 2020, it could be thought of having common tools to reach them: a higher EU budget? Or an authentic but modified golden rule of public finance where some expenditures proved to be productive, with the agreement of all EU member states, would be left out of the scope of binding rules? That is not the hot topic of the day, but had it been before the SGP reform of 2005 that the stability of the Eurozone might not have been at stake the way

it has been since the worldwide crisis.

I thank you for your attention.

From Trichet to Draghi: Results and prospects

By Christophe Blot and Eric Heyer

During eight years as head of the ECB, we have seen two Jean-Claude Trichets (JCT): one dogmatic, the other pragmatic. What will be the face of his successor, Mario Draghi of Italy, as he takes office during the unprecedented crisis facing the euro zone?

Over the first five years, the pre-crisis period, we had **JCT the dogmatist:** a very experienced central banker, he scrupulously stuck to his mandate, namely to keep inflation close to 2%. In light of this single criterion, considered essential by the Germans, JCT's record was good, as average inflation in the euro zone during the period was 2.1%. However, several criticisms can be leveled at his post-crisis activity: the first is that in trying to give flesh to the single currency and make it credible, JCT decided to make it "strong" – which is different from "stable". No arrangements were made to control the exchange rate, and he was pleased to see the euro rise from $1.10 in 2003 to almost $1.50 in late 2007, an appreciation of 37%. The dogma of the strong euro, of competitive disinflation, has certainly helped to contain inflation, but at the expense of Europe's competitiveness and growth. A less strict interpretation of price stability would have led the ECB to pay more attention to the euro's exchange rate, which would in turn have promoted more vigorous growth

and employment in the euro zone. Between 2003 and 2007, average annual growth in the euro zone was 0.6 percentage point lower than in the US and the UK (2.1% against 2.7%), and the unemployment rate was more than 3 points higher (8.4% in the euro zone against 5.1% in the US and UK), with comparable performances on inflation. The second criticism has to do with JCT's strict interpretation of the fight against inflation, which led him into a serious miscalculation: in the summer of 2008, just weeks before the collapse of Lehman Brothers, while the US economy was already in recession and fears were growing for Europe, the ECB decided to raise interest rates out of fear of renewed inflationary pressures fueled by the rising prices of energy and food raw materials. However, worrying about inflationary pressures at a time when the global economy was about to sink into the greatest crisis since the 1930s was not very perceptive.

For the past three years, a period of crisis, we've had the **JCT the pragmatist**: in the absence of a system of European governance, JCT has been a pillar of Europe's response to the crisis, as he engaged as equals with heads of state and made significant efforts to rescue the financial system. In this regard, and in contrast to the previous four years, he has taken some liberties with the mandate and statutes of the ECB by implementing unconventional measures, especially at the time of the sovereign debt crisis. But by raising rates since the beginning of the year, against a background of mass unemployment and substantial under-utilization of the euro zone's production capacity, JCT the pragmatist has committed the same error of interpretation as JCT the dogmatist did three years earlier: as the rise in inflation was not associated with the risk of an overheating European economy, but rather had its origin in the rising prices of food and energy raw materials, the rate increases have not had any impact on inflation but, on the other hand, they have contributed a bit to further weakening European growth.

In fact, the ECB quickly revised its diagnosis, leaving the door open to a rapid cut in interest rates. It is also likely that Jean-Claude Trichet would have acted faster had he not been at the end of his term. In doing what he did, JCT avoided locking his successor into a specific scenario, and thus left him a range of options in his first steps at the head of the ECB. Mario Draghi quickly ended any suspense about his intentions by announcing a quarter point cut in interest rates at his first meeting on 3 November. While he was careful to point out that the ECB does not make any commitments to future decisions, the macroeconomic and financial situation points towards at least one further rate cut.

Yet if the question of interest rate policy is a central element of monetary policy and thus of Mario Draghi's mandate, the challenges facing him go far beyond this issue. In the context of the euro zone crisis, the eyes of the world are focused on the ECB's program of securities purchases, which raises the question of the ECB's role in European governance. This question actually involves a number of critical and interdependent matters: the role of lender of last resort, coordination between fiscal policy and monetary policy, and the ECB's role with respect to financial stability.

The current crisis illustrates the difficulties inherent in the functioning of a monetary union that lacks a fiscal union, since in actuality this means that a member of the union is taking on debt in a currency that it does not control. Even though in normal times monetary policy operations in the United States lead the Fed to hold government securities – mostly short-term – the crisis has prompted the US central bank to expand its purchases of securities and to change the structure of its balance sheet by buying government bonds on secondary markets. The Bank of England has taken similar action by purchasing nearly 200 billion pounds of government bonds[1]. As for the Bank of Japan, it has amplified the unconventional measures that were already in place to fight

the deflation that has plagued the archipelago since the late 1990s. In taking these actions, the central banks have put downward pressure on long-term interest rates, and they have ensured the liquidity of these markets by acting implicitly as lenders of last resort. While the ECB has also gotten involved in this area by buying more than 170 billion euros of government securities (Italian, Greek, Portuguese and Irish), the magnitude of its asset purchase program (2.1% of the total public debt of the euro zone countries) is still below the level implemented by the Federal Reserve and the Bank of England, which respectively own more than 10.5% and 16% of the public debt issued by their governments. Moreover, the ECB took care to specify that the program was temporary, had a limited budget and was designed to restore the effectiveness of monetary policy. In a recent comment, Paul de Grauwe compared the ECB's strategy to that of an army chief going off to war who declares that he would never use his full military potential and he would bring all the troops home as soon as possible, that is to say, without ensuring that final victory had been won. A strategy like this is doomed to failure. Only an open-ended commitment could stop the contagion affecting the euro zone countries plagued by budget problems. And only one central bank can offer such a guarantee, through the creation of money. Yet up to now Europe's countries have rejected this path, including at the summit of October 25, while at his first press conference Mario Draghi has only reiterated the strategy of the ECB, even adding that he did not believe that a lender of last resort is the solution to the crisis in the euro zone. As the size of the remaining EFSF is insufficient to halt the contagion, it is likely that the role of the ECB will once again take center stage. It is to be hoped that Mario Draghi and the members of the Board of Governors will be more pragmatic on this next occasion. It is urgent to recognize the ECB's role as lender of last resort by making the financial stability of the euro zone an explicit objective of monetary policy.

Moreover, beyond the role of lender of last resort, the coordination of economic policy more generally also needs to be revised. The articulation of the policy mix is indeed a central element of performance in terms of growth. In the US, the complementarity between monetary and fiscal policy is now obvious, as by putting pressure on long rates, the Federal Reserve implemented a policy to ensure the sustainability of fiscal policy at the same time that it is promoting the impact on growth. The main criticism of this policy argues that this undermines the independence of the Central Bank. However, there is no evidence today to say that the Fed has abandoned the conduct of monetary policy in favor of the government. The question does not even arise, since the US central bank is pursuing the same objectives as the US government: growth, employment, price stability and financial stability [2]. These objectives are interdependent, and the euro zone will find its way to growth again only once all the authorities are rowing in the same direction.

While these issues are not all the exclusive responsibility of Mario Draghi – a reform of the Treaty could strengthen and legitimize his decisions – his position will nevertheless be decisive. The crisis in the euro zone calls for urgent decisions and will quickly reveal the ambitions and the capabilities of its new president.

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[1] The BoE has, however, just announced that its program to buy securities will be gradually expanded to 275 billion pounds sterling.

[2] See ”The Fed, the ECB and the dual mandate”.