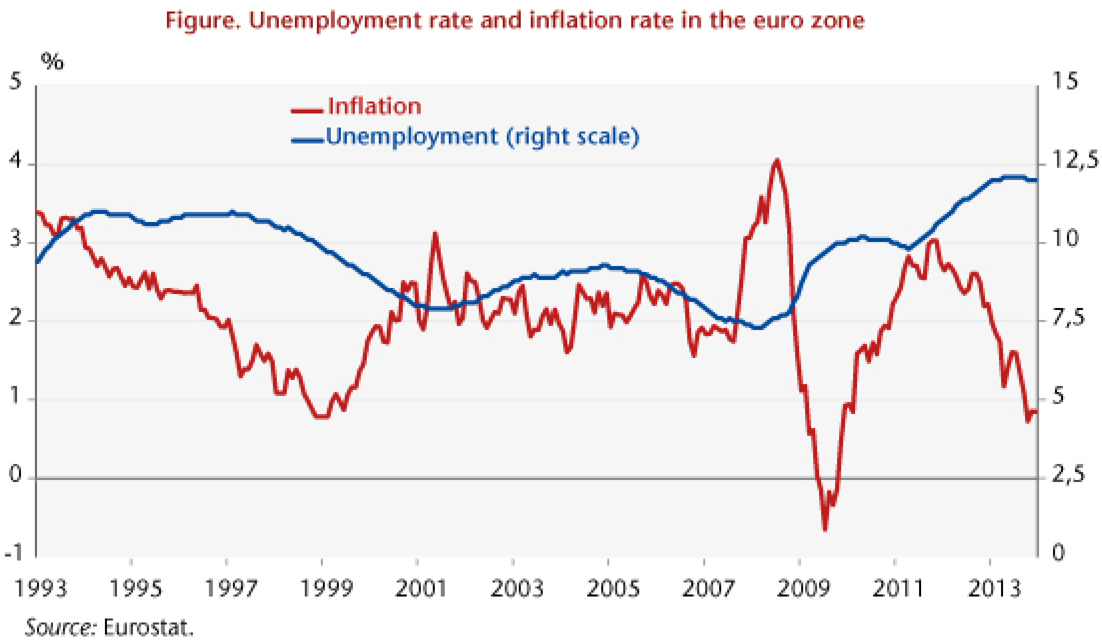
And what if the ECB respected its mandate!

By Christophe Blot

Article 127 of the Treaty on the Functioning of the European Union (TFEU), *i.e.* former Article 105 of the Maastricht Treaty, states clearly that "the primary objective of the European System of Central Banks … shall be to maintain price stability". However, no precise quantification of this goal is given in the Treaty. The European Central Bank has interpreted this by stating that it would target inflation that is below, but close to, 2% over the medium term. Furthermore, Article 127 of the TFEU adds that, "without prejudice to the objective of price stability , the [European System of Central Banks] shall support the general economic policies in the Union, as laid down in Article 3 …", which includes in particular the sustainable development of Europe based on balanced economic growth and price stability, full employment and social progress. It is therefore clear that the goal of growth and employment is not abandoned but subordinated to the goal of price stability. Starting from this review of the definition of the ECB's objectives, what conclusion can we draw on the orientation of monetary policy in the euro zone?

Since the end of 2013, a few signs of economic recovery have appeared in the euro zone. Initial estimates of growth in the fourth quarter of 2013 have confirmed that the recession is ending, with GDP up 0.3%. Nevertheless, the economy is still in poor health. As proof, simply recall that 12% of the labour force is currently unemployed, which is the highest level since 1993 (see chart). Growth is expected to accelerate in 2014 and 2015. According to the ECB forecasts announced in March 2014, growth will hit 1.2% in 2014 and 1.5% in 2015, a pace that is still insufficient to lead to a rapid or significant reduction in the unemployment rate. In addition, since the end of 2013 inflation has dropped below the threshold of 1% and is coming dangerously close to a point where deflation is a risk. Furthermore, still according to the ECB forecasts, inflation should not exceed 1.0% in 2014, before pushing up to 1.3% in 2015 and 1.5% in 2016. It is in any case far from the mid-term target of 2%. The objective of price stability as defined by the ECB will therefore not be met. At his press conference in March, Mario Draghi announced that the maintenance of the ECB key interest rate [1] at 0.25% and the absence of additional (so-called unconventional) measures could stimulate the euro zone. The status quo was justified by the absence of signs of a more rapid fall in inflation. By taking this stand, the ECB President is indicating that he is satisfied with a situation where inflation remains permanently below the 2% level and where the euro zone is marked by persistent mass unemployment. Are we therefore supposed to reinterpret the definition of price stability invoked by the ECB and accept that the term *below* is more important in the eyes of the members of the ECB Governing Council than the term *close* to 2%? The answer to this question is obviously not neutral, since it would reflect a certain asymmetry in the central bank's reaction to inflation, with the ECB reacting more quickly when inflation exceeds 2% than when it falls below 2%, including over the forecast horizon of its own team. But however its main objective is interpreted, the fact remains that the risk to price stability is not currently a barrier to the implementation of a more expansionary monetary policy. In these conditions, the ECB has all the room it needs to be actively concerned about its other objectives, including first of all growth and unemployment.

So what tools does the ECB have available, knowing that with the benchmark rate at 0.25% it has only very limited manoeuvring room for a downward adjustment? The ECB must therefore use other levers. Communication by the central banks has played an increasing role in the implementation of monetary policy, as this can be used to influence agents' expectations and hence the impact of decisions on inflation and growth. In this respect, the central bank has recently (July 2013) engaged in what is called forward guidance by stating that the key rate will be maintained at a low level for an extended period [2]. The ECB could go further by conditioning a hike in the key interest rate on a target unemployment rate, as both the Bank of England and the Federal Reserve have done; this would give added substance to its objectives on employment and growth. In addition, unconventional measures could be used to strengthen the expansionary character of monetary policy. This mainly means measures that alter the size or composition of the central bank's balance sheet, which would supplement the role of the reduction in short-term rates in influencing financing conditions. A recent report by France's Council of Economic Analysis (see here) points in this direction, and in particular proposes that the ECB should purchase securitized small and medium enterprises' (SME) loans in order to reduce the cost of business financing. The Outright monetary transactions (OMT) programme [3] could have been activated to support the reduction in long-term sovereign rates. The announcement of this measure did indeed contribute to lowering long-term sovereign rates in Spain and Italy, in particular because it sent a signal that the risk of collapse of the euro zone was being averted. Up to now, the ECB has not intervened in the markets to buy government securities. Yet given its unlimited capacity for intervention, doing this would help to reduce long-term rates. Note, however, that the OMT programme is currently being challenged by Germany's Constitutional Court in Karlsruhe, which has questioned the programme's constitutionality, with the case being referred to the European Court of Justice. A rejection or restriction of the ECB's actions in this matter would be unfortunate. The ECB's scope for intervention does of course need to be clarified. But it is also essential to retain the objectives of price stability and growth. The judges in Germany and at the European Court of Justice would be well advised to keep this in mind.



Revising the budget in Croatia: yes, but … for whom and why?

By [Sandrine Levasseur](#)

Under the [excessive deficit procedure that Croatia has been subject to since 28 January 2014](#), the country's government has been obliged to revise its projected budget for the forthcoming three years, which is the timeframe that has been set for putting its finances into "good order", with "good order" being understood to mean a public deficit that does not exceed 3% of GDP. This new budget is being fixed in adverse economic conditions, as the government's forecast of GDP growth for 2014 has been revised downward from 1.3% to a tiny 0.2%.

Paradoxically, the new budget could help prolong the recession in the country rather than help it recover, at least in 2014. This paradox is especially worth noting since this is also the opinion of those for whom the Croatian government is making this adjustment: first of all, the rating agencies, and second, the international institutions (or at least the IMF, as the European Commission has to keep quiet on the matter). In fact, a simple glance at the revised budget is enough to see that the fiscal adjustment being proposed by the Croatian government will not have an expansionary impact on GDP. For example, the budget provides for a hike in tax revenues, in particular through an increase in the rate of health insurance contributions from 13% to 15%.But this will also result in undermining the international competitiveness of the country's businesses, which have already been hit hard.

The wages and bonuses of civil servants will fall (by about 6%) so as to give the public finances some breathing room. But these cuts in civil servant salaries will not help perk up domestic demand, which has been anaemic due to the adjustments consumers and businesses have made in their balance sheets. To take the latest example, to help bail out the state finances the profits of state enterprises will not be reinvested in the economy. However, the country is thereby depriving itself of a source of growth since, because of their weight in the economy, these enterprises account for a large share of productive investment.

There is no doubt that Croatia's public finances need to be cleaned up. However, the horizon for the fiscal consolidation decided on by the Croatian government seems to us extremely "short-termist", as it doesn't call into question the existing model of growth or seek sources of sustainable growth. A few weeks ago, in an OFCE note we discussed the impact alternative fiscal adjustments would have on growth and the public finances. In the specific case of Croatia, the government cannot avoid the need to consider doing the following:

restructuring the productive apparatus (including through privatization and concessions); improving the system of tax collection; and, more broadly, implementing an anti-corruption policy to improve the country's "business climate". In the meantime, in large part due to the fiscal decisions being taken, 2014 is likely to wind up as the sixth year in a row Croatia has been in recession. The IMF forecasts, which anticipate that the recessionary impact of the fiscal consolidation will be greater than that projected by the Croatian government, is expecting GDP to fall by about 0.5% to 1% in 2014. In total, the decline in GDP since 2009 will therefore come to between 11.6% and 12.5%. It's not exactly the stuff of dreams….

Should we be celebrating the fall in unemployment at end 2013?

By Bruno Ducoudré and Eric Heyer

Every quarter, the INSEE publishes the unemployment rate as defined by the International Labour Office (ILO): for the fourth quarter of 2013, it **fell** 0.1 point in France, meaning 41,000 fewer unemployed. Likewise, every month the number of jobseekers registered with the Pôle Emploi job centre is reported: during the fourth quarter of 2013, this source indicated that the number of registered jobseekers in category A **rose** by 23,000. In one case unemployment is down, in the other it is up – this does not lead to a clear diagnosis about where unemployment is heading at year end.

What explains the difference in diagnosis between the INSEE and Pôle emploi?

Besides differences related to methodology (an employment survey for the ILO, an administrative source for Pôle emploi), it should not be forgotten that, according to the ILO, a person must meet three conditions to be counted as unemployed: being unemployed, being available for work and performing an active job search. Simply being registered at Pôle emploi is not sufficient to fulfil this last condition. So people registered as category A at Pôle emploi who are not actively seeking work are not counted as unemployed according to the ILO. The ILO criteria are thus more restrictive. Historically, for those aged 25 and over, the number of unemployed registered at Pôle emploi is greater than the number according to the ILO criteria. For those under age 25, registering with Pôle emploi [1] is in general not as worthwhile, except during a period of active social treatment of unemployment, as was the case during the last quarter of 2013: people who wanted to benefit from a subsidized job had to be registered at the job centre.

Table 1. Change in the number of unemployed from Q3 to Q4 2013

1000s

Age	15-24	25-49	50 +	Total
Unemployed (ILO criteria)	-33	3	-11	-41
Registered at Pôle emploi Cat. A	-7	10	20	23
Difference	26	7	31	64

Sources: INSEE, Emploi survey, Pôle emploi DARES.

As shown in Table 1, regardless of the age group, the situation seems less favourable using the Pôle emploi figures than according to the ILO criteria: when confronted with more than 2 years of unemployment, a certain number of discouraged jobseekers stop their active job search and are thus no longer recognized as such within the meaning of the ILO, yet continue to update their status at the job centre, and therefore remain listed in Category A.

Is the reduction in the unemployment rate calculated by ILO criteria good news?

The unemployment rate can fall for two reasons: the first one, virtuous in nature, is as a result of escaping unemployment due to improvements in the labour market; the second, less encouraging, is due to jobless people becoming discouraged and drifting into inactivity. The latest statistics from the ILO emphasize that the 0.1 point fall in the unemployment rate can be explained in full by the fall in the participation rate – which measures the percentage of the work force in the population aged 15 to 64 – and not by a resumption of employment that has remained stable. The decline in the unemployment rate is thus not due to a recovery in employment, but to discouraged jobless people who quit actively seeking employment (Table 2).

Table 2. Breakdown of the change in the labour force participation rate (ILO criteria) Q4 2013

In points

Age	15-24	25-49	>49 ans	Total *	Labour force Q4 2013 (1000s)
Employed	0,3	-0,2	0,2	0	25 547
Unemployed	-0,5	0	-0,1	-0,1	2 784
Labour force	-0,1	-0,1	0,2	-0,1	28 331

*The employment rate, the unemployment rate and the labour force participation rate are average rates weighted for the number of individuals in each age group. The 25-49 age group is the largest, representing about 60% of the total.
Source: INSEE, Emploi survey.

Looking more closely, the employment policy pursued by the government – "jobs for the future", CUI "unique integration contracts" – has had a positive impact on youth employment; the employment rate rose by 0.3 percentage point during the last quarter of 2013. Among seniors, the employment rate is still continuing to rise (+0.2 percentage point) due to the decline in the actual age of retirement. ILO-defined unemployment is of course falling among seniors, but the sharp rise in enrolment at the job centre in this age group (Table 1) undoubtedly reflects a change in their job search behaviour: more and more seniors are no longer looking for work. They are now included in the "halo" of unemployment, which is continuing to rise.

Ultimately, the fall in the ILO-defined unemployment rate, which is characterized by the absence of a recovery in employment and the discouragement of jobseekers, is not such good news.

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[1] To have the right to unemployment compensation and receive assistance for a return to work, it is necessary to prove a 122 day contribution period or 610 hours of work during the 28 months preceding the end of the job contract.

Central banks and public debt: dangerous liaisons?

By Christophe Blot

Since 2008, monetary policy has been in the forefront of efforts to preserve financial stability and stem the economic crisis. Though the Great Recession was not avoided, the lessons of the crisis of the 1930s were learned. The central banks quickly cut short-term interest rates and have kept them at a level close to zero, while developing new monetary policy instruments. These so-called unconventional measures led to an increase in the size of balance sheets, which exceed 20% of GDP in the United States, the United Kingdom and the euro zone and 45% in Japan. Among the range of measures employed was the central banks’ purchase of public debt. The goal was to lower long-term interest rates, either by signalling that monetary policy will remain expansionary for an extended period, or by modifying the composition of the asset portfolios held by private agents. However, the Federal Reserve recently announced that it would gradually reduce its interventions (see here), which could cause a rapid rise in interest rates like that seen in May 2013 (Figure 1) upon the previous announcement of this type. In a context of high public debt, interest rate dynamics are crucial. The central banks need to take into account the enhanced interaction between monetary and fiscal policy by coordinating their decisions with those taken by governments.

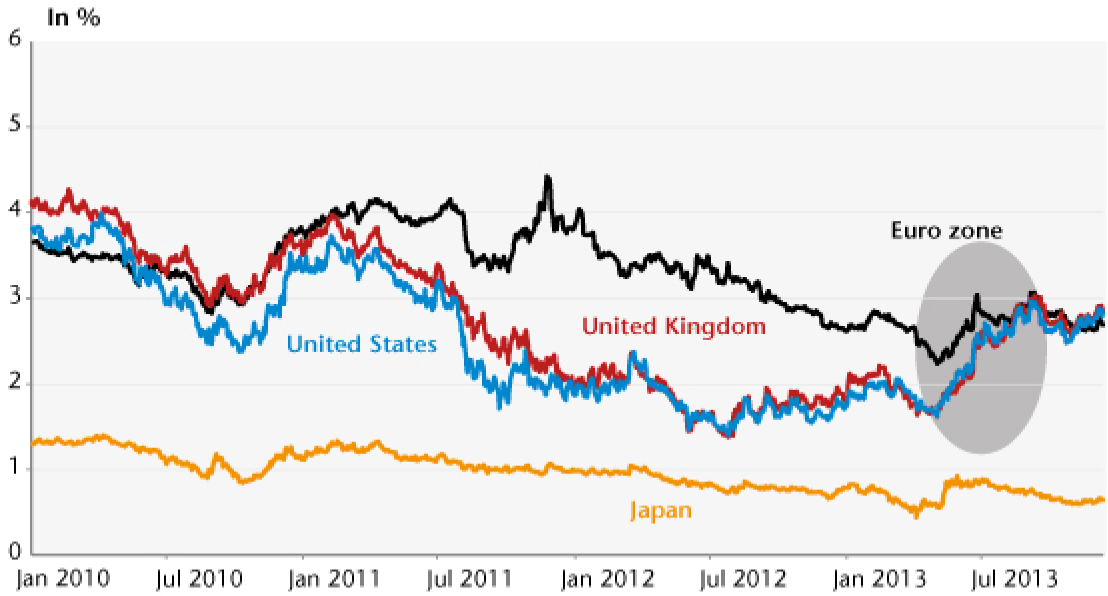
In normal times [1], monetary and fiscal policy pursue common goals, foremost among them macroeconomic stability. There are therefore interactions between the decisions taken by the two authorities. A tightening of monetary policy via an increase in interest rates could for instance counteract a fiscal expansion, and vice versa. It is thus necessary to coordinate economic policy in order to ensure the best macroeconomic balance. The implementation of unconventional monetary policy measures enhances these interactions. The adoption of unconventional measures has led central banks to buy government debt, to such an extent that, with the exception of the ECB, these banks hold a significant portion of the outstanding debt (Figure 2). In doing this, their operations are interfering with the management of debt, which is usually vested in the Treasury. The link between monetary policy and debt management is not new, though it receded as central banks became independent institutions with a primary objective of price stability, which they seek to achieve exclusively by changing the key interest rate. Goodhart [2] (2010) clarifies that this role was historically devolved on them. Nevertheless, the objectives of the central bank and of the agency responsible for issuing public debt may be contradictory (Blommestein and Turner [3], 2012), as the Treasury seeks to minimize the cost of debt service, regardless of the macroeconomic impact of its decisions. Two additional interactions can emerge. On the one hand, the government may partially counteract the central bank's actions on long-term rates by seeking to profit from their decline through additional issues on the maturities targeted by monetary transactions. The excess demand is then partially absorbed by an additional supply for a given maturity. This is what has happened in the United States, as the average maturity of the debt rose from 48.5 months in October 2008 to 64 months in May 2012. Recent work by Chadha, Turner and Zampolli [4] (2013) suggests that this policy of managing the maturity of the public debt supply has a significant impact on interest rates. The minutes of the US Treasury meeting on 2 November 2010 illustrate the potential conflict between objectives: "It was pointed out by members of the Committee that the Fed and the Treasury are independent institutions, with two different mandates that might sometimes appear to be in conflict. Members agreed that Treasury should adhere to its mandate of assuring the lowest cost of borrowing …. A couple [of] members noted that the Fed was essentially a 'large investor' in Treasuries and that the Fed's behavior was probably transitory. As a result, Treasury should not modify its regular and predictable issuance paradigm to accommodate a single large investor."

On the other hand, the reduction in the portfolio of government securities held by the central bank should lead to higher long-term rates. This is in any case what is suggested by some of the recent literature on the impact of unconventional monetary policies. The dynamics of bond yields observed in May 2013 (Figure 1), the first time that the markets anticipated [5] a steady decline in purchases by the Federal Reserve, shows that the increase may be rapid and cause high volatility on the financial markets. The explanation for this increase may be related to the end of or the unwinding of arbitrage operations carried out by investors who took advantage of low long-term interest rates in the industrialized countries in order to take on debt and seek more profitable investments in other markets, in particular the emerging markets. The consequences of such a scenario must be taken into account by the central banks. If the conduct of monetary policy involves making fewer central bank interventions, then the impact on debt service of this pull-back needs to be factored in. Despite the process of public debt reduction, government financing needs will stay high, and additional refinancing costs due to higher interest rates could lead States to strengthen fiscal consolidation, which would have adverse effects on economic activity. Conversely, the maintenance of low interest rates could greatly contribute to facilitating fiscal adjustment by allowing low-cost refinancing and by giving a stimulus to the economy, thereby reducing the recessionary impact of the fiscal adjustment.

Due to the nature of these interactions, to a macroeconomic context marked by a high level of public debt, and to the risk of financial instability, it is essential to coordinate monetary and fiscal policy. This necessity is illustrated perfectly in the case of the United States in an observation by James Tobin quoted by Turner[6] (2011): "The Federal Reserve cannot make rational decisions of monetary policy without knowing what kind of debt the Treasury intends to issue. The Treasury cannot rationally determine the maturity structure of the interest-bearing debt without knowing how much debt the Federal Reserve intends to monetize."

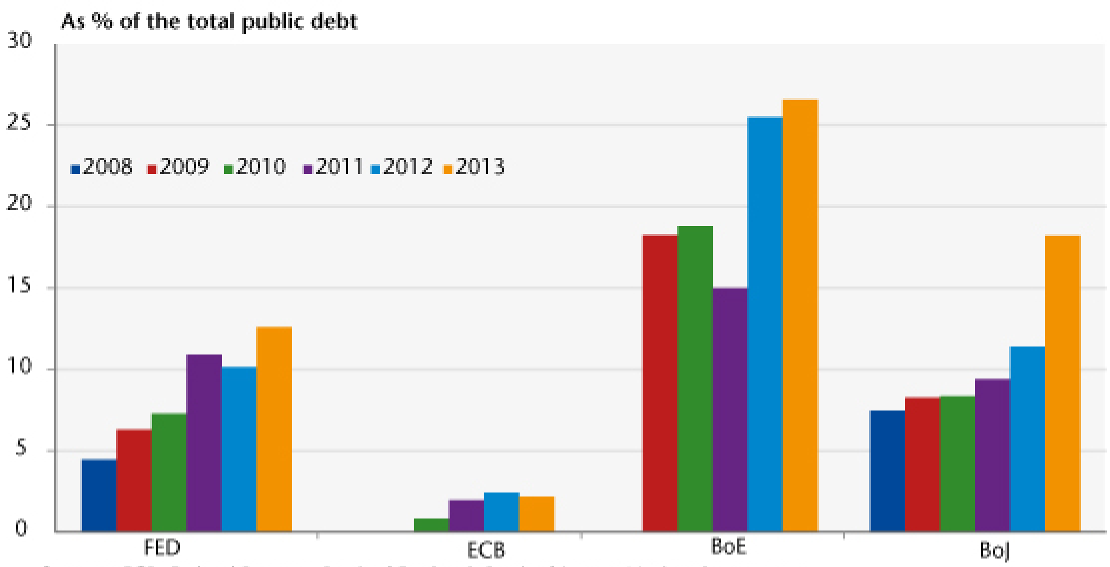
In Europe's case, this seems to be a second-order question, since the ECB has a small portfolio of assets (Figure 2). While taking note that this portfolio is concentrated on bonds issued by certain countries (Italian, Spanish, Portuguese, Greek and Irish), whose public debt represents 42% of euro zone debt, the outstanding debt held by the ECB comes to 5% when considering only the countries in crisis. It's regrettable that the ECB has not taken a more active monetary policy, which would have made it possible to effect a major uniform reduction in interest rates in all the euro zone countries, which would have helped to reduce the need for fiscal consolidation and mitigate its negative effects.

Figure 1. Interest rates on long-term public debt



Source: Datastream.

Figure 2. National public debt held by the central banks



Sources: ECB, Federal Reserve, Bank of England, Bank of Japan, National accounts.

[1] Here the expression "in normal times" refers to the fact that the conduct of monetary policy is usually characterized by decisions taken by the central banks on the key interest rate, which is a short-term rate. During the crisis, the central banks set this key rate at a very low level, near to the zero lower bound, and so turned to new measures to strengthen the expansionary character of monetary policy.

[2] See "The changing role of central banks", *BIS Working Paper* no. 326, November.

[3] See "Interactions between sovereign debt management and monetary policy under fiscal dominance and financial instability", *OECD Working Paper* no. 3.

[4] See "The interest rate effects of government debt maturity", *BIS Working Paper* no. 415, June.

[5] These expectations were initially fuelled by the improving jobs situation in the United States and then by Ben Bernanke's statement confirming a possible pull-back by the Federal Reserve. These elements are described in more detail by the BIS in its Quarterly Review, September 2013.

[6] See "Fiscal dominance and the long-term interest rate", 2011, *Financial markets group special paper series* 199, May.

The responsibility pact's

obligation of a result

By Xavier Timbeau, @XTimbeau, OFCE

The original French text was published in the “Rebonds” section of the newspaper Libération *on 28 February 2014.*

Is the policy supply-side or demand-side? This debate takes us back decades to a time when the advocates of supply-side policy, Ronald Reagan and Margaret Thatcher, wanted to put Keynesian practices into the closet. With respect to the responsibility pact, the debate is moot. There is a clear diagnosis that companies are suffering from such low margin rates that their very survival is threatened. The losses of market share since the 2000s cannot be explained solely by the transition to a post-industrial society. It is thus a priority to boost corporate margins by whatever means necessary. But the restoration of business margins will not be sufficient to put them back on a path of increasing productivity, ensuring their competitiveness in the medium term. Getting back on this path will require numerous reforms, ranging from a better education system to a stable tax system that is as neutral as possible, while making use of the impact of agglomeration and specialization. Coordinating everyone’s projects around a comprehensive strategy to make the energy transition is also a powerful instrument. But the responsibility pact remains silent on this.

To be clear, the responsibility pact aims to improve the situation of business, which could partially offset the decline in activity resulting from the 2008 crisis and the French economy’s loss of competitiveness relative to its partners undergoing deflation (including Spain) or due to a rise in the euro. In so far as the pact is financed by taxes or spending cuts, this will constitute a tax depreciation, which will make consumers, employees and those on social benefits pay for the reduction in business costs. When the decrease in the cost of doing business is more focused on lower wages, then we can expect the creation of something like 130,000 jobs in five years, taking into account the financing (see for example the article by Heyer and Plane in the *revue de l'OFCE* no. 126). The counterparties, the support of the trade unions and the MEDEF employer association and the general mobilization around a shared bleak diagnosis, will not lead to the revolution that some expect, but it is part of the solution.

A fiscal devaluation at a time when the countries of southern Europe are flirting with deflation and everyone is chasing after a balanced current account, including by curbing domestic demand, will of course not lead the euro zone out of crisis, but instead keep it in prolonged stagnation. Fiscal devaluation is not the right policy for Europe. But so long as Europe has no path other than mass suicide, then fiscal devaluation is the logical response for France.

130,000 jobs will not be sufficient to reverse the trend in unemployment. In the face of the more than one million additional unemployed since 2008, it is downright derisory. But the responsibility pact could be something other than a fiscal devaluation. The obligation of a result, namely to reduce unemployment, does not leave much choice. For the responsibility pact to be accompanied by a significant reduction in unemployment, the key is not to finance it. The proposal to be made to our partners consists of laxity on our public deficit trajectory in exchange for reforms that everyone would consider structural. Public spending cuts, favourable taxation of business, the prioritization of competitiveness, are all measures that can generate some manoeuvring room.

France has made a commitment to Brussels to reduce its structural deficit by 50 billion euros. If this fiscal effort is made by 2017, almost 1 point of growth will be lopped off every year, and unemployment will virtually not decline at all by 2017. In fact, only the public deficit would be reduced, to 1.2 percent of GDP; this would open up very favourable prospects after 2017, since the public debt will fall without further budgetary cuts and therefore without hindering the decline in unemployment. It’s a comfortable scenario for François Hollande’s successor, assuming there is one, as they can even use the situation to lower taxes for the rich. With a combination of lower taxes, lower unemployment and a declining public debt, it will look like a “magician” has succeeded an “incompetent”.

On the other hand, using the flexibility offered by the 50 billion euros, that is to say, renouncing the 50 billion goal for structural deficit reduction, would yield a very different result. Simulations at the OFCE indicate that unemployment could be cut by nearly 2 points by 2017. Admittedly, the structural deficit would remain unchanged, but the public deficit, what we see, would be on a downward trajectory: in 2017, it would come to just over 2 GDP points (against 4.2 points at end 2013), bringing the public debt into the region of a reduction in the debt-to-GDP ratio. The situation on the eve of the presidential election would be better, and the voting more open.

To develop this manoeuvring room, our partners (and the European Commission) need to be convinced of just how drastic the situation is. The results of the European elections are likely to remind them and make the obligation of a result clear to all.

Reagan had a great ability to look towards fiscal policy for the motor of his supply-side policy. He thus created the myth that lowering taxes on the rich is good for growth, with consequences for inequality that we are still seeing today. Thatcher believed until the end that reducing the public debt was the right policy. This merely prepared the ground for Tony Blair a few years later. This is the way that political cycles are made, based on results. In the same way, we are responsible for the long-term consequences of the choices we make today.

Growth in the 4th quarter of 2013, but …

By Hervé Péléraux

According to the OFCE's leading indicator, the French economy has grown by 0.5% in the fourth quarter of 2013. This result, which was anticipated, reflects the improvement in business surveys seen for about a year now. However, does this mark the return of GDP to a path of higher long-term growth? It is still too early to say.

The improvement in the business surveys anticipated the interruption in the second recession that took place in the first half of 2011. The national accounts then validated the signal emitted by the surveys, with renewed growth of 0.6% in the second quarter of 2013 (Table). GDP did of course fall again in the third quarter (-0.1%), but on average over the last two quarters there was growth of approximately 0.2% per quarter, a rate that, though very moderate, was still positive.

At the same time, the leading indicator, which aims to arrive at an estimate of GDP growth in the very short term by translating the cyclical information contained in the surveys, also pointed to a slow recovery in activity: on average over the last two quarters, growth was estimated at 0.1%, a figure that is slightly under the assessment of the national accounts.

Table. Rate of growth of French GDP according to the national accounts and the indicator

In %, Q/Q-1, chained prices, base 2005

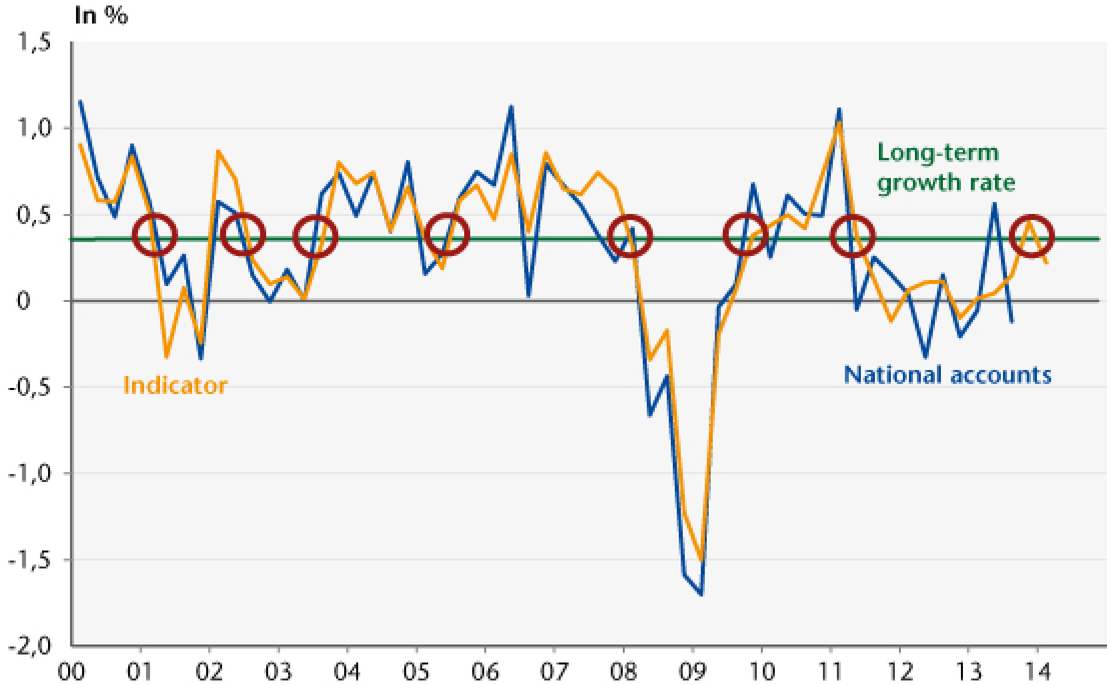
	2012	2013				2014
	Q4	Q1	Q2	Q3	Q4	Q1
National accounts	-0,2	-0,1	+0,6	-0,1	-	-
Indicator	-0,1	0,0	0,0	+0,1	+0,5	+0,2

Sources: INSEE, European Commission, OFCE calculations.

In the last few months, the uncontested growth in the confidence of private agents has enhanced the outlook for the end of 2013: the debate is now focusing on the possibility for the French economy to break through a turning point upwards and for growth to settle in at a level higher than the pace of long-term growth (0.35% per quarter).

Based on past experience, when the indicator has sent out warning signs of a turning point in the economic cycle, the signal issued for the fourth quarter of 2013 is indicating that the long-term growth rate of the French economy is being crossed (Figure). This signal is fragile: the still very partial information on the first quarter of 2014, i.e. the business surveys for January, point towards the growth rate falling below its potential. The possibility of a real lasting recovery that is able to create jobs and reverse the trend in unemployment is thus still very uncertain.

Figure. GDP growth – estimated and forecast



Sources: INSEE, European Commission, OFCE calculations.

Note on the leading indicator*:*

The leading indicator aims to forecast the quarterly growth rate for French GDP two quarters beyond the latest available data. The components of the indicator are selected from survey data sets that are rapidly available and unrevised. The selection of the data series is made on an econometric basis, starting from the business surveys carried out in different productive sectors (industry, construction, services, retail) and among consumers. Two series related to the international environment are also significant: the rate of growth of the real exchange rate of the euro against the dollar, and the real growth rate of oil prices.

Some components are at least two quarters in advance and as such can be used to predict GDP growth. Others are coincidental, or are not sufficiently advanced to make a forecast two quarters ahead. These series need to be forecast, but over a short-term horizon that never exceeds four months.

The leading indicator is calculated at the beginning of each month, shortly after the publication of the business and consumer surveys.

Why not Sundays – but at what price?

By Gérard Cornilleau

With respect to opening DIY stores on Sundays, one aspect of the issue has never been raised. It nevertheless concerns the majority of customers who shop on weekdays during the day. If stores keep their doors open late or outside traditional work days, the labour costs will rise and the structural costs will fall. The rise in cost is due to the wage compensation to be paid to employees who agree to work outside normal hours. It is now clear that such compensation is necessary. The current discussions between the trade unions and the high street chains will undoubtedly lead to an increase in compensation, with wages likely to be doubled for those working Sundays. Evening work, after 9 pm, will also be compensated. Otherwise, the number of "volunteers" is likely to fall drastically. Nor does anyone really want to argue about whether such compensation is "fair"[1]. The reduced structural costs (due in particular to lengthening the duration of capital utilization) should be accompanied by a redistribution of business between neighbourhood shops and the large retailers: as it is unreasonable to expect a higher volume of sales[2], the extension of hours should strengthen the trend towards business concentration, with fewer stores open longer. From the perspective of well-being, this development should be favourable to those who want to shop outside normal times, and can, and unfavourable to those who prefer to do without a local service on a human scale, or would find it difficult to do so, such as the elderly.

This raises the issue of compensating “loser” customers who do not wish to shop outside traditional hours or in less accessible stores. It is not acceptable that in the absence of price discrimination, the customers who demand to be served at night or on Sundays are subsidized. This existence of an implicit subsidy like this is also unjustified from a strictly economic perspective: in order for consumer choices not to be biased, they must bear the cost of the service they want. In other words, Sunday and late night consumers should pay a fair price for the service they use, and the extended hours should not come at the expense of other consumers [3]. Fortunately, there is a simple solution to this problem: a mandatory fixed coefficient could be applied to the price of purchases made after 9 pm or on Sundays [4]. From then on consumers can choose freely whether to buy during normal hours at the current rate, or outside these hours at the higher rate. Detailed statistical work would be needed to determine the amount of the increase, but it is possible to give an order of magnitude: since trade margins are close to 1/3 and payroll accounts for about 60% of the cost of the business operations, a minimum increase of approximately 15% would be required to account for the doubling of wages on Sundays and after 9pm. Furthermore, to compensate for the potential loss of well-being due to the impact of non-standard shopping hours in the commercial facilities, a coefficient of 20% seems reasonable. Once store customers pay for the extra service they want, i.e. shopping on Sundays or evenings, it would be possible to agree for traders to freely choose whether or not to open, under the same conditions as today of paying compensation and of verification of the “voluntary” nature of the work outside standard working hours. Based on customers’ response to this price discrimination, the store's choice of whether to open would be made on a rational basis, without penalizing those that do not do business outside regular hours.

This solution is extremely easy to apply since it would involve only a very slight change in the software coding of store tills. It would also be very easy to verify implementation. It is compatible with greater business freedom and fair compensation for employees. Nevertheless, this could still be opposed for moving in the direction of disrupting social time, which could be avoided only by binding regulations. It seems to me that this could nevertheless be tried out so as to accurately measure the need for opening stores outside "normal" hours: if there are still many takers despite a 20% hike in the bill, then that would indicate a substantial need for longer opening hours. Otherwise, there could be a return to a more satisfactory situation where some stores (or parts of stores) open to meet marginal demand, with most business, and therefore most working time, still focused on the traditional work week and working hours.

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[1] Many professions charge premium rates on Sundays without anybody questioning the legitimacy of this practice. This is particularly the case of the medical profession. If sometime in the future work on Sundays were to become "commonplace", the Sunday price increases could be called into question, including for those professions. On the other hand, increases for night work would continue to be justified by the highly negative impact on health.

[2] See the contribution of Xavier Timbeau (http://www.ofce.sciences-po.fr/blog/never-on-sunday/)

[3] The prices in stores open on Sundays and at night, such as neighbourhood convenience stores, are already well above average, which avoids excessively subsidizing "non-standard"

customers. The higher prices in these shops are readily accepted because they correspond to a specific service. But in the case of a general elimination of regulations on working hours, it is unlikely that stores in traditional channels would spontaneously introduce price discrimination.

[4] This increase is not a tax. The formula associated with this would constitute income for the store, which would be strongly encouraged by competition to lower overall prices.

Revisions of the growth potential: the impact on deficits

By Hervé Péléraux

Public finances – battered by the Great Recession

At the end of the Great Recession of 2008/09, the fiscal problem that governments had to face was seemingly simple, as was the solution put forward. The operation of the automatic stabilizers and the stimulus packages put in place to counter the 2008/09 recession sharply increased the public deficits. This situation, which was dictated by urgency, was acceptable in the short term, but not in the longer term. Logically this would lead to an adjustment in the public accounts to reduce the deficits and halt the growth of the debt. Fiscal discipline at a forced pace under the baton of the European Commission was therefore the economic policy instrument adopted by almost all the euro zone countries.

The appropriateness of this strategy, which was undertaken to solve the initial problem, i.e. the excessive deficits in the euro zone, should nevertheless be discussed. It relied on a macroeconomic diagnosis made at the end of the recession in 2008/09 that conditioned the assessment on the spontaneous capacity for an economic recovery – in effect, the fraction of the public deficit that was likely to be spontaneously absorbed by renewed growth depended on this capacity for recovery.

Part of the deficits could be absorbed on their own

The public deficit excluding interest expense, i.e. the primary deficit, can be subdivided into two components: a cyclical component and a structural component. The cyclical component results from cyclical fluctuations in GDP around its potential, that is to say, the level of GDP achievable without inflationary pressures using the available production factors: during a phase when GDP is slowing relative to its growth potential, and thus when the output gap is widening, tax revenues slow, and public spending, in particular on social welfare, picks up. What follows is a spontaneous increase in the deficit. In economic theory this self-corrective mechanism is called the “automatic stabilizers”. The other component of the deficit is deduced from the previous one as a complement to the total deficit: this is the deliberate component, which results from the impact of economic policy. This discretionary component can be eliminated only by implementing a policy that is symmetrical to what gave rise to it, that is to say, by means of an austerity policy. By its nature it has a dampening effect on the recovery, whereas the expansionary policy during the previous phase results in boosting activity. Fiscal policy is thus an instrument for smoothing the economic cycle.

The spontaneous portion of the deficit that appeared after the 2008/09 recession was destined to be automatically reduced once growth returned. Only the elimination of the discretionary component justified a restrictive policy. The extent of the effort needed to achieve this therefore depended on the measurement of the output gap, which conditioned the estimate of the cyclical deficit, and by inference the estimate of the deliberate deficit.

The cycle's effect on the evaluation of the potential

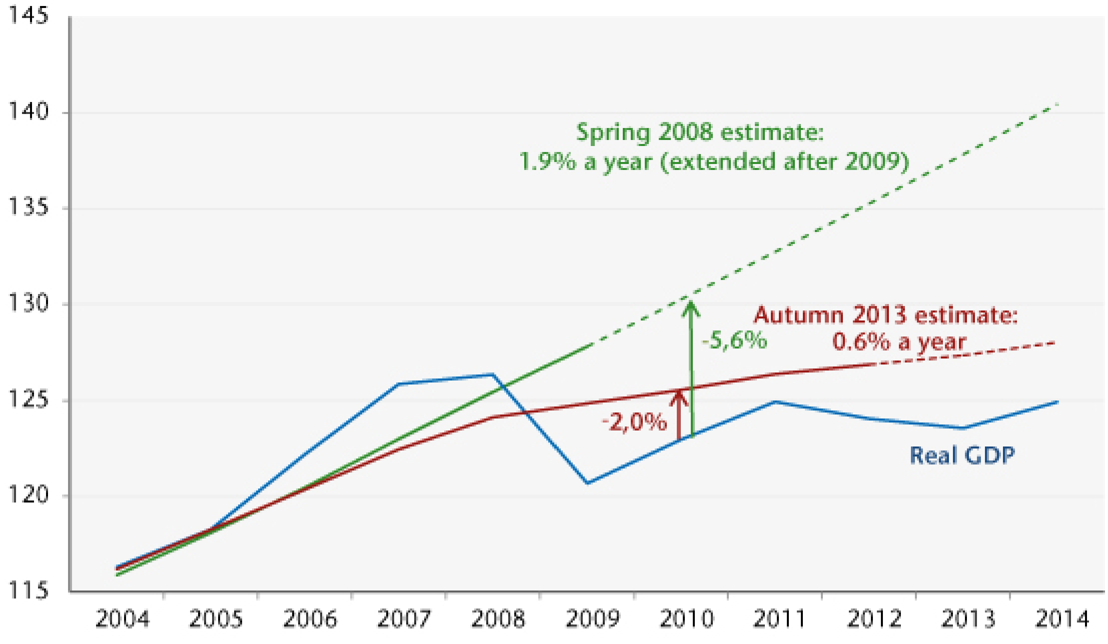
The measurement of the output potential that is used to calculate the output gap is obviously central for calibrating as accurately as possible the budget cuts needed to eliminate the portion of the deficit that cannot be absorbed spontaneously by growth. But policymakers face a major difficulty here, i.e. the unobservable nature of the potential, which consequently must be estimated – and economists are far from unanimous about these estimates. Moreover, periodic revisions can be significant even within the same institution, which modifies the diagnosis made and – if this institution happens to be responsible for defining the rules constraining fiscal policy, as in the case of the European Commission (EC) – the measures to be taken as well.

A review of the revisions of the growth potential calculated by the EC shows the uncertainty of this estimate (see last section below). The estimate also appears to depend on current growth, which is somewhat paradoxical for an estimate of a supply function that depends on long-term economic parameters such as increases in the labour force, productivity and the capital stock. It is understandable that the trajectory of these supply parameters is deflected slightly during cyclical hiccups, particularly through investment, which is a vehicle for technical progress and ensures the growth of capital or a loss in human capital due to long-term unemployment. But the fact that the inclusion in the estimates of a cyclical phenomenon, even one as massive as the recession of 2008/09, is leading to revisions of the growth potential on the order of that seen between Spring 2008 and Spring 2009 raises questions. This is particularly so as these revisions have also affected the years prior to the recession, which were not affected by changes in the conditions of accumulation. Thereafter, the resumption of growth in 2010 led to revisions of the growth potential in the other direction, including for the years prior to the recession. Finally, the economic downturn in 2011 led to a further series of revisions, once again downwards.

Self-sustained austerity

The reduction in growth potential led to significant revisions downwards of the estimated output gap (see chart). These are not neutral for calibrating the fiscal consolidation policy. This is because for a given deficit, the estimate of the output gap of -2% for 2010, for example, versus nearly -6% under the assumption of a continuation of the trajectory of potential GDP estimated before the recession, would increase the part of the perceived structural deficit and thus call for heightened austerity. That’s what happened in 2010, when the stimulus packages gave way to plans for drastic budget cuts. Generalized to all member countries, they nipped the nascent recovery in the bud and plunged the euro zone countries into a new recession.

Revision of the euro zone’s growth potential



Sources: European Commission, Eurostat.

The excessive sensitivity of the estimate of potential growth to current growth precipitated the commitment to austerity policies in the euro zone and subsequently pushed towards tightening fiscal restraint further. By depressing economic activity, austerity fuelled factors that undercut supply through the destruction of capital, a slowdown in investment and deskilling the labour supply. The economies' capacity for a spontaneous recovery was thus undermined, which could only lead to an increase in the share of the structural deficit in the total deficit, and ultimately to the need for greater austerity.

The budget purge thus led to a second recession, which invalidated the deficit reduction targets set at the beginning, as the automatic stabilizers have again increased the cyclical component of the deficit. Rigour, poorly calibrated, was counter-productive and thus could not achieve the initial goal of rapid deficit reduction. The results are far from being commensurate with the sacrifices made by the European economies.

The European Commission's estimate of the euro zone's potential GDP

The 2008/09 recession led the European Commission to revise its estimate of the growth potential for the member countries rather significantly. For the euro zone as a whole, the revision process began between Spring 2008 and Spring 2009, when the effects of the financial crisis were expressed in real activity: the start of the recession in the euro zone in the fourth quarter of 2008 was associated with sharp downward revisions of the growth potential for 2008 and 2009, by -0.7 and -1.2 points, respectively (Table). There were also relatively substantial revisions to earlier years, from -0.3 to -0.5 points for the years 2004 to 2007. However, no major revision occurs between the estimates of Spring 2009 and Spring 2010, despite the downturn in year-on-year GDP growth, indicating that the modification of the economic landscape had already been included in the estimates.

The growth potential has been revised not only downwards, but also upwards when growth picked up after the recession. Between Spring 2010 and Spring 2011, the revisions were spread from +0.1 to +0.3 points and also affected more distant years. Finally, a new series of downward revisions took place with the second economic downturn in 2011. The years prior to 2008 changed little, but they fall within a broader range for the years 2008 to 2013, from -0.2 to -0.8 points, which for 2012 amounts to dividing the potential growth rate by two and a half.

Table. Revisions of the euro zone's growth potential

	Spring 2008	Spring 2009	Spring 2010	Spring 2011	Spring 2012	Spring 2013
2004	1,9	1,6	1,7	1,9	1,9	1,9
2005	1,9	1,5	1,6	1,7	1,8	1,8
2006	2,0	1,5	1,5	1,8	1,8	1,8
2007	2,1	1,6	1,5	1,8	1,8	1,7
2008	2,0	1,3	1,3	1,6	1,4	1,4
2009	1,9	0,7	0,8	0,9	0,7	0,6
2010		0,7	0,8	1,0	0,7	0,6
2011			1,0	1,1	0,8	0,7
2012				1,1	0,6	0,4
2013					0,7	0,4
2014						0,5
GDP growth * (year on year)	1,0	-1,3	-2,1	2,0	0,7	-0,9

* The year-on-year GDP growth shown here corresponds to the latest national accounts known at the time when the estimate is made, i.e. Q4 for the preceding year for the European Commission's Spring estimate. These figures are calculated with the GDP as is known at the time, i.e. with the version available at the beginning of the month of April for each year.
Sources: European Commission, Eurostat.

The effect of current growth on the estimation of growth potential by the European Commission is thus obvious. This results in a high variability of the growth potential and therefore significant revisions of the output gap, which affects economic policy decisions since the structural balance depends on this evaluation.

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.

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[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?