Greece on a tightrope

By Céline Antonin, Raul Sampognaro, Xavier Timbeau and Sébastien Villemot

This text summarizes the special study, "Greece on a tightrope"

Since early 2015, Greece's new government has been facing intense pressure. At the very time that it is negotiating to restructure its debt, it is also facing a series of repayment deadlines. On 12 May 2015, 750 million euros was paid to the IMF by drawing on the country's international reserves, a sign that liquidity constraints are becoming more and more pressing, as is evidenced by the letter sent by Alex Tsipras to Christine Lagarde a few days before the deadline. The respite will be short: in June, the country has to make another payment to the IMF for 1.5 billion euros. These first two deadlines are only a prelude to the "wall of debt" that the government must deal with in the summer when it faces repayments of 6.5 billion euros to the ECB.

Up to now, Greece has made its payments despite its difficulties and the suspension of the bailout program negotiated with the "ex-Troika". Thus, 7.2 billion euros in remaining disbursements have been blocked since February 2015; Greece has to come to an agreement with the former Troika before June 30 if it is to benefit from this financial windfall, otherwise it will fail to meet its payment deadlines to the ECB and IMF and thus default.

Besides Greece's external repayments, the country must also meet its current expenses (civil servant salaries, retirement pensions). But the news on the fiscal front is not very encouraging (see State Budget Execution Monthly Bulletin, March 2015): for the first three months of the year, current revenue was nearly 600 million euros below projections. Only the use of its European holding funds, combined with an accounting reduction in expenditures (1.5 billion euros less than forecast) allowed the Greek government to generate a surplus of 1.7 billion euros and to meet its deadlines. So by using bookkeeping operations, the Greek government was able to transfer its debt either to public bodies or to its providers, thus confirming the tight liquidity constraints facing the State. Preliminary data at the end of April (to be taken with caution because they are neither definitive nor consolidated for all government departments) seem nevertheless to qualify this observation. At end April, tax revenues had returned to their expected level; however, the government's ability to generate cash to avoid a payment default is due to its holding down public spending through the accounting operations described above. These accounting manipulations are simply emergency measures, and it is high time, six years after the onset of the Greek crisis, to put an end to this psychodrama and finally find a lasting solution to Greece's fiscal difficulties.

Our study, "Greece on a tightrope", considers what would be the best way to resolve the Greek debt crisis over the long term and the potential consequences of a Greek exit from the euro zone. We conclude that the most reasonable scenario would be to restructure the country's debt, with a significant reduction in its present value (cutting it to 100% of Greek GDP). This is the only way to significantly reduce the likelihood of a Grexit, and is in the interest not only of Greece but also of the euro zone as a whole. Furthermore, this scenario would reduce the scale of the internal devaluation needed to stabilize Greece's external position.

If the Eurogroup were to refuse to restructure Greece's debt, a new assistance program would then be needed in order to deal with the current crisis of confidence and to ensure funding for the cash needs of the Greek State over the coming years. According to our calculations, this solution would require a third bailout plan of around 95 billion euros, and its success would depend on Greece being able to generate major primary budget surpluses (of around 4% to 5% of Greek GDP) over the coming decades. Historical experience shows that, due to political constraints, there is no guarantee of being able to run a surplus of this magnitude for such a long time, so this commitment is not very credible. A new assistance program would not therefore eliminate the risk that the Greek State would face yet another financial crisis in the coming years.

In other words, the full repayment of the Greek debt is based on the fiction of running a budget surplus for several decades. Accepting a Greek exit from the euro zone would imply a significant loss of claims that the world (mainly Europe) holds both on the Greek public sector (250 billion euros) and on the private sector (also on the order of 250 billion). To this easily quantifiable loss would be added the financial, economic, political and geopolitical impact of Greece’s departure from the euro zone and possibly the European Union. This might look like an easy choice, since writing off 200 billion euros in loans to the Greek State would make it possible to end this psychodrama for once and for all. But the political situation is deadlocked, and it is difficult to give up 200 billion euros without very strong counterparties and without dealing with the issue of moral hazard, in particular the possibility that this could induce other euro zone countries to demand large-scale restructurings of their own public debt.

The Greek Sisyphus and its public debt: towards an end to the ordeal?

By Céline Antonin

After its failure to elect a new President by a qualified majority vote, the Greek Parliament was dissolved, with early elections to be held on 25 January 2015. The radical left party Syriza is leading the opinion polls on the election, ahead of the "New Democracy" party of the outgoing Prime Minister, Anthony Samaras. While Syriza's economic programme has met with enthusiasm from the population, it has aroused concern from the Troika of creditors (IMF, ECB and EU), particularly on three issues: the country's potential withdrawal from the euro zone, the implementation of a fiscal stimulus, and a partial sovereign default. This last topic will be the main issue after the elections.

The election's real stakes: restructuring Greece's public debt

Fears about Greece's potential exit from the euro zone (the infamous "Grexit") need to be nuanced. The situation is different from what it was at the time of the sovereign debt crisis, when bond rate differentials were fuelling worry about contagion and the breakup of the euro zone. Furthermore, Syriza is not in favour of leaving the euro, and no-one can force the country's hand, given that there is no provision for this in any text. Finally, the consequences of such a decision on the other members could be severe, so that a Greek withdrawal from the euro zone would come only as a last resort.

Syriza is calling for an end to austerity and for a fiscal stimulus of 11 billion euros along with restoring the minimum wage to its previous level, better pensions, rehiring civil servants and increased public spending. Can a compromise be reached with the Troika? Nothing is less sure, and it is virtually certain that Syriza will have to revise its ambitions downwards. The Greek deficit has of course shrunk. The country ran a small primary surplus in 2014 and is expected to continue its fiscal consolidation policy in 2015-2016. But Greece must continue to borrow to finance the interest on the debt, to repay or renew the debt reaching maturity and to repay the loans from the IMF. To do this, Greece must rely largely on external aid. From the second half of 2015, the country will face a financing gap of 12.5 billion euros (19.6 billion euros if it does not get IMF assistance). Moreover, Greece's still fragile banks[1] are very dependent on access to the ECB's Emergency Liquidity Assistance Program (ELA), which allows them to obtain emergency liquidity from the Bank of Greece. If Greece rejects the reforms, a showdown with the Troika is likely. The ECB has already threatened to cut off the country's access to liquidity. In addition, the Troika is the main creditor of Greece, which however has a new bargaining point: to the extent that Greece borrows only what it needs to repay its debt, and not to fund its budget deficit, it could threaten its creditors with a unilateral default on payments, even if this is a dangerous game that could deprive it of access to market financing for many years to come.

It is precisely this issue of restructuring Greece's debt and a partial default that is being emphasized by Syriza and which will likely be one of the main post-election issues. Alexis Tsipras wants to cancel a portion of the public debt, to put a moratorium on interest payments, and to condition repayments on the country's economic performance. According to forecasts by the EU Commission and the IMF, Greece's public debt ratio is expected to fall from 175% of GDP in 2013 to 128% in 2020. However, the assumptions underlying this scenario are not realistic, *i.e.* nominal growth of more than 3% in 2015, a primary surplus of 4.5% of GDP between 2016 and 2019, etc.

Given the size of Greece's public debt in 2013 and its amortization profile (with reimbursements amounting to 13 billion euros in 2019 and up to 18 billion euros in 2039[2]), a new restructuring seems inevitable.

A public debt that is essentially held by euro zone countries

Since the onset of the Greek crisis in autumn 2009, the composition of the country's public debt has changed substantially. While in 2010, the debt was held by financial investors, the picture in early 2015 is very different [3]. After two assistance plans (in 2010 and 2012) and a restructuring of the public debt held by the private sector in March 2012 (Private Sector Involvement Plan), 75% of the public debt now consists of loans (**Table 1)**. Together the IMF, the ECB, the national central banks and the countries of the Eurozone hold 80% of Greece's public debt.

Table 1. Breakdown of Greece's public debt, by holder, september 2014

In billion euros

	September 2014	As % of total debt
Total	**321,7**	**100**
Debt securities	**79,8**	**25**
Commercial paper (Short-term)	13,4	4
Treasury bills (Long-term)	66,4	21
By ECB and national central banks	*25,0*	8
By private sector	*41,4*	13
Loans	**241,8**	**75**
IMF	32,1	10
Greek central bank + domestic loans	4,4	1
Euro zone countries	194,8	61
From 1st assistance plan (Greek Loan Facility)	*52,9*	*16*
From 2nd assistance plan (EFSF)	*141,9*	*44*
Other loans and repos	10,5	3

Sources: Debt Management Agency, IMF, ECFIN, author's calculations.

Conversely, since the March 2012 restructuring plan, Europe's banks have sharply reduced their exposure to Greece's public debt (**Table 2**). Moreover, their capital levels have risen since 2010, especially with the gradual implementation of the Basel 3 reform. The banks thus have a safety margin in the case of a partial default by Greece.

Table 2. Exposure of banks to Greek debt (public and total)

In billions of euros

	Total Greek debt (public + private)			Greek public debt		
	Q3 2009	Q1 2012	Q2 2014	Q4 2010	Q1 2012	Q2 2014
Total banks	430,5	105,6	73,8	62,9	9,0	3,5
European banks	389,2	99,1	47,8	60,2	8,3	2,2
France	112,4	54,7	3,0	20,3	2,5	0,1
Germany	61,8	8,3	18,9	20,0	1,0	0,2
United Kingdom	17,9	11,1	18,1	4,6	0,3	0,8
Non-European banks	NA	6,5	26,1	2,6	0,7	1,3
United States	27,8	5,1	24,6	2,0	0,6	1,3

Sources: BIS, ECB, author's calculations.

Since more than half of Greece's public debt is held by members of the euro zone, no renegotiations can take place without their involvement.

So what are the possibilities for restructuring the debt?

The European countries have already made several concessions to help Greece service its debt:

– The maturity of the loans has been increased and the interest rate on loans granted by the EFSF has been reduced. For the first assistance program (bilateral loans), the initial maturity was 2026 (with a grace period until 2019) and the interest rate was indexed to the 3-month Euribor plus a risk premium of 300 basis points. In 2012, this risk premium was cut to 50 basis points and the maturity was extended by 15 years to 2041;

– Any profits made by the ECB and the national central banks on the bonds they hold were returned to Greece;

– Interest payments on the EFSF loans were deferred by 10 years.

Solutions like some used in the past could be implemented. The debt could be rescheduled. Indeed, the rate charged on the loans in the first assistance package (3-month Euribor + 50 basis points) is generally higher than the financing costs of the European countries, and could be lowered. And the term of the loans in the first and second assistance packages could be extended by another 10 years, until 2051. According to the Bruegel think-tank, these two measures combined would reduce Greece's total repayments by 31.7 billion euros.

These measures nevertheless seem limited for resolving the issue of Greek debt: they only postpone the problem. Other measures are needed to relieve Greece of its public debt burden. As the euro zone countries are the main ones exposed to Greece's debt, they have an interest in finding a compromise: if there is a unilateral default, it is taxpayers throughout Europe who will wind up paying.

As for the IMF, there's no point waiting for debt forgiveness. The institution is indeed the senior creditor in case of a country's default, and lender of last resort. Since its founding, it has never cancelled a debt. It is therefore with the members of the euro zone, Greece's main creditors, that a partial default needs to be negotiated. On the one hand, Greece can threaten an uncoordinated unilateral default, causing losses for its creditors. But on the other, it has no interest in alienating euro zone members and the ECB, which have been its main supporters during the crisis. A sudden default would deprive it of access to market financing for many years; even if Greece has achieved a primary surplus, the situation is unstable and it still needs external financing, even if only to honour its repayments to the IMF. One solution would be for the euro zone countries to accept a discount on the face value of the government debt they hold, as was done with private investors in March 2012.

In conclusion, Greece is facing a series of challenges. In the short term, the priority is to find sources of financing to get through 2015. To do this, the country will have to deal with the Troika, in particular the ECB, whose action will be crucial. The Bank has warned Greece that if negotiations fail, it could cut off the country's access to liquidity.

Furthermore, on 22 January 2015, the ECB must reach its long-awaited decision on quantitative easing; the issue is whether the ECB will accept the redemption of Greek government bonds. In the longer term, the issue of restructuring the debt will inevitably arise, regardless of who wins the polls. However, the restructuring is likely to be easier with public creditors than with the private banks, if, that is, Greece has in turn won the trust of its European partners.

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[1] See the results of the stress tests published by the ECB on 26 October 2014.

[2]See the Hellenic Republic Public Debt Bulletin, no. 75, September 2014, Table 6.

[3] For a comparison with the situation in June 2012, see Céline Antonin, "Retour à la drachme: un drame insurmontable?", [Return to the drachma: an insurmountable drama?], *Note de l'OFCE* no. 20, June 2012.

Labour market reform in Italy: Matteo Renzi up against the wall

By Céline Antonin

While Matteo Renzi had enjoyed a relative "state of grace" since his election in February 2014, the Senate vote in early December on the hotly disputed reform of the labour market (the Jobs Act) has led to a general strike, a first since he took office. Is this the end of Matteo Renzi's honeymoon with the Italian people? Although his ascension to power had sparked a wave of hope, the initial results have been disappointing. The reforms are going down poorly as Italy experiences its third consecutive year of recession (-0.2% growth forecast in 2014), and the country is facing criticism from the European Commission for its inability to reduce its structural deficit. This reform is inspired by a free market approach and aims to introduce a flexi-security system. The measure that is the particular focus of passion would remove Article 18 of the Labour Code, which allows reinstatement in the case of unfair dismissal.

In the latest *Note de l'OFCE* (no. 48, 16 December 2014), we study the reform of the labour market being undertaken in Italy, which is a major challenge due to the segmentation of the labour market, high youth unemployment and inappropriate costs relative to labour productivity. However legitimate the Jobs Act may be, it seems too partial to have any real impact. In the short term, Italy's priority should be on investment. The only way the country can re-establish normal access to bank financing and return to growth is through the combination of an expansionary monetary policy, the continued pursuit of a banking union, and an ambitious public investment policy. Once these conditions have been met, then the question of a structural reform of the labour market will arise; this reform must be coupled with reform of the goods market in order to allow Italy to restore productivity and achieve a sustainable improvement in its growth potential.

Banking Europe: Strength in the Union?

By Céline Antonin and Vincent Touzé

On 4 November 2014, the European Central Bank became the single supervisor of banks in the euro zone. This was the first step in the banking union.

The economic and financial crisis that started in 2007 has exposed several European weaknesses:

1. The national bank markets, though seemingly compartmentalized, proved to be highly interdependent, as was seen in the high level of propagation-contamination;
2. There was often a lack of coordination in the national support provided;
3. Given the context of high public indebtedness, State support for the bank system led to a strong correlation between bank risk and sovereign risk;
4. The absence of fiscal transfer mechanisms strongly limited European solidarity.

In 2012, the idea of a banking union arose out of a triple necessity: to break the link between the banking crisis and the sovereign debt crisis by enabling the direct recapitalization of troubled banks through the European Stability Mechanism; to prevent bank runs; and to prevent the euro zone banking markets from fragmenting.

The banking union is being built on three pillars: a single supervision mechanism (SSM); a single resolution mechanism (SRM), with a resolution fund and a bail-in process; and a single deposit guarantee system with a guarantee fund.

The banking union sets out new solutions. Nevertheless, grey areas remain, and the European solidarity provided by the banking union could prove insufficient to deal with major shocks.

The latest *Note de l'OFCE* (no. 46 of 18 November 2014) reviews the context surrounding the establishment of the banking union and takes stock of the advantages and limitations of the progress made in constructing the union. This Note was produced as a special study entitled "Comment lutter contre la fragmentation du système bancaire de la zone euro?", [How can the fragmentation of the euro zone banking system be fought?] *Revue de l'OFCE*, no. 136 (2014).

Changes in taxation in Europe from 2000 to 2012: A few analytical points

By Céline Antonin, Félix de Liège and Vincent Touzé

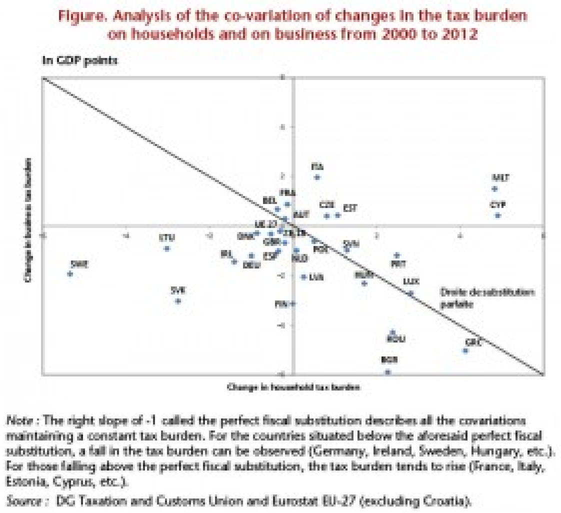
There is great diversity to Europe's tax systems, reflecting the choices of sovereign States with differentiated destinies. Since the Treaty of Rome, the Member States have steadily refused to give up national authority over taxation, with the exception of a minimum level of coordination on value-added tax (VAT). Europe now faces a real risk of a rise in non-cooperative tax strategies, with each country seeking to improve its economic performance at the expense of the others.

This kind of aggressive strategy is being fuelled by two factors: on the one hand, a drive for competitiveness (fiscal devaluation), aimed at reducing the tax burden on businesses so as to improve price competitiveness; and on the other, a drive for fiscal advantage, aimed at luring the rarest factors of production to the national territory. On a macroeconomic level, it is difficult to distinguish clearly between these two factors. However, one way of understanding how the European states have improved their position may be to look at how the tax burden on business has evolved in comparison with the burden on households.

OFCE Note no. 44 describes changes in the compulsory tax burden (TPO) in Europe. It is based on statistics from *Tendances de la fiscalité*, which is published jointly by Eurostat and the European Commission's Taxation and Customs Union Directorate. These statistics have the advantage of providing harmonized data on tax rates, with a breakdown of the tax base (capital, labour, consumption) and the type of paying agent (household, business, individual entrepreneur). We study the period 2000-2012: it is of course always difficult to separate trends in taxation from cyclical adjustments, especially as budget constraints tighten. Nevertheless, the 2000-2012 period should be sufficiently long to reveal changes of a structural nature.

Based on these data, we first highlight contrasting trends in the tax burden in the European Union, which can be broken down into four phases: two phases of rises (between 2004 and 2006 and since 2010) and two phases of reductions (before 2004 and from 2006 to 2010), which is linked in particular with cyclical factors. In addition to this common dynamic, we can see non-convergent adjustments made by the European countries in the taxation of households and the taxation of business (see graph). We then focus on possible tax substitutions between payroll taxes and consumption, and between payroll taxes and employee contributions.

Over the period 2000-2012, it is difficult to talk about tax competition at a global level, even though there was a slight decrease in the average tax burden within the European Union and very specific moves in this direction by certain countries. While some countries have definitely reduced the tax burden on business (UK, Spain, Germany, Ireland, Sweden, etc.), others have increased it (Belgium, France, Italy, etc.). However, in the long-term, it would seem difficult to maintain such a high level of tax diversity. At a time when European integration is being intensified, greater tax harmonization seems more necessary than ever.



Euro zone: Recovery or deflation?

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

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

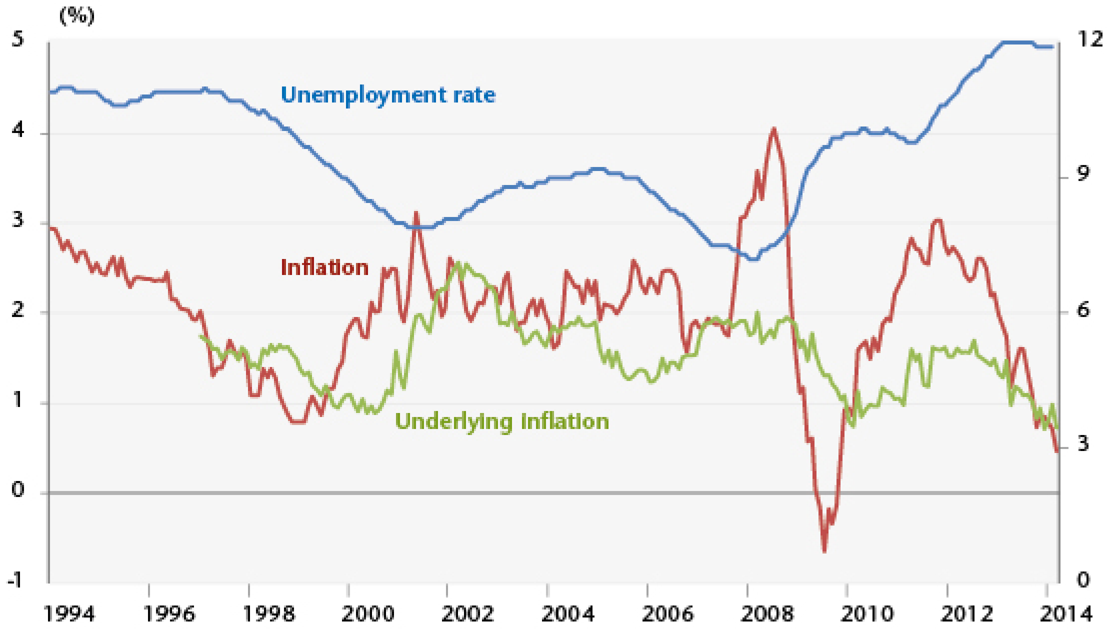
Will the euro zone embark on the road to recovery, or will it sink into a deflationary spiral? The latest macroeconomic indicators are sending out conflicting signals. A return to growth is being confirmed, with three consecutive quarters of rising GDP. However, the level of unemployment in the euro zone remains at a historically high level (11.9% for the month of February 2014), which is fuelling deflationary pressures, as is confirmed by the latest figures on inflation (0.5% yoy for March 2014). While this reduction in inflation is partly due to changes in energy prices, the fact remains that underlying inflation has fallen under 1% (Figure 1). In these conditions, a turnaround in inflationary expectations cannot be excluded, which would undoubtedly push the euro zone into deflation. The ECB has been concerned about this situation for several weeks and says it is ready to act (see here). However, no concrete proposal for a way to ease monetary policy and ensure that expectations are not anchored on a deflationary trajectory has been set out.

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

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

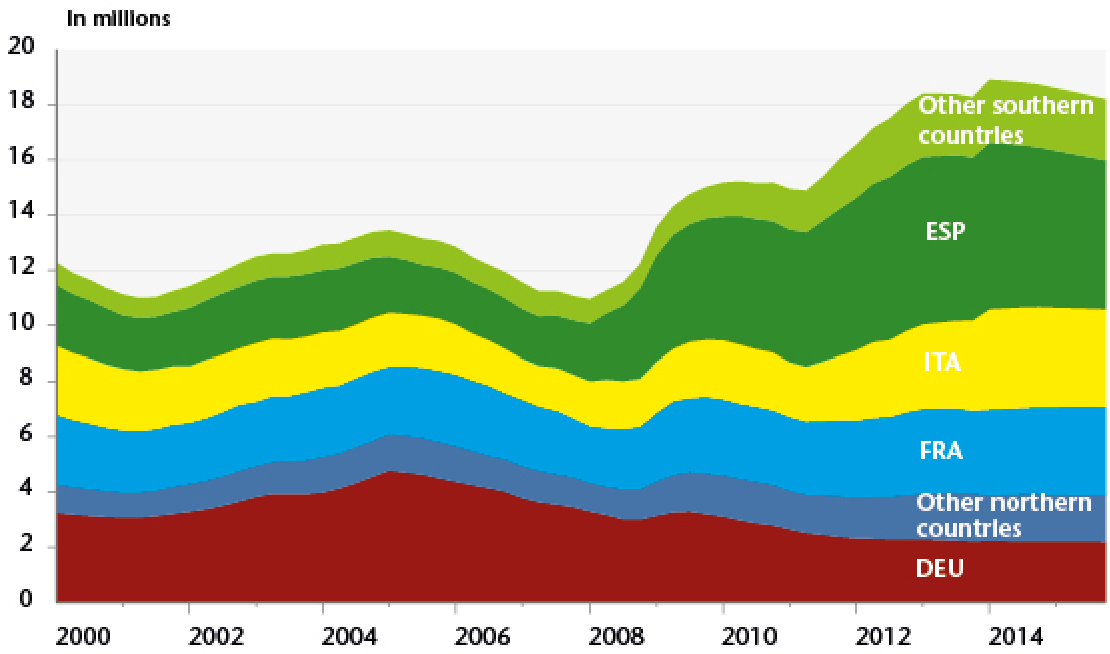
The situation in the euro zone is reminiscent of Japan in the 2000s. The country began to experience deflation in 1999 [2] following the recession associated with the Asian crisis. At that point, despite average growth of 1.4% between 2000 and 2006, prices failed to pick up, and the country's central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

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



Source : Eurostat.

Figure 2. Unemployment in the euro zone countries



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

Sources : Eurostat, OFCE forecast April 2014.

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[1] In July, ECB President Mario Draghi declared that the central bank would save the euro “whatever it takes”. In

September, the ECB announced the creation of a new mechanism called Outright Monetary Transactions (see the post by Jérôme Creel and Xavier Timbeau), which enables it to engage in unlimited purchases of sovereign debt.

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

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

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

By Céline Antonin, Henri Sterdyniak and Vincent Touzé

At the impetus of EU Commissioner Michel Barnier, on 29 January 2014 the European Commission proposed new regulations aimed at limiting and regulating the commercial activities of banks "of systemic importance", that is to say, the infamous "too big to fail" (TBTF).

Regulating proprietary activities: a need born of the crisis

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

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

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

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

An ambitious European regulatory proposal

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

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

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

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

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

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

Compared to French regulations, the regulatory proposal is more restrictive than the law on the separation and regulation of banking activities of 26 July 2013. Indeed, French law provides for the legal compartmentalization only of certain proprietary activities and highly leveraged activities in an independently financed subsidiary; strict prohibition concerns only high-frequency trading activities and speculation in agricultural commodities. And there are numerous exceptions: the provision of services to clients, market-making activities, cash management, and investment transactions and hedging to cover the bank’s own risks. In contrary, the prohibitions are broader in the regulatory proposal, as it applies to all proprietary trading. In addition, the regulatory proposal prohibits investment in hedge funds, whereas the French law permits it provided that such activities are compartmentalized.

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

A reform that doesn't have a consensus

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

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

The banking union provides for the European Central Bank to oversee the large European banks and for the European Banking Agency to set the regulations and rules on supervision. The Commission can therefore be reproached for intervening in a field for which it is no longer responsible. On the other hand, the crisis clearly showed that banking concerns more than just the banks. It is legitimate for EU political institutions (Commission, Council, Parliament) to intervene in the matter.

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

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

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

A fourth pillar for the banking union?

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

However, the separation advocated by the Barnier proposal lends credibility to the banking union and its three pillars (SSM, SRM and deposit insurance). This project does contribute to convergence in banking regulations, from both a functional and a prudential perspective. The establishment of a consistent framework simplifies control by the European supervisor under the SSM (the ECB will monitor the banks' normal activities and ensure that they are not affected by speculative activities). The separation recommended by the Barnier proposal enhances the credibility of the SRM; there will no longer be any banks that are too big to go bankrupt, and investment bank losses will not rebound onto the lending activities of deposit banks and will not have to be borne by the taxpayer. By reducing the risk that deposit banks might fail, the risk of a costly rescue plan for investors (bail-in) is also lowered, as is the risk of needing recourse to deposit insurance. In this sense, the draft regulations can be considered a fourth pillar of the banking union.

For more information:

– Antonin C. and V .Touzé V. (2013), The law on the separation of banking activities: political symbol or new economic paradigm?, OFCE Blog, 26 February 2013.

– Avaro M. and H. Sterdyniak H. (2012), Banking union: a solution to the euro crisis?, OFCE Blog, 10 July 2012.

– Gaffard J.-L. and J.-P. Pollin (2013), Is it pointless to separate banking activities?, *OFCE Blog*, 19 November 2013.

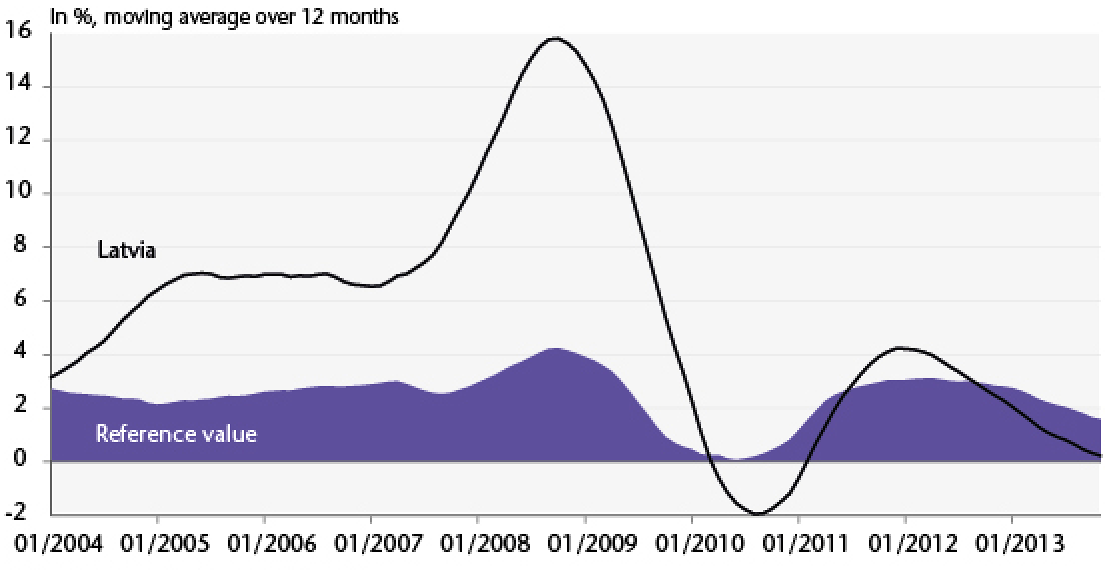
Latvia: goodbye lats, hello euro!

By Céline Antonin

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

At the end of 2008, facing an emergency situation, the country requested international assistance from the IMF and the European Union, which granted this in return for a drastic austerity plan. The aid came to some 7.5 billion euros, about one-third of the country's GDP. The national debt thus rose sharply between 2007 and 2012, from 9% of GDP to 40%. Latvia undertook a fiscal purge in order to boost its competitiveness and reduce its public deficit by drastically lowering public spending, wages and pension payments. This internal devaluation strategy led to sharp disinflation, which allowed Latvia to meet the ERM II goal for price stability (see chart). In accordance with IMF advice, the country has stuck to its goal of joining the euro zone quickly while categorically refusing to use the weapon of an external devaluation to get out of the crisis. It has for instance adhered to its policy of maintaining a fixed exchange rate against the euro without interruption since 1 January 2005.

Figure : Price stability in Latvia with respect to inflation criteria



Sources : Eurostat, author's calculations.

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

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

Europe's banks: sustaining the renewal of confidence

By Céline Antonin and Vincent Touzé

Since August 2012, bank shares in the stock markets have risen and their volatility has reduced, attesting to a return of confidence. Is this newfound confidence sustainable? *OFCE* Note no. 36 of 11 December 2013 attempts to answer this question by taking stock of the state of the banks in late 2013.

The financial crisis saw the valuation of banks suffer due to both a decline in the profitability of activities related to the financial markets and a general crisis of confidence in stock market investments. Since August 2012, however, bank results have improved, as has their performance on the stock markets.

That said, this newfound confidence is emerging in a context of profound change: the crisis has altered the way the European banking system functions, with the European Central Bank playing a greater role in lending to banks and with a sharp reduction in national exposures in the riskier countries (Portugal, Ireland, Italy, Spain and Greece).

Whether this confidence is sustainable will depend on the ability of the banks to face up to two challenges: first, to reduce the risk of insolvency of public and private debt in certain Member States; and second, to adapt to the institutional changes taking place at the European level (implementation of Basel 3, the banking union project and the gradual shift from a bail-out logic to a bail-in logic).

The euro zone quartered

By Céline Antonin, Christophe Blot, Sabine Le Bayon and Danielle Schweisguth

This text summarizes the [OFCE's 2013-2014 forecast for the euro zone economy](#).

After six quarters of decline, GDP in the euro zone has started to grow again in the second quarter of 2013. This upturn in activity is a positive signal that is also being corroborated by business surveys. It shows that the euro zone is no longer sinking into the depths of depression. It would nevertheless be premature to conclude that a recovery is underway, as the level of quarterly growth (0.3%) is insufficient to cause any significant reduction in unemployment. In October 2013, the unemployment rate stabilized at 12% of the workforce, a record high. Above all, the crisis is leaving scars and creating new imbalances (unemployment, job insecurity and wage deflation) that will act as obstacles to future growth, especially in certain euro zone countries.

Several factors point towards a pick-up in economic activity that can be expected to continue over the coming quarters. Long-term sovereign interest rates have fallen, particularly in Spain and Italy. This reflects that the threat of a breakup of the euro zone is fading, which is due in part to the conditional support announced by the ECB a little over a year ago (see [Friends of acronyms: here comes the OMT](#)). Above all, there should be an easing of fiscal austerity, given that the European Commission has granted additional time to several countries, including France, Spain and the Netherlands, to deal with their budget deficits (see [here](#) for a summary of the recommendations made by the European Commission). Driven by the same mechanisms that we have already described in our previous forecasts, a little higher growth should follow this easing of austerity (-0.4 GDP point of fiscal effort in 2013, down from -0.9 point in 2013 and -1.8 in 2012). After two years of recession in 2012 and 2013, growth is expected to come to 1.1% in 2014.

Nevertheless, this growth will not be sufficient to erase the traces left by the widespread austerity measures implemented since 2011, which pushed the euro zone into a new recession. In particular, employment prospects are improving only very slowly because growth is too weak. Since 2008, the euro zone has destroyed 5.5 million jobs, and we do not expect a strong recovery in net job creation. Unemployment could fall in some countries, but this would be due mainly to discouraged jobseekers withdrawing from the workforce. At the same time, less austerity does not mean that there will be no austerity. With the exception of Germany, fiscal consolidation efforts will continue in all the euro zone countries. And whether this is achieved through a reduction in public spending or an increase in the tax burden, households will bear the brunt of the adjustment. At the same time, the persistence of mass unemployment will continue to fuel the deflationary pressures already at work in Spain and Greece. The improved competitiveness that results in these countries will boost exports, but at the expense of increasingly undermining domestic demand. The impoverishment of the countries of southern Europe is going to be aggravated. Growth in these countries in 2014 will again be lower than in Germany, Austria, Finland and France (Table).

As a consequence, the euro zone will be marked by increasing heterogeneity, which could wind up solidifying public opinion in different countries against the European project and making the governance of the monetary union more difficult as national interests diverge.

Table. Growth in the euro zone

In %

	2013				2014				2012	2013	2014
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4			
DEU	0,0	0,7	0,2	0,3	0,3	0,4	0,4	0,4	0,9	0,9	1,5
FRA	-0,2	0,5	0,0	0,2	0,3	0,4	0,4	0,4	0,0	0,1	1,3
ITA	-0,6	-0,3	0,0	0,1	0,1	0,2	0,2	0,2	-2,4	-1,8	0,4
ESP	-0,4	-0,1	0,0	0,0	0,2	0,3	0,3	0,3	-1,6	-1,4	0,7
NLD	-0,4	-0,2	0,3	0,3	0,3	0,3	0,4	0,4	-1,3	-1,1	1,1
BEL	0,0	0,2	0,2	0,4	0,4	0,4	0,6	0,6	0,3	0,1	1,6
IRL	-0,6	0,4	0,2	0,3	0,4	0,4	0,4	0,4	0,1	-0,5	1,4
PRT	-0,4	1,1	0,0	0,2	0,2	0,3	0,3	0,3	-3,2	-1,7	1,0
GRC	1,1	9,6	0,5	-1,1	-3,9	1,2	1,3	1,5	-6,4	-4,1	-0,4
AUT	0,1	0,1	0,3	0,3	0,4	0,4	0,4	0,4	0,6	0,4	1,3
FIN	-0,2	0,2	0,3	0,4	0,4	0,5	0,5	0,5	-0,8	-0,9	1,7
EUZ	-0,2	0,3	0,1	0,2	0,3	0,4	0,4	0,4	-0,6	-0,3	1,1

Sources : Eurostat, OFCE calculations and forecasts, October 2013.