Croatia in the European Union: an entry without fanfare

By Céline Antonin and Sandrine Levasseur

On 1 July 2013, ten years after filing its application to join the European Union, Croatia will officially become the 28th member state of the EU and the second member country from former Yugoslavia. Given the country's size (0.33% of the GDP of the EU-28) and the political consensus on its membership, Croatia's accession should pass relatively unnoticed. However, there are challenges posed by its entry. Indeed, at a time when the European Union is going through the worst crisis in its history, legitimate questions can be raised about whether Croatia is joining prematurely, particularly as it is experiencing its fifth successive year of recession. The latest OFCE Note (no. 27, 26 June 2013) reviews two of the country's main weaknesses: first, a lack of competitiveness, and second, a level of corruption that is still far too high to guarantee steady and sustainable growth.

With 4.3 million inhabitants, Croatia initially experienced a period of strong economic growth up to 2008, based on the strength of its tourist industry and on consumption that was largely underpinned by lending from foreign capital. The crisis revealed, yet again, the limitations of this development model and highlighted the country's structural weaknesses: a high level of dependence on foreign capital, the vulnerability of a system of (quasi) fixed exchange rates, an unfavourable environment for investment and wide-scale tax evasion.

Even though negotiations thankfully addressed some of these problems, others are still unresolved. For instance, with respect to the economy, the domestic market is still not open enough to competition, with the result that the country suffers from a lack of competitiveness. At the legal level, the progress made in the fight against corruption, tax evasion and the underground economy has been woefully inadequate, depriving the country of the foundations for robust growth. Following on the heels of Romania and Bulgaria, the entry of Croatia may unfortunately endorse the idea that curbing corruption is not a prerequisite for joining the EU. In view of the repeated institutional crises that have hit the European Union since 2009 and widespread Euroscepticism, it is now urgent for the EU to makes its priority deepening rather than widening.

Competitiveness: danger zone!

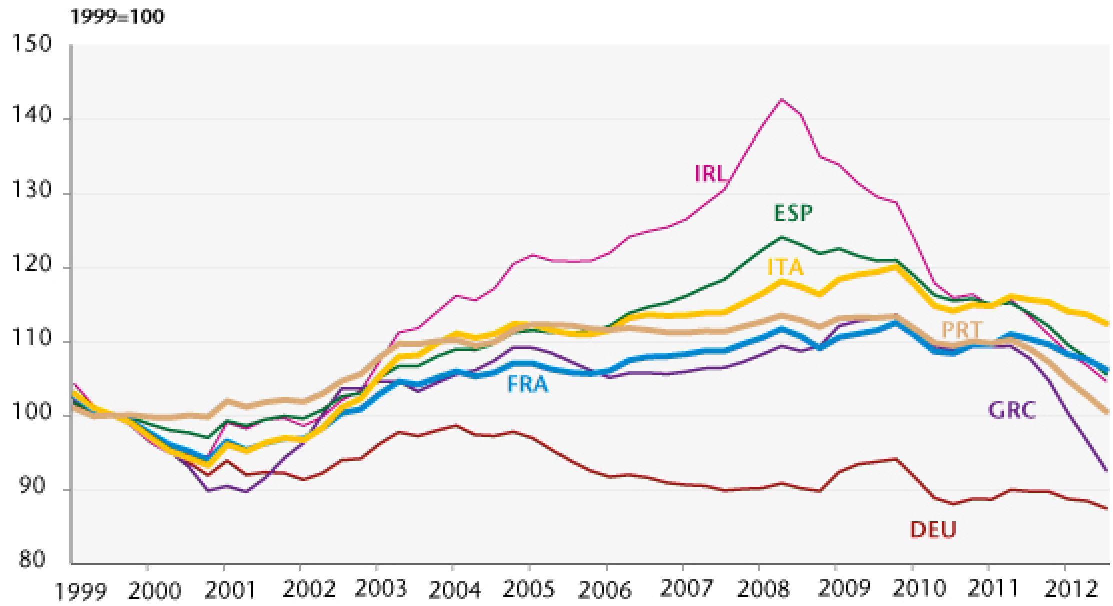
By Céline Antonin, Christophe Blot, Sabine Le Bayon and Catherine Mathieu

The crisis affecting the euro zone is the result of macroeconomic and financial imbalances that developed during the 2000s. The European economies that have provoked doubt about the sustainability of their public finances (Spain, Portugal, Greece and Italy [1]) are those that ran up the highest current account deficits before the crisis and that saw sharp deteriorations in competitiveness between 2000 and 2007. Over that same period Germany gained competitiveness and built up growing surpluses, to such an extent that it has become a model to be emulated across the euro zone, and especially in the countries of southern Europe. Unit labor costs actually fell in Germany starting in 2003, at a time when moderate wage agreements were being agreed between trade unions and employers and the coalition government led by Gerhard Schröder was implementing a comprehensive programme of structural reform. This programme was designed to make the labour market [2] more flexible and reform the financing of social protection but also to restore competitiveness. The concept of competitiveness is nevertheless complex and reflects a number of factors (integration into the international division of production processes, development of a manufacturing network that boosts network effects and innovation, etc.), which also play an important role.

In addition, as is highlighted in a recent analysis by Eric Heyer, Germany's structural reforms were accompanied by a broadly expansionary fiscal policy. Today, the incentive to improve competitiveness, strengthened by the implementation of improved monitoring of macroeconomic imbalances (see here), is part of a context marked by continued fiscal adjustment and high levels of unemployment. In these conditions, the implementation of structural reforms coupled with a hunt for gains in competitiveness could plunge the entire euro zone into a deflationary situation. In fact, Spain and Greece have already been experiencing deflation, and it is threatening other southern Europe countries, as we show in our latest forecast. This is mainly the result of the deep recession hitting these countries. But the process is also being directly fueled by reductions in public sector wages, as well as in the minimum wage (in the case of Greece). Moreover, some countries have cut unemployment benefits (Greece, Spain, Portugal) and simplified redundancy procedures (Italy, Greece, Portugal). Reducing job protection and simplifying dismissal procedures increases the likelihood of being unemployed. In a context of under-employment and sluggish demand, the result is further downward pressure on wages, thereby increasing the deflationary risks. Furthermore, there has also been an emphasis on decentralizing the wage bargaining process so that they are more in tune with business realities. This is leading to a loss of bargaining power on the part of trade unions and employees, which in turn is likely to strengthen downward pressure on real wages.

The euro zone countries are pursuing a non-cooperative strategy that is generating gains in market share mainly at the expense of other European trading partners. Thus since 2008 or 2009 Greece, Spain, Portugal and Ireland have improved their competitiveness relative to the other industrialized countries (see graph). The continuation of this strategy of reducing labor costs could plunge the euro zone into a deflationary spiral, as the countries losing market share seek in turn to regain competitiveness by reducing their own labour costs. Indeed, this non-cooperative strategy, initiated by Germany in the 2000s, has already contributed to the crisis in the euro zone (see the box on p.52 of the ILO report published in 2012). It is of course futile to hope that the continuation of this strategy will provide a solution to the current crisis. On the contrary, new problems will arise, since deflation [3] will make the process of reducing both public and private debt more expensive, since debt expressed in real terms will rise as prices fall: this will keep the euro zone in a state of recession.

Figure 1: Competitiveness measured by unit labour costs (total economy)



Note: A fall in the indicator expresses an improvement in competitiveness.
Source: European Commission.

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[1] The Irish case is somewhat distinct, as the current account deficit seen in 2007 was due not to trade, but a shortfall in income.

[2] These reforms are examined in detail in a report by the Conseil d'analyse économique (no. 102). They are summarized in a special study La quête de la compétitivité ouvre la voie de la déflation ("The quest for competitiveness opens the door to deflation").

[3] For a more comprehensive view of the dynamics of debt-driven deflation, see here.

The chalice of austerity, right to the dregs

Céline Antonin, Christophe Blot and Danielle Schweisguth

This text summarizes the OFCE's April 2013 forecasts

The macroeconomic and social situation in the euro zone continues to cause concern. The year 2012 was marked by a further decline in GDP (-0.5%) and a continuing rise in the unemployment rate, which reached 11.8% in December. While this new recession is not comparable in magnitude to that of 2009, it is comparable in duration, as GDP fell for the fifth consecutive time in the last quarter of 2012. Above all, for some countries (Spain, Greece and Portugal), this prolonged recession marks the beginning of deflation that could quickly spread to other countries in the euro zone (see The onset of deflation). Finally, this performance has demonstrated the failure of the macroeconomic strategy implemented in the euro zone since 2011. The strengthening of fiscal consolidation in 2012 did not restore market confidence, and interest rates did not fall except from the point when the risk of the euro zone's collapse was mitigated by the ratification of the Treaty of stability, coordination and governance (TSCG) and the announcement of the new WTO operation allowing the ECB to intervene in the sovereign debt markets. Despite this, the fiscal dogma has not been called into question, meaning that in 2013, and if necessary in 2014, the euro zone countries will continue their forced march to reduce their budget deficits and reach the symbolic threshold of 3% as fast as possible. The incessant media refrain that France will keep its commitment is the perfect reflection of this strategy, and of its absurdity (see France: holding the required course). So until the chalice has been drunk to the dregs, the euro zone countries seem condemned to a strategy that results in recession, unemployment, social despair and the risk of political turmoil. This represents a greater threat to the sustainability of the euro zone than the lack of fiscal credibility of one or another Member State. In 2013 and 2014, the fiscal stimulus in the euro zone will again be negative (-1.1% and -0.6%, respectively), bringing the cumulative tightening to 4.7 GDP points since 2011. As and to the extent that countries reduce their budget deficits to less than 3%, they can slow the pace of consolidation (Table). While in the next two years Germany, which has already balanced the public books, will cease its consolidation efforts, France will have to stay the course in the hope of reaching 3% in 2014. For Spain, Portugal and Greece, the effort will be less than that what has already been done, but it will continue to be a significant burden on activity and employment, especially as the recessive impact of past measures continue to be felt.

In this context, the continuation of a recession is inevitable. GDP will fall by 0.4% in 2013. Unemployment is expected to break new records. A return to growth is not expected until 2014, but even then, in the absence of any relaxation of the fiscal dogma, hopes may again be disappointed since the anticipated growth of 0.9% will be insufficient to trigger any significant decline in unemployment. In addition, the return to growth will come too late to be able to erase the exorbitant social costs of this strategy, while alternatives to it are discussed inadequately and belatedly.

Table. Public balance and fiscal impulse in the euro zone countries

In GDP points

	Public deficit			Fiscal impulse	
	2012	2013 (p)	2014 (p)	2013 (p)	2014 (p)
Germany	0,2	-0,4	-0,1	0,1	0,0
Austria	-3,0	-2,5	-1,8	-0,6	-0,3
Belgium	-3,0	-2,8	-1,9	-0,5	-1,0
Spain	-10,2	-6,5	-5,8	-2,0	-1,1
Finland	-1,6	-1,5	-0,9	-0,8	-0,7
France	-4,8	-3,9	-3,0	-1,8	-1,4
Greece	-6,6	-5,4	-4,5	-3,8	-2,0
Ireland	-8,2	-8,4	-6,6	-1,9	-1,8
Italy	-3,0	-3,9	-3,4	-1,4	-0,7
Netherlands	-4,1	-3,4	-3,0	-1,7	-0,7
Portugal	-5,0	-4,4	-3,0	-2,1	-1,9
Euro zone 11*	-3,2	-2,6	-1,8	-1,1	-0,6

* Excluding Cyprus, Luxembourg, Malta, Slovakia and Estonia.

Sources : Eurostat, European Commission, OFCE calculations and forecast March 2013.

Cyprus: Aphrodite to the rescue?

By Céline Antonin and Sandrine Levasseur

For two weeks Cyprus sent tremors through the European Union. If the banking crisis that the island is going through has attracted much attention, it is essentially for two reasons. First, because the dithering over the rescue plan led to a crisis of confidence in deposit insurance, and second, because it was the first time that the European Union had allowed a bank to fail without coming to its aid. While the method of resolving the Cyprus crisis seems to represent an institutional advance [1], insofar as investors have been forced to face up to their responsibilities and citizens no longer have to pay for the mistakes of the banks, the impact of the purge of the island’s real economy will nevertheless be massive. With its heavy dependence on the banking and financial sector, Cyprus is likely to face a severe recession and will have to reinvent a growth model in the years to come. In this respect, the exploitation of natural gas resources seems an interesting prospect that should not be ruled out in the medium / long term.

To grasp what is at stake in Cyprus today, let us briefly recall the facts. On 25 June 2012, Cyprus requested financial assistance from the EU and the IMF, essentially in order to bail out its two main banks (Laiki Bank and Bank of Cyprus), whose losses are estimated at 4.5 billion euros due to their high exposure to Greece. Cypriot banks were hit both by the depreciation of the Greek assets they held on their balance sheets and by the partial write-down of Greek debt under the second bail-out plan (PSI Plan of March 2012 [2]). Cyprus estimated that it needed 17 billion euros in total over four years to prop up its economy and its banks, about one year of the island's GDP (17.9 billion euros in 2012). But its backers were not ready to give it this much: the national debt, which had already reached 71.1% of GDP in 2011, would become unsustainable. The IMF and the euro zone thus came to an agreement on a smaller loan, with a maximum amount of 10 billion euros (9 billion financed by the euro zone and 1 billion by the IMF) to recapitalize the Cypriot banks and finance the island's budget for three years. Cyprus was in turn ordered to find the remaining 7 billion through various reforms: privatizations, an increase in corporate tax from 10 to 12.5%, and a windfall tax on bank deposits.

Initially [3], Nicosia decided to introduce a one-off tax of 6.75% on deposits of between 20,000 and 100,000 euros and 9.9% on those above 100,000 euros, and a withholding tax on interest on these deposits. Given the magnitude of the resulting protest, the government revised its approach, and the taxation of deposits gave way to a bankruptcy and restructuring. The solution adopted concerned the country's two main banks, Laïki Bank and Bank of Cyprus. Laïki was closed and split into two: first, a "good bank" that will take over the insured deposits (less than 100,000 euros) and the loans from the ECB to Laïki [4], but which will also take over its assets and ultimately be absorbed by Bank of Cyprus; and second, a "bad bank" that will accommodate the stocks, bonds, unsecured deposits (above 100,000 euros), and which will be used to pay off Laïki's debts [4], according to the order of priority associated with bank liquidations (depositors being paid first). In addition to absorbing the "good bank" hived off of Laïki, Bank of Cyprus will freeze its unsecured deposits, some of which will be converted into shares to be used in its recapitalization. To prevent a flight of deposits, temporary [5] capital controls were put in place.

This plan introduces a paradigm shift in the method of resolving banking crises in the European Union. At the beginning of the euro zone crisis, in particular in the emblematic case of Ireland, the European Union considered that creditors had to be spared in the event of losses, under the logic of "too big to fail", and it called on the European taxpayer. But in 2012, even before the declaration of Jeroen Dijsselbloem, Europe's doctrine had already begun to bend [6]. Hence, on 6 June 2012, the European Commission proposed a Directive on the reorganization and resolution of failing credit institutions, which provided for calling on shareholders and bondholders to contribute. [7] However, the rules on creditors are to apply only from 2018, after approval of the text by the Council and the European Parliament. This type of approach is now being tested experimentally in the Cyprus crisis.

Heavy consequences for the real economy

The situation of the country before 2008

In the period preceding the global economic crisis, the Cypriot economy was thriving, and indeed in 2007 even in danger of overheating. Over the period 2000-2006, its GDP grew on average by 3.6% per year, with growth of 5.1% in 2007. The unemployment rate was low (4.2% in 2007), with even some labour shortage as a result of the emigration of Cypriot nationals to other EU countries. The influx of foreign workers into Cyprus helped to hold down wages. Consumer spending and, to an even greater extent, business investment, which were largely financed through credit, were particularly dynamic starting in 2004, with growth rates that in 2007 reached, respectively, 10.2% and 13.4%. Inflation was moderate, and in this generally positive context, Cyprus qualified to adopt the euro on 1 January 2008.

In this pre-crisis period, the Cypriot economy – a small, very open economy – relied in the main on two sectors: tourism and financial services.

The two key sectors of the Cypriot economy

Revenue from tourism (Table 1) has provided a relatively stable financial windfall for the Cypriot economy. This (non-cyclical) flow brings in approximately 2 billion euros annually. [8] As a share of GDP, however, the weight of tourism has decreased by half since 2000, to a level of less than 11% in 2012. Likewise, the share of tourism in the export of services fell sharply during the last decade: in 2012, it accounted for 27% (against 45% in 2000). Over the last 15 years, the number of tourists has fluctuated somewhat between 2.1 million (in 2009) and 2.7 million (2000), compared with about 850,000 people who are residents of the island.

Financial services constitute the other pillar of the Cypriot economy (Table 2). Two figures give a clear idea of its significance: bank assets accounted for more than 7.2 times GDP in 2012 (with a maximum of 8.3 achieved in 2009), and the stock of FDI in the sector “Finance & Insurance” is estimated at more than 35% of GDP, *i.e.* more than 40% of all FDI inflows.

Table 1. Weight of tourism in Cyprus

	2000	2004	2009	2012
Tourist revenue				
In millions of €	2 040,1	1 678,4	1 493,2	1 926
In % of GDP	20,5	13,3	8,9	10,8
By tourist (in €)	759	715	697	781
In % of services exports	44,8	32,6	25,0	26,8
Tourists (1000s of people)	2 686	2 349	2 141	2 465

Source: Central Bank of Cyprus and National statistical office. Author's calculations.

Table 2. Weight of the banking sector in Cyprus

	2007	2008	2009	2010	2011	2012
Banking assets						
In billions of €	92,9	118,1	139,4	135,0	131,6	128,1
Relative to GDP	5,8	6,9	8,3	7,8	7,3	7,2
Stock of FDI in the Finance and Insurance sector						
In billions of €						6,4
In % of GDP						35,6
In % of total FDI						41,6

Source: Central Bank of Cyprus and National statistical office. Author's calculations.

As major sources of wealth for the Cypriot economy, these two sectors have played an important role by, at least until 2007, compensating (partially) the considerable deficit in the balance of payments, which has risen continuously since the early 1990s and fluctuated at around 30% of GDP since 2000 (Table 3). The "fuel" bill has been an increasing burden on imports into Cyprus, mainly due to higher oil prices: the energy bill has tripled over the last decade, rising from 461 million euros in 2000 to 1.4 billion in 2011. As a percentage of GDP, the rise in energy costs has also been very visible, as it has shot up from 5% of GDP in 2000 to 8% in 2011.

Reducing the size of the financial sector therefore raises the question of a new growth model for the Cypriot economy, *i.e.* its "industrial conversion".

Table 3. Extract from the balance of payments of Cyprus

In millions of € (unless stated otherwise)

		2000	2004	2007	2008	2009	2010	2011
Balance of goods								
Exports	Total	1 011	936	1 083	1 190	971	1 137	1 404
	o/w "re-exports"	600	521	578	643	491	570	777
Imports	Total	4 104	4 578	6 353	7 367	5 692	6 517	6 311
	o/w "fuels"	461	503	895	1 247	880	1 157	1 381
Exports - Imports	Total	-3 093	-3 641	-5 271	-6 176	-4 721	-5 381	-4 907
	Total (% of GDP)	-31 %	-29 %	-33 %	-36 %	-28 %	-31 %	-27 %
Balance of services								
Exports	Total	4 552	5 147	6 579	6 538	5 779	6 049	6 262
Imports	Total	1754,40	2 201	2 841	2 937	2 416	2 467	2 676
Exports - Imports	Total	2 797	2 946	3 739	3 601	3 363	3 583	3 586
	Total (% of GDP)	28 %	23 %	24 %	21 %	20 %	21 %	20 %
Balance of goods and services								
Exports - Imports	Total	-295	-696	-1 532	-2 575	-1 358	-1 798	-1 321
	Total excl. "fuels"	165	-192	-637	-1 328	-479	-641	60
	Total (% of GDP)	-3 %	-6 %	-10 %	-15 %	-8 %	-10 %	-7 %
	Total excl. "fuels" (% of GDP)	2 %	-2 %	-4 %	-8 %	-3 %	-4 %	0 %

Source: Office statistique national, Eurostat et banque centrale de Chypre. Calculs des auteurs.

The temptation to exit the euro

The plan decided by the Troika undermines the island's growth model by penalizing the country's hyper-financialization, and condemns it to years of recession. To avoid a long convalescence, the idea of leaving the euro zone has taken root, as it did in Greece. However, leaving the euro zone is far from a panacea. Regaining monetary sovereignty undeniably offers certain advantages, as is described by C. Antonin and C. Blot in their note, Comparative study of Ireland and Iceland: first, an internal devaluation (through lower wages) would not be as effective as an external devaluation (through exchange rates); second, fiscal consolidation is less costly when it is accompanied by a favourable exchange rate policy. Nevertheless, given the structure of the Cypriot economy, we do not think that leaving the euro is desirable.

In fact, upon leaving the euro, the Central Bank of Cyprus would issue a new currency. Assuming it remains convertible, this currency would depreciate vis-à-vis the euro. By way of comparison, between July 2007 and December 2008 the Icelandic krona lost 50% of its value vis-à-vis the euro. Such a depreciation would have two consequences:

– One, an improvement in competitiveness (the real exchange rate has appreciated by 10% since 2000), which would boost exports and help reduce the deficit in the balance of trade in goods and services (Table 1). Since the accession of Cyprus to the European Union in 2004, this balance has deteriorated as a result of several factors: first, the slowing of inflation from 2004 related to pegging the exchange rate to the euro, which encouraged the growth of real wages at a higher rate than productivity gains; and second, the boom in bank lending, with the substantial decline in risk premiums on loans as a result of accession to the EU [9]. Consumption was boosted, the competitiveness of the Cypriot economy deteriorated, and imports increased. Would exiting the euro reverse this trend? This is the argument of Paul Krugman, who supports Cyprus leaving the euro zone by evoking a tourist boom and the development of new export-oriented industries. However, according to our calculations, a 50% depreciation in the real exchange rate would result in an increase in the value of exports of 500 million euros, including 150 million from additional tourism revenue. [10] As for imports, they are weakly substitutable, as they are composed of energy and capital and consumer goods. Given the weakness of the country's industries, Cyprus will not be able to undertake a major industrial restructuring in the short or medium term. There are therefore limits to improvements in the trade balance. Furthermore, inflation would increase, including through imported inflation, which would lead to a fall in consumer purchasing power and mitigate any competitiveness gains.

– In addition, the devaluation would substantially increase the burden of the outstanding debt, but also of private debt denominated in foreign currency. Net foreign debt in Cyprus is low, at 41% of GDP in 2012. In contrast, public debt reached

70% of GDP, or 12.8 billion euros. 99.7% of the public debt is denominated in euros or in a currency that is part of the European Exchange Rate Mechanism (and thus pegged to the euro), and 53% of this debt is held by non-residents. In addition, the deficit was 6.3% of GDP. If Cyprus no longer had the euro, it would without doubt default on part of its public debt, which would temporarily deprive the country of access to foreign capital, and thus require the kind of violent fiscal consolidation that Argentina went through in 2001.

The exploitation of natural gas resources

The crisis in Cyprus raises the question of the natural gas discoveries in the south of the island in the early 2000s. According to the US Geological Survey, the Levant Basin located between Cyprus and Israel could contain 3,400 billion cu.m of gas resources. By way of comparison, the entire EU has 2,400 billion cu.m (mainly in the North Sea).

Cyprus thus has *a priori* a major natural gas bonanza, even if all of the deposits are not located in its Exclusive Economic Zone (EEZ). At present, only one out of the twelve parcels of land belonging to the Cypriot EEZ has been subject to exploratory drilling, and in December 2011 a deposit of 224 billion cu.m of natural gas was discovered. According to the Government of Cyprus, the value of this field, called Aphrodite, is estimated at 100 billion euros[11]. The exploration of the other eleven parcels belonging to the Cypriot EEZ could prove successful (or even very successful) in terms of natural gas resources. As the licenses for the exploration of these eleven parcels are in the process of being awarded by the Cypriot authorities, the EU could have used the (sad) occasion of the rescue package to secure a portion of the aid granted to Cyprus on its gas potential. Why did the EU not seize on such an occasion?

For the EU, the discovery of the natural gas reserves is good news, in the sense that the exploitation of these deposits will help it to achieve the energy diversification that it values so highly. However, several problems have arisen, problems that darken the prospects for exploiting the gas fields in the very near future. First of all, the discovery of gas reserves in the Levant basin has revived tensions with Turkey, which occupies the northern part of the island of Cyprus and which believes it has rights to the exploitation of the fields. The growing number of Turkish military manoeuvres reflects an effort to impose its presence in the areas being surveyed and could lead to an escalation of violence in the region, especially since the Greek-Cypriot authorities (the southern part) have been working with Israel to defend the gas fields. [12] Second, even assuming that the Greek-Turkish dispute is resolved, the exploitation of the gas will require heavy investment in infrastructure, in particular the construction of an LNG tanker whose cost is estimated at 10 billion euros. Finally, there will be no immediate return on the investment, as it will take at least eight years to put in place the necessary infrastructure. In these conditions, it is understandable why the EU did not take the opportunity to secure some of the aid to Cyprus against these gas resources: exploitation is still too uncertain and, in any case, the horizon is too distant (given the immediacy required for a response to the crisis).

Furthermore, the EU would likely wind up in an awkward situation vis-à-vis several countries. If the EU supports Cyprus in the gas dispute, this comes down to supporting Israel, at the very time that the EU is holding negotiations on Turkey’s membership and is trying to build good relations in the region, including with the regimes that have emerged from the “Arab Spring”. In addition, two pipeline projects are already in competition: the South Stream project, linking Russia to Western Europe by 2015, and Nabucco, connecting Iran, via Turkey, to Western Europe by 2017. A new gas pipeline connecting the Cypriot fields to the European continent would further reduce Russia’s bargaining power, by shifting the centre of gravity of natural gas southwards. This would promote greater dispersion and intensify geopolitical divisions in Europe, between a Northern Europe (including Germany) supplied by Russia and a Southern Europe dependent on the Middle East and Turkey.

Conclusion

If in the immediacy of the crisis the EU has made the right choice (that of the "bad" and "good" bank), the question is posed in the medium / long term of a new growth model for the Cypriot economy. Given the comparative advantages of Cyprus, the exploitation of natural gas seems to offer the only serious solution for the economy's conversion. However, for this strategy to be achievable, the EU will have to take a clear position in favour of Cyprus in the Greek-Turkish dispute.

Not only would the exploitation of the gas bring Cyprus energy self-sufficiency, it would also constitute a major source of revenue for the island. Energy costs would cease being a burden on the balance of payments (Table 1). This is especially important, because, even though tourism (another pillar of the economy) has provided a stable (non-cyclical) source of income since 2000, it is not immune to geopolitical events in the region or to new competition over tourist destinations, in particular from the "Arab Spring" countries.

Consider this simple calculation. Suppose Cyprus manages to maintain its tourism revenues at the level of 2 billion euros (an assumption that, despite the caveats outlined above, is nevertheless realistic); in the absence of industrial restructuring, if the share of the banking sector in the economy is halved (as desired by the Troika and common sense), then Cypriot GDP would return to its 2003 level, or slightly less than 12 billion euros. And GDP per capita would fall by about a third….

Industrial reconversion is thus important for the Cypriot economy, just as for other economies in crisis…. except that Cyprus has Aphrodite.

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[1] See Henri Sterdyniak and Anne-Laure Delatte, ”Cyprus: a well-conceived plan, a country in ruins…”., OFCE blog, March 2013.

[2] See Céline Antonin, Would returning to the drachma be an overwhelming tragedy?, *OFCE Note* no. 20, 19 June 2012.

[3] For more on the dithering on the rescue plan, see Jérôme Creel, “The Cypri-hot case!”, OFCE blog, March 2013.

[4] These loans, granted via Emergency Liquidity Assistance (ELA), amount to 9 billion euros.

[5] Article 63 of the Treaty of the European Union prohibits restrictions on the movement of capital, but Article 64b authorizes Member states to take control measures for reasons of public order or public safety.

[6] “*If the bank can’t recapitalize itself, then we’ll talk to the shareholders and the bondholders. We’ll ask them to contribute in recapitalizing the bank. And if necessary the uninsured deposit holders*”, statement by Jeroen Dijsselbloem, 25 March 2013, to the *Financial Times*.

[7] http://www.revue-banque.fr/risques-reglementations/breve/les-creanciers-des-banques-mis-contribution

[8] The tourist revenue of Cyprus depends in the main on tourists from Britain (43% in 2011), Russia (14%), Germany and Greece (6.5 % each).

[9] On the factors worsening the current accounts, see Natixis, Retour sur la crise chypriote, novembre 2012.

[10] Estimation made using the elasticities calculated by the IMF.

[11] Not far from Aphrodite, 700 billion cu.m of deposits were discovered in the Israeli EEZ, proof that the region is rich in natural gas.

[12] The tensions between Cyprus (southern part) and Israel were resolved (peacefully) by the signing of a treaty in December 2010 defining their respective exclusive economic zones (EEZ). The two entities also plan to cooperate in the construction of common infrastructures to exploit the gas. See the analysis of Angélique Palle on the geopolitical consequences of the discovery of these natural gas resources in the Levant basin.

The law on the separation of banking activities: political symbol or new economic paradigm?

By Céline Antonin and Vincent Touzé

Imprudence, moral hazard and systemic gridlock were key words for the banking crisis. Governments that were unhappy to have had no choice but to come to the rescue of the banks are now trying to regain control and impose new regulations. The regulations with the highest profile concern the separation of *trading activities (trading on own account or for third parties) from other banking activities (deposits, loans, strategic and financial consulting, etc.). These are expected to have the advantage of creating a tighter barrier between activities, with the idea that this could protect investors if bank operations go badly on the financial markets. On 19 February 2013, the French Parliament passed a law on the separation of banking activities. Although the initial targets were ambitious, the separation is only partial, as only proprietary financial activities will be spun off. As these cover less than 1% of bank revenues, this measure tends to be symbolic. However, by giving legal force to the principle of separation, the State is demonstrating its willingness to take a more active role in supervision.*

The idea of compartmentalizing banking activities is not new. In the aftermath of the 1929 crisis, the United States adopted the Glass-Steagall Act (1933), which required a strict separation between commercial banks (specialized in lending and in managing deposits) and investment banks (specialized in financial activities). France followed suit with its own banking law of 1945 [1]. The expected benefits of separating banking activities are twofold. On the one hand, customers' deposits would be better protected, because they could no longer be asked to absorb the potential losses of market activities; on the other hand, in case of bankruptcy, State aid would be limited, because only the retail part of the bank would be covered by a government guarantee.

Forty years later, in the wake of the major wave of deregulation in the 1980s-1990s, France was one of the first to abolish this distinction, with the Banking Act of 1984, thus establishing the principle of universal banking. This principle leads to grouping activities with high needs for liquidity (the financing of the economy) with those that make it possible to gather liquidity (deposit activities). This grouping has the undeniable merit of giving the banks a more solid financial foundation. Other benefits also flow from this: greater leverage; the size factor leads to economies of scale; and the banks' ability to internationalize allows them to join the "too big to fail" category. Across the Atlantic, these arguments certainly worked in favour of the abolition of the Glass Steagall Act in 1999 by the Clinton administration.

Since 2008, the banks have been hit by a number of shocks: the subprime crisis; the fall in financial stocks; the slump in economic growth; and fear of defaults on sovereign debt (for banks in the euro zone). These shocks have shown that some of the advantages of universal banking could turn into disadvantages if leverage is used too systematically and if large banks in difficulty begin to pose a systemic risk. Many voices then began to be heard advocating a new Glass-Steagall Act, based on a view that separating market activities [2] from other banking activities is a way of preventing large-scale banking crises. Trading on own-account activities concentrates the bulk of bank malfunctions, in particular reckless risk-taking and the occasional "mad" trader [3]. This compartment has thus now become the focus of increasing attention by the regulators.

The Dodd-Frank Wall Street Reform and Consumer Protection Act [4] adopted in the United States in 2010 did not establish the separation of banking activities in a strict sense, but adopted the "Volcker rule," which prohibits banks from "playing" with depositors' money. This led to a virtual ban on the speculative proprietary activities of banking entities as well as on investments in hedge funds or private equity funds. In addition to this rule, this Act also represented a major reform in favour of the tighter regulation of all financial agents (banks, insurance companies, hedge funds, rating agencies, etc.) as well as closer monitoring of systemic risks.

Europe is in turn planning legislation on the separation of banking activities. At the request of European Commissioner

Michel Barnier, the group of experts led by the Governor of Finland's Central Bank, Erkki Liikanen, presented a report on 2 October 2012. It advocates a strict bank compartmentalization [5] but also reviews the remuneration of financial managers and traders, with a view to overhauling the current arrangements, which tend to "push people into crimes" such as excessive speculation, in order to make these arrangements more compatible with long-term objectives. If this report is turned into a European directive, it will then have to be transposed into the national law in each Member State. However, this Europe-level approach is likely to be overtaken by the legislative processes in several European countries. In Germany, a bill on banking regulation [6] was introduced by the government on 6 February 2013, and could enter into force by January 2014 (with implementation by July 2015). The United Kingdom stood out in 2011 with the publication of the Vickers report [7], although the British government is in no hurry to implement its recommendations, with a probable deadline of 2019. France, with its "law on the separation and regulation of banking activities", has not been left behind.

A MODEST FRENCH ACT …

The French law has several components. In addition to establishing the principle of separation, it also provides for measures to protect bank clients and to strengthen the supervision and control of the banks.It does this in several ways:

– Each bank will be forced to develop a preventive recovery plan [8] for dealing with a crisis and a resolution plan in case it is failing (a bank testament). The resolution plan will be submitted for the appreciation of the Prudential Control Authority (ACP), which becomes the Prudential Control and Resolution Authority (ACPR).

– The Deposit Guarantee Fund (FGD) becomes the Deposit

Guarantee and Resolution Fund (FGDR), with an increased capacity to intervene in the event of a bank failure.

– Macro-prudential supervision is strengthened by the establishment of the Financial Stability Council (CSF).

– The rights of bank clients are enhanced (transparency on the cost of loan insurance, free choice of loan insurers, right to a bank account, etc.).

However, the flagship measure in the reform is the separation between “activities useful to the economy” and speculative activities. Banks are to confine their proprietary or “own account” activities in an ad hoc subsidiary that is subject to specific regulation and funded independently. These subsidiaries will be prohibited from practicing certain speculative activities that are deemed “too risky or that may be harmful to the economy or society”, such as activities on the markets for derivatives whose underlying assets are agricultural commodities, or high-frequency trading. Many activities will nevertheless be spared, such as providing services to customers, market-making activities, cash management, and bank investment or hedging operations to cover its own risks.

This law separating bank activities, which was initially presented as ambitious, will ultimately have only a limited impact. The universal banking model is not called into question. The admission of the head of the Société Générale bank could not be any clearer [9]: less than 1% of revenues are concerned. We are therefore a long way from how banking was compartmentalized prior to 1984. The criterion for separation is ambiguous. In fact, the border is porous between hedging risk and pure speculation: the law advances a fuzzy principle of “economic relevance”, and the banks may be tempted to play around in this legal vacuum. As for market making [10], it is difficult to distinguish between speculative proprietary activities, which have to be spun off, and activities to promote market liquidity: high-frequency trading is for instance usually practiced under the guise of market-making agreements, so the law may be no more than a sword slashing water if the status of market maker is not defined more precisely [11].

The law also provides for prohibiting a banking group from holding shares of a speculative type, like a hedge fund. However, the loans granted by banks to hedge funds are always accompanied by guarantees. From this point of view, the law will also have little impact.

… BUT COULD IT GO FURTHER?

Finding a new financial paradigm for a banking model is a complex exercise. In practice, it is not easy to separate banking activities purely and simply without causing problems, and there are generally many limits to banking reform.

First, limiting investment banks' access to deposits as a source of liquidity, or eliminating this outright, would lead them to resort to more debt financing, which might be difficult to reconcile with the constraints set by the Basel III prudential regulations, which took effect on 1 January 2013. It is already very demanding in terms of equity levels.

Furthermore, it is important to note that banking risk is not inherent just in market activities. There are many other recent examples. Mortgage lending has also been an important source of risk: in Spain, falling house prices and the insolvency of borrowers virtually bankrupted the banks; in the United States, the subprime crisis is a crisis of real estate loans that affected the markets through sophisticated securitization mechanisms that allowed the banks to take the risk off of their balance sheets (at least ostensibly); in the UK, Northern Rock is a retail bank that specialized in mortgages and was hit hard by the credit crunch and the housing crisis. To some extent, universal banks have played an important role in saving banks that were too specialized, for example, JPMorgan Chase (Universal) took over Washington Mutual (savings and loan) and Bear Stearns (business), and Bank of America (universal) rescued Merrill Lynch (business).

In addition, the separation is supposed to wall off banking activities more tightly. But what happens if the subsidiary that manages the proprietary speculation goes bankrupt and causes heavy losses to the parent? In the past, two of the four major French groups, Crédit Agricole and BPCE, had insulated their market activities in their respective subsidiaries, Natixis and Cacib, but nevertheless had to come to their rescue in 2008 and 2011, respectively. The insulation seems to be very permeable.

In a context of financial globalization, compartmentalization may never be very effective. By its very principle globalized finance makes it possible to connect everything. This is in particular the role of the interbank markets [12].

In practice, it is difficult for a government to reform its banking sector in the absence of coordination with other countries. The domestic banks have foreign subsidiaries that may not be subject to the regulations. And above all, the profitability of rival foreign banks might improve, which would weaken the competitiveness of the domestic banks. At the European level, national interests differ, and each country may be tempted to impose its own bill. If the Liikanen report is turned into a Directive, then each Member State will be required to transpose it into their legal system. For the moment, the legislation of Germany and France is taking the lead. It is possible that these changes will influence any future directive.

If the effort to compartmentalize goes too far, there is also a risk of shifting the interconnections to less visible levels. It is essential to avoid falling into the trap posed by the dangerous illusion of thinking that we have eliminated a risk, when in fact it has just been moved.

Finally, too much regulation can sometimes kill regulation. In the financial sector, regulatory constraints may serve as a basis for speculation. So if a bank is having difficulty meeting certain regulatory constraints, the markets will be encouraged to speculate in order to provoke its failure and then profit from this. Caution is therefore needed before introducing new regulations.

Trying to apply the principle of separation too strictly could also lead to not supporting a commercial bank that is facing significant liquidity problems. However, according to the principle of “too big to fail”, such a decision is not always wise. The failure to support Lehman Brothers was punished in a way that had a significant long-term impact, as its collapse hit the entire economic and financial network.

It is also worth noting that taking banking and financial regulation to be a miracle cure could have deleterious effects on individual and collective responsibility. People think that the law can resolve any problem. Yet at the same time, it is very likely that the vectors of the next financial crisis will manage to circumvent the regulatory constraints, hence the importance for the supervisory authorities to remain vigilant and adopt a critical approach at all times.

GOING BEYOND THE POLITICAL SYMBOL

The government undeniably has little leeway to separate banking activities, because too much regulation may be ineffective or even dangerous. As a consequence, this law separating banking activities is not radical and will have a moderate effect on the banks. For its part, the government may have a clear conscience for having done something along the lines of its foreign counterparts. The bankers in turn are probably not unhappy at having given the impression of serving the public interest, especially at such a low cost.

Some will view this as just a poor political symbol. Others will try to go further and view this as giving hope that this reform will be seen as a strong signal to the banking world. This hope may not be in vain, as the principle of separation is now enshrined in law, and future governments will have plenty of time to strengthen it.

In practice, a change in economic paradigm that would lead to harmful speculation becoming increasingly rare will not result simply from a separation of activities. Banking laws should not be too complicated, because the devil has a tendency to hide in the details. The supervisory authorities must constantly keep a critical eye on the functioning of the markets, and the law needs to allow them some flexibility in determining when and how they should intervene. On these issues, Volcker's statement in 2011 is unambiguous [13]: "I'd write a much simpler bill. I'd love to see a four-page bill that bans proprietary trading and makes the board and chief executive responsible for compliance. And I'd have strong regulators. If the banks didn't comply with the spirit of the bill, they'd go after them." It is also worth examining various measures to make financial professionals (managers and market operators) more responsible. In this respect, the Liikanen report proposes revising the pay systems for bank executives and financial managers in order to make these systems more compatible with a long-term vision. It is also necessary to explore the possibility of increasing the criminal liability [14] of financial leaders. The permeability of the interface between careers in the regulatory sector and in the regulated sector also needs to be examined. In this regard, there are certainly ways to make the system less permeable. After all, recent history has shown that it is possible to go from being Chairman of the Fed to being a trusted advisor for a rich and powerful hedge fund….

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[1] Law 45-15 of 2 December 1945 provided for the specialization of financial institutions by classifying the banks in three categories: deposit banks, business banks and long-term and medium-term lending banks (Articles 4 and 5).

[2] Asset management can be exercised:

– for one's own account (*proprietary trading*): the bank buys or sells financial instruments that are funded directly out of its own resources. These resources include not only the bank's capital, but also savers' deposits and loans. This means that, in addition to its own funds, the other categories involved in the bank's financing, including customer deposits, indirectly bear a risk.

– or on behalf of third parties (*non-proprietary trading*): unlike proprietary trading, the market or borrowing risks are borne mainly by the client. However, on certain products, the bank could face significant operating risks.

[3] http://lexpansion.lexpress.fr/economie/trading-pour-compte-propre-la-face-cachee-des-banques_233686.html.

[4] Title VI of the Act proposes improving regulation and is considered to be an application of the "*Volcker Rule*", *http://useconomy.about.com/od/criticalssues/p/Dodd-Frank-Wall-Street-Reform-Act.htm.*

[5] The report recommends a separation of proprietary market activities but also of certain other activities on the financial markets and derivatives for third parties.

[6] Germany is also preparing a bill, under which the German banks will be obliged to wall off their proprietary trading. As in France, the universal banking model will not be called into question.

http://m.lesechos.fr/redirect_article.php?id=reuters_00495696&fw=1.

[7] In September 2011, the Vickers Report recommended separating retail banking services from investment activities, by ringfencing retail banking services in subsidiaries, along with the requirement of a 10% equity cushion for retail banks. The British government is committed to introducing the reforms into law by 2015, with implementation set for 2019.

[8] This plan provides for different possibilities for recovery (recapitalization, a savings plan, restructuring, etc.) and excludes any call for public financial support.

[9] “We believe that, while in 2006-2007, 15% of activities could be considered market activities, 15% to 20% of which could be classified as disconnected from the customer, and consequently transferred to a subsidiary, this proportion is now less than 10%, and ranges from 3.5% to around 5% on average.” Frédéric Oudéa, 30 January 2013, at a hearing before the Finance Committee of the National Assembly, http://www.assemblee-nationale.fr/14/pdf/cr-cfiab/12-13/c1213060.pdf.

[10] Market-making corresponds to the permanent presence of an operator who provides liquidity to the market.

[11] In this respect, we should mention the amendment tabled by Karine Berger, who wants Bercy [the Ministry of the Economy] to set the threshold above which market activities must always be spun off.

[12] Since 2008, the crisis of confidence in the banking market has posed great difficulties for access to liquidity in some banks, even though they are perfectly solvent, which has forced the central banks to intervene and take the place of the interbank market.

[13] 22 October 2011,

http://www.nytimes.com/2011/10/22/business/volcker-rule-grows-from-simple-to-complex.html?pagewanted=all&_r=0.

[14] In this respect, the American authorities have not hesitated to take action against financial institutions that have failed to meet their obligations. See, for example, the recent action taken against Standard & Poor's, http://www.bloomberg.com/news/2013-02-06/s-p-lawsuit-portrays-cdo-sellers-as-duped-victims.html. See too the proceedings taken against a former employee of Goldman Sachs: http://www.sec.gov/litigation/complaints/2010/comp-pr2010-59.pdf and http://dealbook.nytimes.com/2013/01/31/trader-accused-of-misleading-clients-leaves-goldman/ or the investigation into the infamous "London whale": http://www.reuters.com/article/2013/02/15/us-lehman-jpmorgan-londonwhale-idUSBRE91E00W20130215.

Is it possible to get over a banking crisis? Comparative analysis of Ireland and Iceland

By Céline Antonin and Christophe Blot

In economics, miracles sometimes prove to be mirages. Iceland and Ireland are witnesses. These two small open economies, paradises of liberalized deregulated finance, harboured growth in the early 2000s, but were hit hard by the financial crisis.

The subsequent almost complete nationalization of their financial systems has had a negative impact on the public debt of the two countries. To stem the rising debt and the risk of unsustainability, since 2010 the two governments have implemented fiscal austerity plans, but with a difference: Ireland belongs to the euro zone, while Iceland doesn't. The latest *Note of the OFCE* (no. 25 dated 4 February 2013 [in French]) reviews the recent macroeconomic and financial situation of the two countries to show the extent to which different policy mixes may account for different trajectories for a recovery.

While in Iceland the banking crisis was amplified by a currency crisis, the depreciation of the crown was then a factor in the recovery, so that the country is now growing again. GDP was very volatile: between the third quarter of 2007 and the second quarter of 2011, GDP declined by more than 13%, but has rebounded by 5.7% since. There was less volatility and a shorter recessionary phase in Ireland than in Iceland (8 quarters), and the amplitude of the decline was smaller (-10.7%). However, the recovery is more timid, with GDP growth of only 3.4% since late 2009.

Our analysis leads us to two main conclusions: first, an internal devaluation is less effective than an external devaluation; and second, fiscal consolidation is less costly when it is accompanied by favourable monetary conditions and exchange policy. It is in light of these points that one can redefine the optimal policy mix in the euro zone, as we suggest in more detail in the iAGS report. An active monetary policy is essential to allow the refinancing of the public debt. The European Central Bank should therefore act as lender of last resort for the member countries. The countries running a surplus need a "reflationary" policy to help reduce their current account imbalances. Fiscal adjustments should be relaxed or even postponed to allow a more rapid return to growth.

The euro zone: confidence won't be enough

By Céline Antonin, Christophe Blot and Danielle Schweisguth

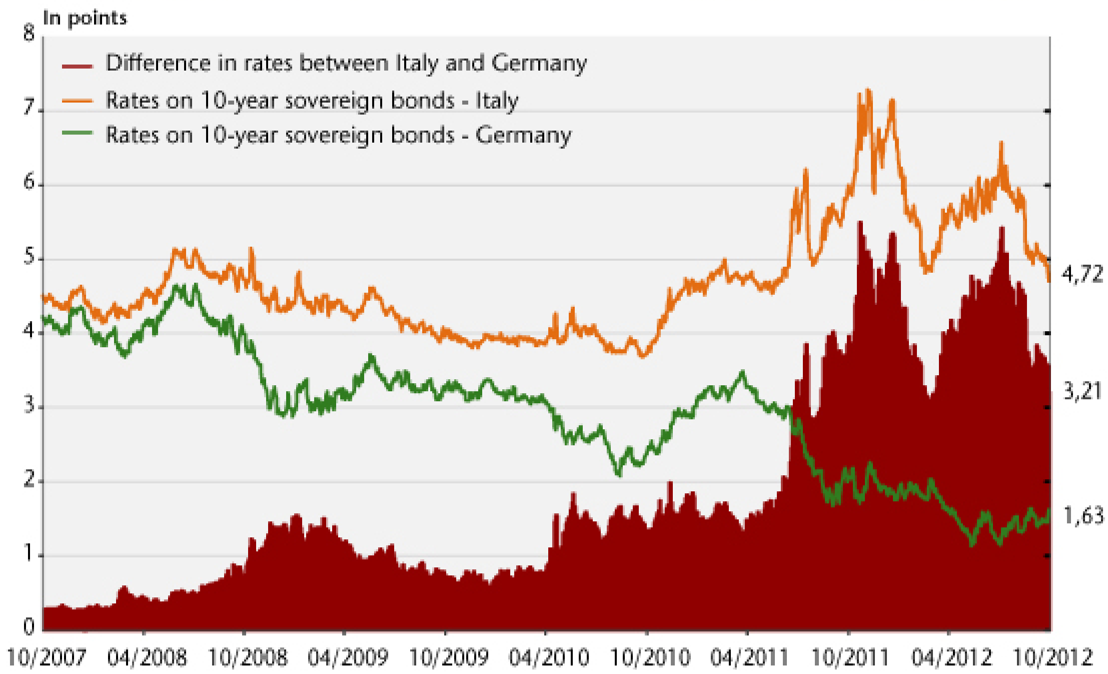
This text summarizes the OFCE's October 2012 forecasts for the economy of the euro zone.

After more than two years of crisis in the euro zone, this time the meeting of the European Council, held on 18 and 19 October, had nothing of the atmosphere of yet another last-chance summit. Even though discussions on the future banking union [1] were a source of tension between France and Germany, there was no sword of Damocles hanging over the heads of the European heads of state. However, it would be premature to assume that the crisis is coming to an end. It is sufficient to recall that the GDP of the euro zone has still not regained its pre-crisis level, and in fact declined again by 0.2% in the second quarter of 2012. This decline is forecast to continue, as we expect GDP to fall by 0.5% in 2012 and by 0.1% in 2013. Consequently, the unemployment rate in the euro zone, which has already surpassed its previous historical record from April 1997, will rise further, reaching 12.1% by end 2013. What then are the reasons for the lull? Can the euro zone quickly resume its growth and hope to finally put an end to the social crisis?

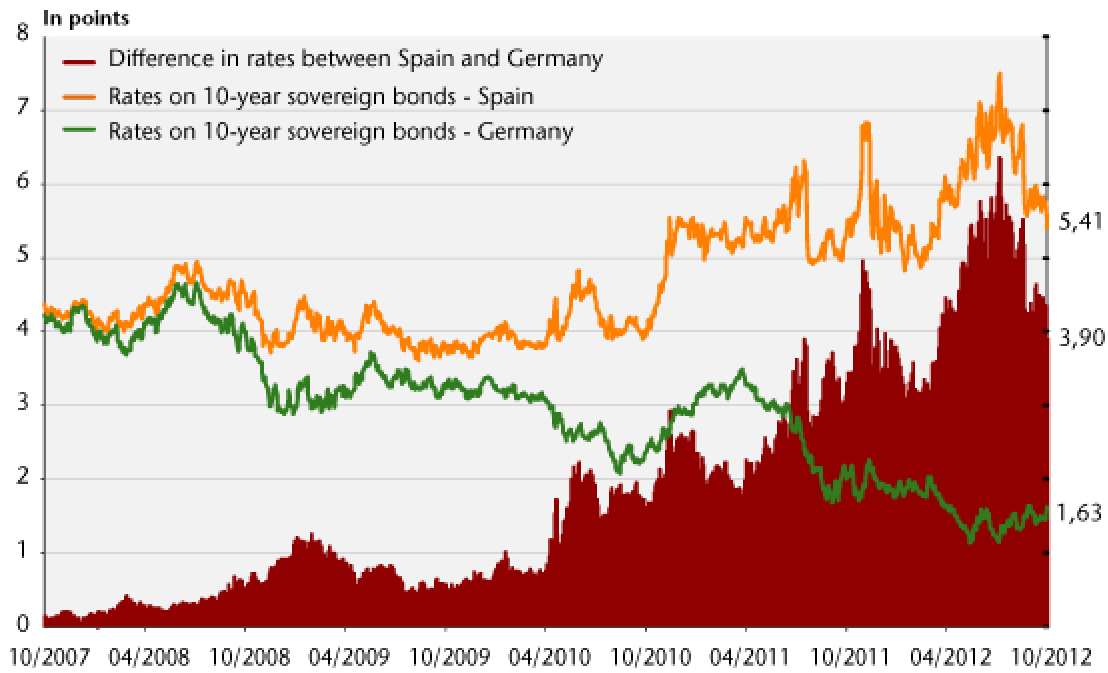
Since the end of 2011, Europe has adopted a new treaty (the Treaty on stability, coordination and governance, the TSCG) which is being ratified in the 25 signatory countries. The new law is specifically intended to strengthen both budgetary discipline – through the adoption of national golden rules – and solidarity through the creation of the European Stability Mechanism (ESM), in so far as the use of the ESM is conditional on ratification of the TSCG. On 6 September, the ECB unveiled the basic points of its new conditional purchase of sovereign debt (see here), which is aimed at reducing the interest rates of countries subject to the ESM. Thus, the risk premium, as measured by the difference between the Italian and Spanish sovereign interest rates and the German rate, after peaking on 24 July 2012, decreased respectively by 2.2 and 2.5 points (Figures 1 and 2). This is of course still far from normal, but this lull is nevertheless welcome and it shows that the spectre of a breakup of the euro zone has receded.

Could this new wave of optimism be a precursor to an upturn in the economy of the euro zone? The answer to this question is, unfortunately, negative. The fiscal policies of countries in the zone are still highly restrictive, a situation that has even intensified in 2012, pushing Italy and Spain back into recession and deepening the recession that was already hitting Portugal and Greece. For the euro zone as a whole, the fiscal stimulus will come to 1.7 percent of GDP in 2012 (table). The series of votes on national budgets confirms this strategy of a forced reduction of budget deficits for 2013, with the overall fiscal consolidation for the euro zone as a whole coming to 1.3%. There will be significant differences between the countries, since in Germany the fiscal stimulus will barely be negative (-0.2 point) while in Spain, Italy and Greece it will be more than -2 GDP points. However, the recessionary impact of this synchronized fiscal consolidation will be even greater given that the euro zone countries are still at the bottom of the economic cycle. In these conditions, the targets for budget deficit reduction will not be met, which will inevitably raise the question of the appropriateness of further budget cuts. More and more Member States thus risk being caught in a vicious circle where low growth calls for further fiscal adjustments that in turn deepen the economic and social crisis. It is essential that any decision about improving the governance of the European Union or the transmission of monetary policy restores confidence and creates the conditions for a return to growth. But this will be insufficient to escape the recession and should not obscure the impact of the fiscal strategy.

Graphique 1. Long-term sovereign interest rates in Italy and the Italy-Germany *Spread*



Graphique 2. Long-term sovereign interest rates in Spain and the Spain-Germany *Spread*



Source : Datastream.

Tableau. Fiscal stimulus in the euro zone countries

In GDP points

	2009	2010	2011	2012	2013
Germany	0,7	1,5	-0,9	-0,5	-0,2
Autria	0,4	0,6	-1,6	-0,1	-0,9
Belgium	1,9	-0,3	-0,1	-1,1	-0,8
Spain	3,8	-2,5	-1,1	-3,4	-2,4
Finland	0,4	1,5	-1,6	-0,4	-1,3
France	2,3	-0,5	-2,9	-1,6	-1,8
Greece	3,2	-8,0	-5,3	-5,0	-3,9
Ireland	2,2	-4,4	-1,5	-2,4	-1,8
Italy	0,8	-0,4	-1,2	-3,2	-2,1
Netherlands	4,0	-1,1	-0,2	-1,0	-1,2
Portugal	5,0	-0,7	-3,7	-3,7	-1,8
Euro zone 11*	1,8	-0,3	-1,3	-1,7	-1,3

* Excluding Cyprus, Luxembourg, Malta, Slovakia, Slovenia and Estonia.
Note : The fiscal stimulus is measured by the opposite of the variation in the cyclically adjusted primary balance, that is, excluding interest charges and exceptional revenue: it approximates the discretionary budget policy.
Sources : OFCE calculations and forecasts, October 2012.

tab

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[1] See here for an analysis of the importance of the proposed banking union and the questions it raises.