Should households pay for a competitiveness shock?

By Henri Sterdyniak

France is suffering from an industrial problem. Its current account balance went from a surplus of 2.6% of GDP in 1997 to a deficit of 1% in 2007 and then 2% in 2012, while Germany went from a deficit of 0.4% of GDP in 1997 to a surplus of 5.7%. This raises the issue of France's industrial recovery. Should a major transfer take place from households to large companies for the purpose of a competitiveness shock or to redress business margins? There are many who advocate such a shock (including the MEDEF, but also the CFDT). This would reduce employers' social contributions (by at least 30 billion euros) and in return increase levies on households. The issue of France's industrial recovery is discussed in detail in the latest *Note de l'OFCE* (No. 24 of 30 October 2012).

It is out of the question to reduce the social security contributions of employees, as these finance only retirement and unemployment benefits, and thus contributory benefits that depend on the contributions paid and that cannot be financed through taxes. Only employer contributions intended for the family or health insurance can be reduced. And then it's necessary to find a substitute resource: VAT or the CSG wealth tax?

In fact, there is little difference between an increase in the CSG tax and an increase in VAT. In both cases, households will lose purchasing power. In the case of a VAT increase, this would involve higher prices. However, inflation is automatically reflected in the minimum wage and social benefits, and after wage bargaining, in salaries too, so any gain in business competitiveness / profitability is likely to be temporary unless indexing is suspended. In contrast, the

victims of a higher CSG would not enjoy automatic indexing mechanisms and would have to accept a reduction in purchasing power. Using the CSG thus makes for a more long-term option.

The big issue at the macroeconomic level is the reaction of companies, which will have to arbitrate between maintaining their prices to rebuild their margins or lowering their prices to become more competitive.

Let’s imagine ourselves in a country with a GDP of 100 and exports and imports of 25. The share of wages (including employer contributions) and consumption is 80, and the share of profits and investment is 20. In the short run, wages and pensions are fixed. The reform consists of reducing the amount of employer contributions by 5 (*i.e.* 5% of GDP), while increasing the CSG tax by the same amount Two scenarios can be adopted based on the pricing policy chosen by companies.

In the first case, the companies maintain their prices and increase their margins. There is no *ex post* gain in business competitiveness, but profitability rises. Wages suffer a loss of 6.25% of their purchasing power (*i.e.* 5/80). Will the revival in investment offset the fall in consumption? Let’s use standard assumptions, *i.e.* a propensity to consume wages of 0.8 and to invest profits of 0.4, with a multiplier of 1. GDP falls in the short term by 2% and employment first drops and then eventually recovers due to the substitution of labour for capital. The measure is costly in terms of purchasing power, and higher employment is not ensured.

In the second case, the companies fully pass on the reduction in charges in their producer prices, which fall by 5%, with consumer prices decreasing by 4% (as the prices of imported goods remain stable). The purchasing power of wages is down by only 1%. The gains in competitiveness come to 5%. Will the gains in foreign trade offset the reduction in consumption? With a price elasticity of exports of 1 and of imports of 0.5, GDP increases by 1.25%. The measure is less painful.

Should it be done?

The government needs to ask households to accept a reduction in their income, even though they have already lost 0.5% in purchasing power in 2012, consumption stagnated in 2011 and 2012, France is in a state of recession, and demand is already too low.

Should France adopt Germany's strategy: to gain competitiveness at the expense of household purchasing power, knowing that this strategy is a losing one at the level of the euro zone as a whole? Admittedly, this would replace the devaluation that is impossible today in the euro zone, but it would hurt our European partners (which could even respond, to our detriment) and it does not guarantee gains in competitiveness vis-à-vis countries outside the euro zone, which depends primarily on changes in the exchange rate for the euro. Nor would a measure like this replace a reform of the zone's economic policy. Finally, it takes time for gains in competitiveness to translate into renewed growth. For instance, from 2000 to 2005, French growth came to 7.8% (1.55% per year), and German growth to 2.7% (0.55% per year). Can France afford to lose another 5 percentage points of GDP?

France is in an intermediate position between the Northern countries which have made strong gains in competitiveness at the expense of purchasing power and the Southern countries which have experienced excessive wage increases. On a base of 100 in 2000, the level of real wages in 2011 was 97.9 in Germany and 111.2 in France (an increase of 1% per year, corresponding to trend gains in labour competitiveness). Who is wrong? Should we ask the employees in the euro zone countries, first one then another, to become more competitive than the employees of their partner countries by accepting wage cuts?

The margin of French companies was 29.6% in 1973. This fell to 23.1% in 1982, rebounded to 30.2% in 1987, and was 30.8% in

2006, *i.e.* a satisfactory level. The decline occurring since then (28.6% in 2011) can be explained by the drop-off in activity and the retention of labour. It was not caused by higher taxation nor by excessive wage increases. Overall, the share of profits has returned to a satisfactory level historically. But in 1973 gross fixed capital formation was around the level of profits, while it is lower by 3 points of added value today and the share of net dividends paid has increased significantly. What commitments would business make in terms of investment and employment in France in exchange for a measure that would greatly boost profits? How could companies be prevented from increasing their dividends or their investments abroad?

Making use of an internal devaluation like this implies that France is suffering primarily from a lack of price competitiveness. However, deindustrialization undoubtedly has other deeper causes. Companies prefer to develop in the emerging countries; young people are rejecting poorly paid industrial careers with an uncertain future; France is failing to protect its traditional industries or to develop in innovative sectors; the financial sector has favoured the joys of speculation over financing production and innovation; and so forth. All this will not be solved by an internal devaluation.

France needs a big industrial leap forward. It needs to carry out a different strategy: it is growth that must rebuild business margins, and it is industrial policy (via France's Public Bank Investment [the BPI], research tax credits, competitiveness clusters, support for innovative companies and for certain threatened sectors, and industrial planning) that must ensure an industrial recovery. This should be funded by the BPI, which needs to have sufficient capacity for action and specific criteria for its interventions.

Long-term competitiveness based on an environmental tax

By Jacques Le Cacheux

“Shock” or “Pact”? The debate over the loss of France’s competitiveness has recently focused on how fast a switchover from employer payroll taxes to another type of financing is being implemented, implying that the principle of doing this has already been established. As France faces a combination of a deteriorating situation in employment and the trade balance, plus growing evidence that its companies are becoming less competitive compared to those of most of our partners [1] and that business margins are alarmingly low for the future, the need to reduce labour costs seems to be clear. But how and how fast are subject to debate. Should there be a rise in the CSG tax, VAT, or other charges, at the risk of reducing the purchasing power of households in an economic context that is already worse than bleak?

The economic situation has to be managed at the euro zone level

The value of switching a portion of charges on employers – a figure of 30 billion is often bandied about – over to another levy is often disputed by invoking the risks that such a strategy would pose to what is already sluggish growth: undermining consumption would further curtail business opportunities, hurting activity and thus employment and margins.

But France is in this depressed situation only because the European Union is committed to a forced march of fiscal adjustment that everyone – or almost everyone – now recognizes

is counterproductive and doomed to failure: as the heartbreaking situation in Spain illustrates, the quest to reduce the budget deficit when the economy is in recession is futile, and “virtuous” efforts – repeatedly slashing public spending and increasing taxes – merely weaken the economy further and increase unemployment, since the fiscal multipliers are very high, as Keynes demonstrated over 70 years ago!

Fiscal support for economic activity is the only way out. But the experience of the early years of the first Socialist government is alive in all our memories: the failure was as great as were the illusions, and the “turn to austerity” made the government unpopular. An approach that failed in the context of the early 1980s, with a less open economy, an autonomous monetary policy and the possibility of adjusting the currency’s exchange rate, is all the less appropriate in the context of deeper integration and the single currency. Trying to maintain the purchasing power of French households while the rest of the euro zone is in recession and French companies are less competitive could only widen the deficit without boosting growth or employment.

We must therefore continue the fight in Europe: to slow down the pace of deficit reduction; to implement a more accommodative monetary policy in the euro zone, which would have the double advantage of reducing the cost of debt, public and private, thereby making them more sustainable, and of exerting downward pressure on the exchange rate of the euro, boosting external competitiveness at a time when the US and Japanese central banks are seeking to reduce the value of their own currencies, which would automatically push the euro up; and to jointly engage in a coordinated European policy to support growth, by funding research and investing in trans-European transport and electricity and in education and training.

The national productive capacity must be supported and

stimulated

The lack of competitiveness of French industry is not reducible to a problem of labour costs. And it is well known that a downward spiral of wage moderation and social dumping, which we can already see is wreaking havoc in Europe, can only lead the euro zone into a deflationary spiral, comparable to what these same countries vainly attempted in the 1930s in their "every man for himself" effort to escape the Great Depression.

Reducing social spending cannot therefore be an answer, while rising unemployment and the precarious situation of an increasing number of households, workers and retirees are pushing up the needs on all sides. Lowering wages, as some countries have done (Greece and Ireland in particular), either directly or through an increase in working hours without an increase in pay, is not a solution, as wage deflation will further depress demand and thereby feed yet another round of social dumping in Europe.

Improving cost competitiveness by reducing the charges on wages may be part of the solution. But this option does not necessarily send the right signals to businesses and will not necessarily lead to a decrease in their selling prices or an increase in hiring: windfall gains are inevitable, and the greatest affluence is likely to go to shareholders as much as to customers and employees. Reductions in social security contributions could be targeted for certain levels of pay, but they cannot be sectoral or conditional or else they would violate European rules on competition.

It is also necessary to encourage and assist French companies in modernizing their supply capacity. The new Public Investment Bank [*Banque publique d'investissement* – BPI] can help by funding promising projects. But we can also make use of the taxation of corporate profits, including through incentives for investment and research that allow tax credits

and depreciation rules: this is a way of more directly using incentives for businesses and conditioning public support on conduct that is likely to improve their competitiveness.

Environmental taxation: a lever for long-term competitiveness

Which charges should now bear the cost of these measures to boost business? Discussions on the respective advantages and disadvantages of VAT and the CSG tax abound. Suffice it to recall here that the VAT has been created to anticipate the reduction in tariff protection, which it replaces very effectively without discriminating on the domestic market between domestic products and imports but while exempting exports: an increase in VAT therefore differs little from a devaluation, with very similar pros and cons, especially with regard to its non-cooperative character within the euro zone. But also recall (see our post of July 2012) that consumption is now relatively less taxed in France than a few years ago, and less than in many of our European partners.

The recourse to a genuine environmental tax would, with regard to the other options for financing these concessions, have the great advantage of promoting sectors that are less polluting and less dependent on fossil fuels – while at the same time diminishing our problems with trade balances, which are partly due to our energy imports – and putting in place the right price and cost incentives for both businesses and consumers. In particular, taking a serious approach to the energy transition demands the introduction of an ambitious carbon tax that is better designed than the one that was censored by the *Conseil constitutionnel* in 2009. Its creation and its step-by-step implementation need to be accompanied by reforming both the direct levies on household income and the main means-tested benefits so that compensation is kept under good control (cf. article in the work "Réforme fiscale", April 2012).

A "competitiveness shock" therefore, but also a "sustainable

competitiveness pact", which encourages French companies to take the right paths by making good choices for the future.

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[1] See in particular the post of 20 July 2012.

How France can improve its trade balance*

By Eric Heyer

Prime Minister Jean-Marc Ayrault has made a commitment to restoring France's balance of trade, excluding energy, by the end of his five-year term. Without addressing the curious anomaly of leaving the energy deficit out of the analysis of the country's trade position, as if it did not count in France's dependence on the rest of the world, we will examine the various solutions that the government could use to achieve this goal.

The first solution is to do nothing and to wait until the austerity policy that has been implemented in France through public spending cuts and higher taxes reduces consumer spending. In the face of higher unemployment and the resulting increase in household precautionary savings, the French will cut back on consumption. However, since some of this comes from outside France, this will limit imports into France from abroad and, everything else being equal, improve the country's trade balance.

This solution, it is clear, not only is not virtuous, as it relies on a reduction in employee purchasing power and rising unemployment, but it also has little chance of success, because it assumes that French exports will not follow the same path as imports and will continue to grow. However, since our partner countries are following this same strategy of a rapid return to balanced public finances, their austerity policies will result in the same dynamics as described above for France, thereby reducing their own domestic demand and hence their imports, some of which are our exports.

As a result, and since the austerity programmes of our partners are more drastic than ours, it is very likely that our exports will decline faster than our imports, thus exacerbating our trade deficit.

The second solution is to increase our exports. In a context where our European partners, who represent 60% of our trade, are experiencing low or even negative growth, this can be achieved only through gains in market share. Lowering the cost of labour seems to be the fastest way to do this. But in the midst of an effort to re-establish a fiscal balance, the only way to lower the charges on labour is to transfer these to another tax: this was the logic of the “social VAT” set up by the previous government, but repealed by the new one, which seems to lean more towards transferring these to the CSG tax, which has the advantage of having a larger tax base, affecting all income, including capital income.

But in addition to the fact that this strategy is not “cooperative”, since it resembles a competitive devaluation and thus is essentially aimed at gaining market share from our euro zone partners, there is no indication that it would be sufficient. Indeed, there is nothing to prevent our partners from adopting the same approach, particularly since their economic situation is worse than ours, and this would cancel all or part of any potential gains in our competitiveness.

The last solution consists of making the country more competitive by raising the productivity of our employees and by specialising in high value-added sectors that are not subject to competition from the emerging countries with their low costs.

This is a medium-term strategy and requires the establishment of policies to promote innovation, research and development, and training. It also means expanding the range of our traditional products such as automobiles, but also specializing in the industries of the future.

The need for a transition to an ecological mode of production that is more energy-efficient could represent this industry of the future, and therefore be the solution to our trade deficit.

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* This text is taken from a series of reports by Eric Heyer for the programme “Les carnets de l’économie” on France Culture radio. It is possible to listen to the series on France Culture.

Competitiveness and industrial demand: The

difficulties facing the French-German couple

Jean-Luc Gaffard

The obsession with competitiveness has returned to centre stage with the election campaign. This reflects the reality that French companies are indeed suffering a loss of competitiveness, which is behind the deterioration in foreign trade for almost a decade. This loss is clear vis-à-vis the emerging markets and explains the trend towards relocating abroad. It is also clear vis-à-vis firms from other developed countries, mainly in the euro zone and in particular German companies. This latter situation is especially serious, as it challenges the coherence of European construction (cf. OFCE, note 19: Competitiveness and industrial development: a European challenge in French).
The gap in competitiveness that has emerged with Germany is clearly based on non-price competition. One of the reasons for this is Germany's superior business model, which is characterized by the maintenance of a network of local businesses of all sizes that focus on their core business and on the international fragmentation of production. This model is especially suitable for business development that is targeted at global markets, and it largely protects the countries hosting these companies from the risk of deindustrialization.

It would, nevertheless, be a mistake to ignore that this development is also the product of an adverse change in price competitiveness. This reflects labour market reforms in Germany, which lowered the relative cost of labour, as well as strategies that are based on the segmentation of production and the outsourcing of intermediate segments, which have also contributed to lowering production costs.
Germany has thus managed to virtually stabilize its market

share of global exports by increasing their level in the European Union (+1.7% in the 2000s) and even more so in the euro zone (+2.3%), while France has lost market share in these same areas (3.1% and 3.4%, respectively).

Two developments have particularly hurt France's industry. Its network of industrial SMEs has fallen apart. They were hit less by barriers to entry than by barriers to growth. All too often SME managers have been inclined or encouraged to sell the enterprises to large corporations rather than to ensure their growth. This is due both to the lack of genuine partnerships with these corporations and to the difficulties experienced in obtaining permanent financing from the banks and markets. For their part, the large industrial firms, both those operating on a multitude of local markets and those in the international markets, have chosen to focus on acquisitions and on the geographical decentralization of both their operations and their equipment and services suppliers. This strategy has been designed to meet geographical shifts in demand and to deal with the demand for immediate profitability set by volatile shareholders, but this has come in part at the expense of the development of local production networks. This process involved a vast movement of mergers and acquisitions that primarily drew on financial skills. The financial institutions were, in turn, converted to the universal banking model, abandoning some of their traditional role of being lending banks and investment banks. These concomitant developments have proved disastrous for overall competitiveness, particularly as hourly labour costs in industry were rising simultaneously.

There are two requirements for restoring the competitiveness of French companies and thereby encouraging the country's re-industrialization. The first is to allow immediate control of labour costs and the restoration of profit margins; this could be helped in particular by tax measures that would adjust the financing of a portion of social protection. The second

requirement is to promote the reorganization of industry through the creation of a network of stable relationships between all those involved in the industrial process, especially by the use of aid that is conditioned on cooperation between large and small firms in "competitiveness clusters".

This medium-term effort will nevertheless largely remain ineffective if cooperative policies are not implemented across Europe. These policies need both to stimulate supply through the implementation of technology development programmes and to boost internal demand wherever it is clearly insufficient to satisfy production capacity.

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

by Jérôme Creel

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

The loss of the AAA rating on French government bonds is not surprising – far from it. The sovereign debt crisis that has shaken the euro zone for over two years, starting in the autumn of 2009, was not managed properly because it occurred during a recession, at a time when all the EU Member States had their eyes glued to their own economic difficulties. In the absence of a concerted response that included immediate

solidarity and mutual guarantees by the euro zone Member States of the zone's entire public debt, with the support of the European Central Bank (cf. Catherine Mathieu and Henri Sterdyniak, here), the foreseeable contagion occurred. The objective public finance mistakes committed by successive Greek governments followed by the vagaries of the Irish banks have now led to a systemic crisis in Europe.

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

1. Should the austerity measures be strengthened? In a commentary on the supplementary 7 billion euro French austerity plan announced in November 2011, Mathieu Plane (see in French here) pointed out that the race for the AAA rating had already been lost. The impact of this austerity plan on economic growth was objectively inconsistent with the fiscal consolidation target – and Standard & Poor's was surely not unaware of this argument.
2. Why did S&P single out Germany and Slovakia, the only economies in the euro zone not downgraded on Friday 13 January? While their commercial links are undeniable (cf. Sandrine Levasseur, 2010, here), which could justify their comparable treatment, the main markets for both of these economies, and particularly Germany, lie in the euro zone. Slowing growth in the euro zone outside Germany will not leave the other side of the Rhine unaffected (cf. Sabine Le Bayon, in French here). It is difficult to see how the contagion of the crisis could stop at the borders of Germany and Slovakia. The recent take-up of German government 6-month bonds at a negative interest rate could even be interpreted to

reflect extreme distrust of Germany's commercial banks. In any case, its economy, situated in the euro zone, is no less fragile than that of France.

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

“Social VAT”: Is it anti-social?

by Jacques Le Cacheux

The prospect of a “social” value added tax, which was raised anew by the President of France on December 31 during his New Year speech, is once again provoking controversy. While the French employers association, the MEDEF, has included this measure in a series of proposed tax changes designed to restore France’s competitiveness, the Left is mostly opposed. It views the “social VAT” as an oxymoron, an antisocial measure that is designed to cut the purchasing power of consumers and hits the poorest among them disproportionately and unfairly. But what exactly are we talking about? And from the viewpoint of taxes on consumption, what is the situation in France relative to its main European partners?

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

France now has one of the lowest rates of implicit taxation on consumption in the European Union (Eurostat). Its standard VAT

rate was reduced to 19.6% in 2000 after having been raised to 20.6% in 1995 to help ensure compliance with the Maastricht criteria, as the recession of 1993 had pushed the budget deficit significantly higher. This rate is now slightly lower than the rate applied by most of our partners, particularly as the deterioration of public finances has recently prompted several European countries to raise their standard rate of VAT. The reduced rate, at 5.5%, was, until the increase decided in December 2011 on certain products and services, the lowest in the EU.

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

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

if it were on employee contributions.

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

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

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

payroll would increase, meaning that the depressive impact on consumption often cited by opponents of this measure would only be minor, or even non-existent.

In short, “social VAT” should be neither put on a pedestal nor dragged through the dirt. As with any tax reform, we should certainly not expect a panacea against unemployment, or even a massive shift in our external accounts, even though it should help to improve our external price-competitiveness. But rebalancing our tax burden to focus more on consumption and less on the cost of labour is a worthy goal. In the context of globalization, taxing consumption is a good way to provide resources for the public purse, and VAT, a French innovation that has been adopted by almost every country, is a convenient way of doing this and of applying, without explicitly saying so, a form of protectionism through the de-taxation of exports. VAT is not, on the other hand, a good instrument for redistribution, since the use of a reduced rate on consumer products ultimately benefits the better-off as much or more than it does the poor. Most of our European partners have understood this, as they either do not have a reduced rate (as in Denmark) or have one that is substantially higher than ours (often 10% or 12%). It would be desirable to make the French tax system fairer, but this requires the use of instruments that have the greatest and best-targeted potential for redistribution: direct taxes – income tax, CSG-type wealth taxes, property tax – or social transfers, or even certain government expenditures (education, health). What is missing in the proposed “social VAT” is making it part of a comprehensive fiscal reform that restores consistency and justice to the system of taxes and social contributions as a whole.

From Trichet to Draghi: Results and prospects

By Christophe Blot and Eric Heyer

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

Over the first five years, the pre-crisis period, we had **JCT the dogmatist:** a very experienced central banker, he scrupulously stuck to his mandate, namely to keep inflation close to 2%. In light of this single criterion, considered essential by the Germans, JCT's record was good, as average inflation in the euro zone during the period was 2.1%. However, several criticisms can be leveled at his post-crisis activity: the first is that in trying to give flesh to the single currency and make it credible, JCT decided to make it "strong" – which is different from "stable". No arrangements were made to control the exchange rate, and he was pleased to see the euro rise from $1.10 in 2003 to almost $1.50 in late 2007, an appreciation of 37%. The dogma of the strong euro, of competitive disinflation, has certainly helped to contain inflation, but at the expense of Europe's competitiveness and growth. A less strict interpretation of price stability would have led the ECB to pay more attention to the euro's exchange rate, which would in turn have promoted more vigorous growth and employment in the euro zone. Between 2003 and 2007, average annual growth in the euro zone was 0.6 percentage point lower than in the US and the UK (2.1% against 2.7%), and the unemployment rate was more than 3 points higher (8.4% in the euro zone against 5.1% in the US and UK), with comparable performances on inflation. The second criticism has to do with JCT's strict interpretation of the fight against inflation,

which led him into a serious miscalculation: in the summer of 2008, just weeks before the collapse of Lehman Brothers, while the US economy was already in recession and fears were growing for Europe, the ECB decided to raise interest rates out of fear of renewed inflationary pressures fueled by the rising prices of energy and food raw materials. However, worrying about inflationary pressures at a time when the global economy was about to sink into the greatest crisis since the 1930s was not very perceptive.

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

In fact, the ECB quickly revised its diagnosis, leaving the door open to a rapid cut in interest rates. It is also likely that Jean-Claude Trichet would have acted faster had he not been at the end of his term. In doing what he did, JCT avoided locking his successor into a specific scenario, and thus left him a range of options in his first steps at the head of the ECB. Mario Draghi quickly ended any suspense about his

intentions by announcing a quarter point cut in interest rates at his first meeting on 3 November. While he was careful to point out that the ECB does not make any commitments to future decisions, the macroeconomic and financial situation points towards at least one further rate cut.

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

The current crisis illustrates the difficulties inherent in the functioning of a monetary union that lacks a fiscal union, since in actuality this means that a member of the union is taking on debt in a currency that it does not control. Even though in normal times monetary policy operations in the United States lead the Fed to hold government securities – mostly short-term – the crisis has prompted the US central bank to expand its purchases of securities and to change the structure of its balance sheet by buying government bonds on secondary markets. The Bank of England has taken similar action by purchasing nearly 200 billion pounds of government bonds[1]. As for the Bank of Japan, it has amplified the unconventional measures that were already in place to fight the deflation that has plagued the archipelago since the late 1990s. In taking these actions, the central banks have put downward pressure on long-term interest rates, and they have ensured the liquidity of these markets by acting implicitly as lenders of last resort. While the ECB has also gotten involved in this area by buying more than 170 billion euros of government securities (Italian, Greek, Portuguese and Irish),

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

Moreover, beyond the role of lender of last resort, the coordination of economic policy more generally also needs to be revised. The articulation of the policy mix is indeed a central element of performance in terms of growth. In the US, the complementarity between monetary and fiscal policy is now obvious, as by putting pressure on long rates, the Federal Reserve implemented a policy to ensure the sustainability of

fiscal policy at the same time that it is promoting the impact on growth. The main criticism of this policy argues that this undermines the independence of the Central Bank. However, there is no evidence today to say that the Fed has abandoned the conduct of monetary policy in favor of the government. The question does not even arise, since the US central bank is pursuing the same objectives as the US government: growth, employment, price stability and financial stability [2]. These objectives are interdependent, and the euro zone will find its way to growth again only once all the authorities are rowing in the same direction.

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

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

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