# Poverty and social exclusion in Europe: where are things at?

By Sandrine Levasseur

In March 2010, the EU set itself the target for the year 2020 of reducing the number of people living below the poverty line or in social exclusion by 20 million compared with 2008, *i.e.* a target of 97.5 million "poor" people in 2020. Unfortunately, due to the crisis, this goal will not be reached. The latest available figures show that in 2013 the EU had 122.6 million people living in poverty or social exclusion. Surprisingly, the EU's inability to meet the target set by the Europe 2020 initiative is due mainly to the EU-15 countries, the so-called "advanced" countries in terms of their economic development [1]. Indeed, if the trends observed over the last ten years continue, the Central and East European countries (CEEC) will continue to experience a decline in the number of people living below the poverty line or in social exclusion. How is it that the countries of the EU-15 are performing so poorly in the fight against poverty and social exclusion? It is important to keep in mind that the East and Central European countries also perform better when we consider other indicators of income inequality within a country (*e.g.* the Gini coefficient, the ratio of the income of the 20% richest over that of the 20% poorest). The EU-15's performance is troubling not only with regard to relative poverty and social exclusion, but also in terms of all the statistics concerning living conditions and income inequality.

### Risk of poverty and social exclusion: what exactly are we talking about?

In order to reduce poverty and social exclusion, the Europe

2020 initiative focuses on three types of groups: people at risk of poverty, people facing severe material deprivation, and people with a low work intensity[2]. A person belonging to several different groups is counted only once.

According to Europe 2020, people are at risk of poverty when their disposable income falls below 60% of the median income observed at the national level, the median income being the level of income at which half the country's population has a higher income and half a lower one. Since the median income threshold is calculated nationally, this means for example that a Romanian individual at the threshold of the median income has an income well below that of a French person earning the median income: the Romanian median income is in fact one-fifth the French median income in terms of purchasing power parity, that is to say, when we take into account the price differences between the countries[3]. The indicator of the poverty risk used by Europe 2020 is thus a measure of income inequality between individuals *within a country*, not between countries.

Note that disposable income is considered in adult equivalents, *i.e.* incomes were first recorded at the household level and then weights were assigned to each member (1 for the first adult; 0 5 for the second and each person over age 14; and 0.3 for children under age 14). Also note that the disposable incomes in question here are *after* social transfers, *i.e.* after taking account of allowances, benefits and pensions – that is, they are after any action by the country's social system. In addition, the level used to define the threshold for the risk of poverty (*i.e.* 60% of median income) aims to take into account situations other than extreme poverty: the goal is also to take account of people who are having difficulty meeting their basic needs. For example, the poverty threshold of 60% of median income in France was 12,569 euros per year in 2013 (or 1047 euros a month). The concept of material deprivation is used to refine

the definition of unmet basic needs.

People experiencing severe material deprivation are those whose lives are constrained by a lack of resources and who face at least four out of the following nine material deprivations: an inability 1) to pay the rent or utility bills (water, gas, electricity, telephone); 2) to heat the dwelling adequately; 3) to meet unexpected expenses; 4) to eat a daily portion of protein (meat, fish or equivalent); 5) to afford a week's holiday away from home; 6) to own a car; 7) to have a washing machine; 8) to have a color TV; or 9) to have a telephone.

People living in a household with a low work intensity are those aged 0 to 59 who live in a home where the adults (aged 18 to 59) worked less than 20% of their potential capacity in the last year.

According to the latest available statistics (Table 1), 122.6 million people in the EU-28 belonged to at least one of these three groups in 2013, *i.e.* nearly one person out of every four (slightly more than 24%).

**Table 1. People living below the poverty line or in social exclusion**

In 1000s of people and % of the country's total population

| | 2005 (or 2007*) | 2009 | 2011 | 2013 | Change in the number of poor or socially excluded between 2005 (or 2007*) and 2013 | Share in the 2013 population (%) |
|---|---|---|---|---|---|---|
| Belgium | 2 338 | 2 145 | 2 271 | 2 286 | -52 | 20,4 |
| Denmark | 921 | 962 | 1 039 | 1 059 | 138 | 18,8 |
| Germany | 15 022 | 16 217 | 16 074 | 16 212 | 1 190 | 20,1 |
| Ireland | 1 038 | 1 150 | 1 319 | 1 040 | 2 | 22,6 |
| Greece | 3 131 | 3 007 | 3 403 | 3 904 | 773 | 35,5 |
| Spain | 10 481 | 11 232 | 12 791 | 12 630 | 2 149 | 27,2 |
| France | 11 127 | 11 200 | 11 840 | 11 229 | 102 | 17,1 |
| Italy | 14 621 | 14 835 | 17 112 | 17 326 | 2 705 | 28,5 |
| Luxembourg | 77 | 85 | 84 | 96 | 19 | 17,5 |
| Netherlands | 2 705 | 2 483 | 2 598 | 2 648 | -57 | 15,7 |
| Austria | 1 416 | 1 577 | 1 593 | 1 572 | 156 | 18,5 |
| Portugal | 2 745 | 2 648 | 2 601 | 2 877 | 132 | 27,6 |
| Finland | 887 | 886 | 949 | 854 | -33 | 15,7 |
| Sweden | 1 325 | 1 459 | 1 538 | 1 602 | 277 | 16,6 |
| United Kingdom | 14 530 | 13 389 | 14 044 | 15 586 | 1 056 | 24,2 |
| **EU-15** | **82 364** | **83 275** | **89 256** | **90 921** | **8 557** | **22,6** |
| Czech Republic | 1 988 | 1 448 | 1 598 | 1 508 | -480 | 14,3 |
| Estonia | 347 | 312 | 307 | 313 | -34 | 23,8 |
| Latvia | 1 027 | 808 | 821 | 702 | -325 | 35,1 |
| Lithuania | 1 400 | 943 | 1 011 | 917 | -483 | 31,2 |
| Hungary | 3 185 | 2 924 | 3 051 | 3 285 | 100 | 33,3 |
| Poland | 17 080 | 10 454 | 10 196 | 9 748 | -7 332 | 25,3 |
| Slovenia | 362 | 339 | 386 | 410 | 48 | 19,9 |
| Slovakia | 1 724 | 1 061 | 1 112 | 1 070 | -654 | 19,8 |
| **CEEC-8** | **27 113** | **18 289** | **18 482** | **17 953** | **-9 160** | **24,7** |
| Bulgaria* | 4 663 | 3 511 | 3 693 | 3 493 | -1 170 | 48,2 |
| Romania* | 9 904 | 9 112 | 8 630 | 8 601 | -1 303 | 43,1 |
| CEEC-10 | — | 30 912 | 30 805 | 30 047 | -11 633 | 30,1 |
| Croatia | — | — | 1 384 | 1 271 | — | 29,9 |
| Cyprus | 188 | 188 | 207 | 240 | 52 | 28,0 |
| Malta | 81 | 82 | 90 | 99 | 18 | 23,3 |
| **EU-28** | — | — | **121 742** | **122 578** | **≈ -3 000** | **24,2** |

*Source*: Eurostat, author's calculations.

## Contrasting developments between the EU-15 and the CEE countries with regard to poverty and social exclusion

While a little over 30% of the CEE population lives in poverty or social exclusion (versus 22.6% in the EU-15), what is striking is that the number of poor and socially excluded has been decreasing in the CEE countries over the last 10 years while it has been increasing in the EU-15, especially since the onset of the crisis (Table 1).

Over the past decade, the number of people living in poverty or social exclusion fell in almost all the CEE countries (with the exception of Hungary and Slovenia) and rose in almost all the EU-15 countries (with the exception of Belgium, the Netherlands and Finland). During these 10 years, the CEE countries experienced a decline of 11.5 million in the ranks of the poor and socially excluded, while the EU-15 recorded an increase of 8.5 million, *i.e.* an 85% rise since 2009. The crisis has clearly hit the EU-15 hard in terms of poverty and social exclusion. The CEE countries have, all things considered, proved fairly resilient: a number of them are even continuing to see a decrease in the number of poor and socially excluded.

## What’s behind these contrasting trends in poverty and social exclusion?

The main factor explaining the contrasting trends in poverty between the EU-15 and the CEE countries is that the economic situation has generally developed more favourably in East Europe than in West Europe, including during the crisis period.

Indeed, the average GDP growth rate over the last ten years (2004 to 2013) was 3.2% in the CEEC, compared with 0.8% in the EU-15. The CEE countries, though hit by the crisis, nevertheless recorded average annual growth of 0.7% in 2009-2013 (against 0.1% in the EU-15). Likewise, the unemployment and employment rates during the crisis reflected a more favourable situation on the CEE labour markets than on the EU-15 markets (Table 2).

**Table 2. Employment and unemployment rates in the EU-15 and in the CEE countries**

In %

| | Annual average | | | Change in percentage points between the pre-crisis and crisis periods |
|---|---|---|---|---|
| | 2004-2013 | 2004-2008 | 2009-2013 | |
| **Employment rate** | | | | |
| EU-15 | 70,4 | 71 | 69,9 | -1,1 |
| CEEC-10 | 64,9 | 64,2 | 65,5 | 1,3 |
| CEEC-8 | 65,0 | 64,2 | 65,8 | 1,6 |
| **Unemployment rate** | | | | |
| EU-15 | 8,8 | 7,7 | 10,0 | 2,3 |
| CEEC-10 | 9,6 | 9,8 | 9,5 | -0,4 |
| CEEC-8 | 10,4 | 10,8 | 10,1 | -0,8 |

*Source:* Eurostat, author's calculations.

The risk of poverty prior to social transfers continued to fall in the CEE countries, while from 2009 it rose in the EU-15 (Table 3). Consequently, the share of people in the CEE countries living below the poverty line (out of each country's total population) *before transfers* has fallen below the level observed in the EU-15. The crisis has thus had a direct differentiated effect (*i.e.* before redistribution) on income inequality within countries: in Europe's East, income inequality has fallen, while in the West it has risen.

The workings of the social security systems in the EU-15 countries have, however, resulted in reversing (or mitigating) the differences in *post-transfer* poverty rates (Table 3). In 2013, the post-transfer poverty rate was 16.5% in the EU-15, compared with 17.2% in the CEE countries (15.4% excluding Bulgaria and Romania). The Gini coefficient, which is a more common measure of within-country income inequality, also confirms that income inequality is now higher in the EU-15 than in the CEEC[4].

Note that during the crisis the intensity of the redistribution (in % points or rates) was higher in the EU-15 than in the CEEC. However, over time the redistribution rate fell in both the East and the West, starting in 2009. Prior to the crisis, the social security systems in the EU-15 resulted

in a 37.3% reduction in the number of people living in poverty and social exclusion; during the crisis, the rate fell to 36.8%. In the CEE countries, the fall in the redistribution rate was even greater, on the order of 3.7 percentage points. By way of illustration, if the redistribution rate for the pre-crisis period had been maintained during the crisis period, an additional 1.4 million people would have avoided the risk of poverty during the crisis (0.5 million in the EU-15 and 0.9 million in the CEEC).

**Table 3. Percentage of people at risk of poverty* and redistribution through social transfers**

In %

| | Annual average | | | Change in percentage points between the pre-crisis and crisis periods |
|---|---|---|---|---|
| | 2004-2013 | 2004-2008 | 2009-2013 | |
| **% of people at risk of poverty**** | | | | |
| **Pre-transfer (A):** | | | | |
| **CEEC-8** | 24,6 | 26,1 | 23,4 | -2,7 |
| **CEEC-10** | 25,7 | 27,0 | 24,7 | -2,3 |
| **EU-15** | 25,8 | 25,5 | 26,1 | 0,6 |
| **Post-transfer (B):** | | | | |
| **CEEC-8** | 15,7 | 16,0 | 15,4 | -0,6 |
| **CEEC-10** | 17,5 | 17,8 | 17,2 | -0,6 |
| **EU-15** | 16,3 | 16,0 | 16,5 | 0,5 |
| **Redistribution** | | | | |
| **In % points: (A)-(B)** | | | | |
| **CEEC-8** | 8,9 | 10,1 | 8,0 | -2,1 |
| **CEEC-10** | 8,2 | 9,2 | 7,5 | -1,7 |
| **EU-15** | 9,5 | 9,5 | 9,6 | 0,1 |
| **Rate in % [(A)-(B)]/(A)** | | | | |
| **CEEC-8** | 36,2 | 38,7 | 34,2 | -4,5 |
| **CEEC-10** | 31,9 | 34,1 | 30,4 | -3,7 |
| **EU-15** | 36,8 | 37,3 | 36,8 | -0,5 |

** Due to the lack of available data "before" and "after" social transfers, people at risk of social exclusion are not taken into account here.*
*** Number of "poor" people in the country relative to the country's population.*
*Source:* Eurostat, author's calculations.

This brings us to the second explanatory factor. Are the austerity programmes being implemented in many EU countries to comply with the Stability and Growth Pact and / or to satisfy the financial markets responsible for the post-transfer increase in the number of people at risk of poverty that has taken place in the EU-15? And have these programmes acted to

hold back the decline in poverty rates observed in the CEE countries, which otherwise would have been even greater?

The empirical literature on this issue is clear-cut: it shows that income inequality within countries increases during periods of fiscal consolidation[5] (Agnello and Sousa, 2012; Ball *et al.*, 2013; Mulas-Granados, 2003; Woo *et al.*, 2013). Among the tools of fiscal consolidation (*i.e.* cuts in public spending, increases in tax revenues), it is the spending cuts in particular that increase income inequality (Agnello and Sousa, 2012; Ball *et al.*, 2013; Bastagli *et al.*, 2012; Woo *et al.*, 2013). Austerity programmes implemented after the onset of a banking crisis have a much greater negative effect on income inequality than programmes implemented when not in a banking crisis (Agnello and Sousa, 2012). Furthermore, small consolidations (*i.e.* involving a cut in the public deficit of less than 1 GDP point) have a bigger negative effect on inequality than large fiscal consolidations (Agnello and Sousa, 2012).

If the results of this (still sparse) literature are accepted, the timing of the fiscal consolidation implemented in recent years has not been ideal: the programmes have been introduced too early with respect to the occurrence of the crisis. Nor have they been optimal in size: they are insufficient to cut the deficit substantially but very costly in terms of increasing income inequality between individuals. While it is difficult to form a firm and final opinion on the link between fiscal consolidation and income inequality (and poverty) based on the sparse literature, the afore-mentioned studies do have a value: they raise questions about the potentially harmful impacts of the austerity policies that have been implemented in recent years.

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[1] The Europe 2020 initiative sets out poverty reduction and social exclusion targets for each country. Here we are

basically interested in the different trends between the two areas: the EU-15 and the CEE countries.

[2] See the article by Maître, Nolan and Whelan (2014) for a critical in-depth analysis of the statistical criteria for poverty and social exclusion.

[3] In current euros, the difference in income would be even greater: in 2013, the French median income was 20,949 euros a year, and Romania's 2071 euros, so Romania's median income per year would thus be one-tenth, not one-fifth, of the French level.

[4] The difference (in favour of the CEE countries) is even more pronounced due to the exclusion of Bulgaria and Romania: the Gini coefficient after transfers is then 0.291 against 0.306 for the EU-15. The Gini coefficient can take a value between 0 and 1. As the coefficient approaches 1, an increasingly small share of the population has a larger and larger share of total income. Ultimately, when the coefficient reaches 1, a single individual has all the income.

[5] Because of the way the poverty line is calculated (*i.e.* 60% of median income), an increase in the share of people living below the poverty line definitely corresponds to an increase in income inequality between individuals.

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# Rotation of voting on the ECB Governing Council: more than

# symbolic?

By Sandrine Levasseur

Lithuania's adoption of the euro on 1 January brought the number of euro zone members to nineteen, the threshold at which the voting system in the European Central Bank (ECB) Governing Council has to be changed. While this change took place almost unnoticed in France, things were different in Germany and Ireland, where the introduction of the system of rotation in the voting that decides the euro zone's monetary policy has raised concern and even opposition. Is this reaction justified? Here we propose some food for thought and reflection.

**1) How will the system of rotation function?**

Until now, at the monthly meetings of the ECB Governing Council that decides monetary policy (policy rates, unconventional policies) in the euro zone, the principle "one country, one vote" applied. In other words, each country had, through the Governor of its central bank, a systematic right to vote. To the votes of the 18 Governors were added the votes of the six members of the ECB Executive Board, for a total of 24 votes.

From now on, with the entry of a 19th member into the euro zone, the countries are classified into two groups, in accordance with the Treaty[1]. The first group consists of the 5 "largest" countries, as defined by the size of GDP and the financial sector, with respective weights in the criterion of 5/6 and 1/6. The second group consists of the other countries, currently numbering 14 [2]. Each month the group of five "big" countries has 4 votes and the Group of 14 "small" countries 11 votes (Table 1). The voting within the two groups is organized according to a principle of rotation defined by a precise schedule: the Governor of each "big" country will not vote one

time out of every five, while the Governor of each “small” country will not vote 3 times out of 14. However, the 6 members of the ECB Executive Board will continue to benefit from a systematic monthly right to vote. So every month, the conduct of the euro zone’s monetary policy will be decided by 21 votes, while under the old principle, that of “one country, one vote”, 25 votes were cast.

All the Governors will continue to take part in the Council’s two monthly meetings, whether or not they take part in the voting.

**Table 1. Rotation group and participation in the ECB's capital**

| | GPD* (bn euros) | Bank assets (BA) | Criteria for membership in a vote rotation group (GDP 5/6; AB 1/6) | Rotation group | ECB capital**** | |
|---|---|---|---|---|---|---|
| **Euro zone (19 countries)** | | | | | Share in % | Million euros |
| Germany | 2 718 | 7 682 | 3 545 | Group 1 (5 countries/4 votes) The governor of each country votes 80% of the time | 18.0 | 1 948.2 |
| France | 2 044 | 8 229 | 3 074 | | 14.2 | 1 534.9 |
| Italy | 1 560 | 4 127 | 1 988 | | 12.3 | 1 332.6 |
| Spain | 1 023 | 3 287 | 1 400 | | 8.8 | 957.0 |
| Netherlands | 602 | 2 339 | 892 | | 4.0 | 433.4 |
| Belgium | 380 | 1 071 | 496 | Group 2 (14 countries/11 votes) The governor of each country votes 78.6% of the time | 2.1 | 228.2 |
| Austria | 311 | 922 | 413 | | 2.0 | 212.5 |
| Ireland | 164 | 1 049 | 312 | | 1.2 | 125.6 |
| Finland | 193 | 523 | 248 | | 1.3 | 136.0 |
| Portugal | 164 | 517 | 223 | | 1.7 | 188.7 |
| Greece | 182 | 421 | 221 | | 2.0 | 220.1 |
| Luxembourg | 45 | 944 | 195 | | 0.2 | 21.9 |
| Slovakia | 72 | 60 | 70 | | 0.8 | 83.6 |
| Slovenia | 35 | 49 | 38 | | 0.3 | 37.4 |
| Lithuania | 34 | 25 | 33 | | 0.4 | 44.7 |
| Cyprus | 17 | 91 | 29 | | 0.2 | 16.4 |
| Latvia | 23 | 28 | 24 | | 0.3 | 30.5 |
| Estonia | 18 | 19 | 18 | | 0.2 | 20.9 |
| Malta | 7 | 55 | 15 | | 0.1 | 7.0 |
| | GPD* (bn euros) | Bank assets (BA) | Criteria for membership in a vote rotation group (GDP 5/6; AB 1/6) | Rotation group | ECB capital**** | |
| **Other EU members** | | | | | Share in % | Million euros |
| **Potential members of the euro zone:** | | | | | | |
| Poland | 388 | 361 | 384 | Timetable abandoned | 5.1 | 20.8 |
| Republic Czech | 150 | 192 | 157 | Timetable abandoned | 1.6 | 6.5 |
| Romania | 139 | 89 | 131 | 2019 | 2.6 | 10.6 |
| Hungary | 99 | 116 | 102 | Timetable abandoned | 1.4 | 5.6 |
| Croatia | 43 | 59 | 46 | Timetable abandoned | 0.6 | 2.5 |
| Bulgaria | 40 | 49 | 41 | Timetable abandoned | 0.9 | 3.5 |
| **Countries with opt-out clause:**** | | | | | 0.0 | |
| United Kingdom | 1 916 | 9 146 | 3 121 | Never | 13.7 | 55.5 |
| Sweden | 420 | 1238 | 556 | Never | 2.3 | 9.2 |
| Danmark | 248 | 1 065 | 384 | Never | 1.5 | 6.0 |
| **European Union (28 countries)** | **13 036** | **43 753** | | | 100 | 10 825.0 |

* At end September 2013.

** Explicit (United Kingdom and Denmark) or implicit (Sweden).

*** As announced by the national authorities.

**** The contribution to ECB capital is based on the country's GDP and population (1/2; 1/2). The key can be different from the amount actually paid into the ECB capital. The net profits and losses of the ECB are not allocated to countries that are not members of the euro zone.

*Source:* Eurostat and ECB; author's calculations.

Why change the system of voting rights? The objective is clear and justified: it is to maintain the decision-making capacity of the Governing Council as the number of countries joining the euro zone increases.

The new system of voting rights clearly benefits the members of the ECB Executive Board, which now have 28.6% of the voting

rights (6/21), while the old system would have given them "only" 24% (6/25). The group of "big" countries has 19% (against 20% in the old system). The group of "small" countries gets 52% (11/21) of the voting rights, whereas it would have had 56% (14/25) if the old voting system had been maintained. The group of "small" countries loses relatively more voting rights than the group of "large" countries, to the advantage of the ECB Executive Board.

## 2) The arguments of German and Irish opponents of the system of rotation

The arguments of German opponents of the new system, beyond just a loss of prestige, are that the largest economy in the euro zone and also the largest contributor to the ECB's capital (Table 1) must necessarily take part in the votes deciding the zone's monetary policy. To ensure that Germany's interests are not neglected, when Germany doesn't vote its Governor should have a veto. This veto would also be justified by the principle that you should be responsible only for your own decisions.

In Ireland, according to the opponents of the new system, the myth of equality between the countries of the euro zone is finished: the introduction of a rotation system that favours the big countries is formalizing the lack of equality between the zone's countries. Ireland has thus been explicitly relegated to being a second tier country. Furthermore, Ireland's influence in the decision-making process will be reduced even further as the euro zone continues to expand.

The introduction of the rotation system doesn't seem to have aroused as much resentment from politicians or civil society in other countries in the euro zone.

## 3) Do the German and Irish arguments make sense?

As is well known, Germany has a culture of stability all its own, in particular due to its history a strong aversion to

inflation. In contrast, the countries of southern European are reputed to have a much less marked aversion to the "inflation tax". It is this difference in the degree of "acceptable" inflation that has led to modelling the statutes of the ECB more or less on those of the Bundesbank, which was considered the only way of securing Germany's participation in the euro zone. Today, however, the issue of inflation is no longer posed since the euro zone is entering into deflation, a situation that some think could last for years[3].

Today, it is much more the *methods* the ECB is using to conduct monetary policy that are being questioned in Germany by some of the country's politicians, economists and citizens. The arguments being made by opponents of the rotation system, based on contributions to the ECB's capital and more generally being Europe's leading economic power, echo the policies that have been pursued in recent years by the ECB (e.g. easing eligibility criteria for securities deposited as collateral at the ECB, purchase of securitized assets) but also the future policy of purchasing sovereign bonds. These policies have raised fears in Germany that the ECB balance sheet will contain too much "toxic" debt that sooner or later could be dropped, with the cost of this being borne by the Bank's principal funder.

Is it really believable that Germany's interests wouldn't be taken into account?

There are three arguments for answering "no". First, even when the German Governor doesn't vote, Germany will still have a "representative" on the Executive Board (currently Sabine Lautenschläger)[4]. In theory, of course, the members must consider the interests of the euro zone when they vote and not just the interests of their own country, but the reality is more complex[5]. Furthermore, the Governors, even when they do not vote, still have a right to speak, and therefore some power of persuasion. Finally, more generally, the desire for a consensus will make it necessary to take into consideration

the opinion of the Governors who are not voting.

How justifiable are the arguments of the Irish opponents of the rotation system? It is clear that the counter-arguments developed above (concerning the right to speak and the need for a consensus) that apply to the Germans also apply to the Irish.

However, it is true that Ireland, like all the countries in Group 2, will see its voting rights further diluted as the euro zone expands. When the euro zone is comprised of 20 members, the 15 Group 2 countries will have to share 11 votes (Table 2, source: p. 91). When the euro zone expands again to 21 members, 16 Group 2 countries will still have to share 11 votes … At 22 members, the creation of a third group will result in further dilution of the voting rights of groups 2 and 3, but not of group 1, the group of "large" countries, which will still continue to vote 80% of the time.

The question that is posed for Ireland but also for all the countries currently in Group 2 concerns the future expansion of the euro zone. To date, all the countries of Central and Eastern Europe (CEE) that have not yet adopted the euro have abandoned a timetable for joining the euro zone (Table 1). The only exception is Romania, which has proposed 2019 for joining[6]. Though the prospects of the other countries have not been abandoned, they nevertheless appear very distant[7]. The likelihood that the euro zone will soon include 21 members is rather low, and the probability of exceeding 22 members even lower. Anyway, whatever the configuration, Ireland will never be part of group 3. It is thus the countries that are lagging in today's group 2 (Malta, Estonia, Latvia, etc.) that have the most to lose in terms of the frequency of voting.

Table 2. Rotation system (first and second steps)

| Total no. of governors | Group 1 | | | Group 2 | | | Group 3 | | |
|---|---|---|---|---|---|---|---|---|---|
| | Governors | Votes | Frequency of vote | Governors | Votes | Frequency of vote | Governors | Votes | Frequency of vote |
| **First step: euro zone from 19 to 21 countries** | | | | | | | | | |
| 19 | 5 | 4 | 80% | 14 | 11 | 79% | | | |
| 20 | 5 | 4 | 80% | 15 | 11 | 73% | | | |
| 21 | 5 | 4 | 80% | 16 | 11 | 69% | | | |
| **Second step: euro zone from 22 to 27 countries** | | | | | | | | | |
| 22 | 5 | 4 | 80% | 11 | 8 | 73% | 6 | 3 | 50% |
| 23 | 5 | 4 | 80% | 12 | 8 | 67% | 6 | 3 | 50% |
| 24 | 5 | 4 | 80% | 12 | 8 | 67% | 7 | 3 | 43% |
| 25 | 5 | 4 | 80% | 13 | 8 | 62% | 7 | 3 | 43% |
| 26 | 5 | 4 | 80% | 13 | 8 | 62% | 8 | 3 | 38% |
| 27 | 5 | 4 | 80% | 14 | 8 | 57% | 8 | 3 | 38% |

*Source*: ECB (2009).

## Conclusion

There can be no talk of a unified Europe while explaining that there are several categories of countries. How can there be congratulations for the euro zone gaining new members while at the same time explaining that only certain members can or should participate in its decision-making. In a unified Europe it is not acceptable for there to be a vote in the Council that is systematic only for certain Governors (but not all) or a right of veto that only a few Governors can exercise. Each country loses its monetary sovereignty by joining the euro zone: why should some countries lose more than others? But is it really desirable to go back to the old system of “one country, one vote”? No. The new voting system in the Governing Council is a good compromise between the need to maintain the Council’s decision-making capacity (and therefore have a reduced number of voters) and the need to allow each Governor to vote on a regular basis. From this point of view, the rotation system used in the euro zone is more balanced than that used in the United States, where some members may not vote for one, two or even three years[8]. In the euro zone, the length of time that a Governor does not vote on monetary policy will not exceed one month for Group 1 countries, and for countries currently in Group 2, it shall not exceed three months (so long as the euro zone consists of just 19

countries).

At least in theory. Because, in practice, while the Governing Council will continue to meet twice a month, the vote on the conduct of monetary policy will now take place  only every six weeks … (previously every four). The voting abstention time will thus be (slightly) longer than what is stated in the official documents of the ECB and the euro zone's national central banks…

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[1] More specifically, on 21 March 2003 the European Council amended Article 10.2 of the statutes of the Eurosystem in order to allow the establishment of a system of rotation in the ECB Governing Council. The amended article provided that the rotation system could be introduced from the entry of the 16th member into the euro zone and at the latest upon the entry of the 19th member.

[2] The Treaty provides for the creation of a third group upon the entry of a 22nd country.

[3] For the first time since 2009, consumer prices fell, with prices falling -0.2% year on year.

[4] The other members of the Governing Council are from Italy (Mario Draghi, President of the ECB). Portugal (Vítor Constâncio, Vice-President of the ECB), France (Benoît Cœuré), Luxembourg (Yves Mersch) and Belgium (Peter Praet).

[5] The experience of the US Federal Open Market Committee shows that there is a regional bias in the way the Governors vote (Meade and Sheets, 2005: "Regional Influences on FOMC Voting Patterns", *Journal of Money Credit and Banking*, 33, pp.

661-678).

[6] It will in any case have to respect the Maastricht criteria (criteria on the public deficit, interest rates, inflation, etc.).

[7] This shift is due in part to the fact that many of the Central and East European countries have benefited from the depreciation of their currencies against the euro. They have thus understood that joining the euro zone would not just bring them benefits. In addition, it is assumed here that the United Kingdom, Denmark and Sweden will never join the euro zone because of their opt-out clause.

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# Better abilities or stronger social ties? Drivers of social immobility across EU countries

par Francesco Vona

A high level of income inequality is commonly regarded to be more acceptable when associated with high social mobility. Empirical evidence has however shown that unequal countries are rarely able to ensure high social mobility to their citizens. On the contrary, countries that rank high in the level of inequality are also the worst in term of social mobility[i]. The simple reason is that a given level of social immobility is amplified when rewards to individual

characteristics, which are transmitted from parents to child, are larger. For instance, when the earning advantage for the high skilled is large, intergenerational inequality (that is: the correlation between parent and child incomes) increases because, on average, high skilled workers come from better family backgrounds.

Economists tend to attribute cross-country differences in social mobility to the working of the educational system and its influence on the effective skills possessed by individuals coming from different family backgrounds. In particular, several empirical studies using standardized test scores show that there exist substantial background-related differences in competences and skills at a given level of educational attainment[ii]. Among OECD countries[iii], the influence of family background on test scores achievements is particularly strong in France (the second worst country after the USA in terms of intergenerational educational inequality), Germany and the UK, while it is relatively weaker in Italy and Spain. Whereas background-related differences in the effective level of skills certainly play a major role in creating persistency in socio-economic statuses, the working of labour markets is also an important, yet neglected, source of social immobility. On the one hand, labour market institutions reduce the observed level of intergenerational inequality whereby institutions compressing wages (i.e. centralized wage bargaining, high unionization or minimum wage) are present. On the other hand, family ties constitute a labour market network that can help well-off individuals in finding good jobs and obtaining promotions.

In a recent paper (Raitano and Vona, 2014a)[iv], we assess the role played by labour market networks and individual skills in the transmission of socio-economic inequalities. We argue that high levels of intergenerational inequality can be due to: 1. formal educational attainment; 2. other (empirically unobservable) dimensions of human capital affected by family

background, i.e. soft skills or better quality of education; 3. family and social ties affecting labour market outcomes and occupational sorting. Our main idea is to use intergenerational occupational mobility to distinguish between two types of association between family background and child earnings. A standard type emerges because, especially in top occupations, the well-off child should have a higher level of human capital (a glass ceiling effect) due to the fact that he attended top schools or inherited better soft skills. In contrast, the second type is associated with insurance for the children of the well-off ending up in bottom occupations (a parachute effect), who clearly display a low level of skills for a given level of education. To implement this idea, we use the 2005 module on intergenerational mobility of the EUSILC dataset and examine these two effects in eight EU countries characterized by different levels of intergenerational inequality and belonging to different welfare regimes. Our empirical analysis is motivated by the claim that returns to upward and downward social mobility could arguably stem from different sources. A glass ceiling of upward mobility is likely to depend on both network effects and unobservable skills that are positively correlated with family background. Conversely, it is hard to believe that the parachute effect can be associated with better unobservable skills; hence, in this case, family networks should be of paramount importance.

By way of an example, imagine that a child is in the first tercile group (low social position) of its distribution but that his father was in the third tercile group (high social position). This individual clearly has a good background, but his relative position signals that he has a low ability. In this case, a positive association between family background and earnings (i.e., a parachute effect) would depend on the family network rather than on unobservable skills related to the child’s background. Conversely, it is not easy to infer the true unobservable skills of individuals who maintain their positions and earn more than others while sharing the same

occupation but coming from a worse background. Hence, the identification of the glass ceiling effect is more problematic.

We find that family ties can create a considerable earning advantage for Spanish and Italian workers[v]. In these two countries, the high observed intergenerational inequality is mainly explained by a parachute effect for the well-off worsening their social position. In Italy, this parachute effect is particularly high: all else equal, the child of the well-off who worsens its social position earns annually 12% more than the child of the worse-off who stays in the same position. This result is consistent with a sociological view of social mobility where families play a key role both in the allocation of workers to jobs and in determining earning increases within a job[vi]. Interestingly, this result does not hold for other immobile European countries, such as the UK and to a lesser extent France. In these cases, the earning advantage of the well-off is fully driven by a penalty for those climbing the social scale, i.e. glass ceiling effect. While this result seems consistent with the classical human capital view of intergenerational inequality (where access to elite educational institutions is highly dependent on family background), our study cannot discriminate between the two explanations because a glass ceiling at the top could also be engendered by social networks. However, since the glass ceiling effect is widespread across all countries, including more equal ones (i.e. Germany, Finland, Ireland and Denmark), this effect is most likely due to unavoidable features either of the educational system or of the cumulative process of skill formation, at least in countries where students with similar socio-economic backgrounds are sorted into the same school.[vii]

Overall, our study suggests that intergenerational transmission of inequality strongly depends on the features of the country’s labour market, especially in Mediterranean

countries where family ties are extremely important in finding good jobs. Further research is required to understand which part of intergenerational inequality emerges during the educational period and which part emerges during the working career, accounting for the learning advantage possessed by high skilled individuals and thus for their steeper earning profiles. In future research[viii], we aim at decomposing the two effects in a more precise way for a cohort of Italian workers that we observe during their entire careers.

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[i] See: Corak, M., 2012. How to Slide Down the 'Great Gatsby Curve': Inequality, Life Chances, and Public Policy in the United States. Center for American Progress, December. Available at https://milescorak.files.wordpress.com/2012/12/corakmiddleclass.pdf.

[ii] See: Fuchs T., Wößmann, L., 2007. What accounts for international differences in student performance? A re-examination using PISA data, Empirical Economics 32.

[iii] See: http://www.oecd.org/centrodemexico/medios/44582910.pdf.

[iv] Raitano, M., Vona, F., 2014a. Measuring the link between intergenerational occupational mobility and earnings: evidence from eight European countries, Journal of Economic Inequality forthcoming.

[v] The results are obtained running regressions for samples of representative individuals for each country.

[vi] See: Ganzeboom, H., Treiman, D., 2007. Ascription and achievement in comparative perspective, Russell-Sage University Working Group on Social Inequality, University of

California-Los Angeles.

[vii] Mixing students from different background in the same schools tends to reduce the influence of family background on individual student achievement without having negative effects for the average student achievement in the school. See: Raitano, M., Vona, F., 2013. Peer heterogeneity, school tracking and students' performances: evidence from PISA 2006, Applied Economics 45.

[viii] Raitano, M., Vona, F., 2014b. From the Cradle to the Grave: the impact of family background on carrier path of Italian males, mimeo.

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# What Reforms for Europe?

by *Christophe Blot [1], Olivier Rozenberg [2], Francesco Saraceno [3] et Imola Streho [4]*

From May 22 to May 25 Europeans will vote to elect the 751 Members of the European Parliament. These elections will take place in a context of strong mistrust for European institutions. While the crisis of confidence is not specifically European, in the Old Continent it is coupled with the hardest crisis since the Great Depression, and with a political crisis that shows the incapacity of European institutions to reach decisions. The issues at stake in the next European elections, therefore, have multiple dimensions that require a multidisciplinary approach. The latest issue of the *Debates and Policies Revue de l'OFCE* series (published in French and in English), gathers European affairs specialists – economists, law scholars, political scientists – who starting

from the debate within their own discipline, share their vision on the reforms that are needed to give new life to the European project. Our goal is to feed the public debate through short policy briefs containing specific policy recommendations. Our target are obviously the candidates to the European elections, but also unions, entrepreneurs, civil society at large and, above all, citizens interested by European issues.

In the context of the current crisis, the debate leading to the next European elections seems to be hostage of two opposing views. On one side a sort of self-complacency that borders denial about the crisis that is still choking the Eurozone and Europe at large. According to this view, the survival of the euro should be reason enough to be satisfied with the policies followed so far, and the European institutions evolved in the right direction in order to better face future challenges.

At the opposite, the eurosceptic view puts forward the fundamental flaws of the single currency, arguing that the only way out of the crisis would be a return to national currencies. The different contributions of this volume aim at going beyond these polar views. The crisis highlighted the shortcomings of EU institutions, and the inadequacy of economic policies centered on fiscal discipline alone. True, some reforms have been implemented; but they are not enough, when they do not go in the wrong direction altogether. We refuse nevertheless to conclude that no meaningful reform can be implemented, and that the European project has no future.

The debate on Europe’s future and on a better and more democratic Union needs to be revived. We need to discuss ways to implement more efficient governance, and public policies adapted to the challenges we face. The reader nevertheless will not find, in this volume, a coherent project; rather, we offer eclectic and sometimes even contradictory views on the direction Europe should take. This diversity witnesses the

necessity of a public debate that we wish to go beyond academic circles and involves policy makers and citizens. Our ambition is to provide keys to interpret the current stakes of the European debate, and to form an opinion on the direction that our common project should take.

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# Towards a better governance in the EU?

By Catherine Mathieu and Henri Sterdyniak

The 10th EUROFRAME Conference on economic policy issues in the European Union was held on 24 May 2013 in Warsaw on the topic, "Towards a better governance in the EU?" Revised versions of twelve of the papers presented at the Conference are included in issue 132 of the "Debates and Policies" collection of the *Revue de l'OFCE* entitled "Towards a better governance in the EU?". The papers are organized around four themes: fiscal governance, analysis of fiscal policy, bank governance, and macroeconomic issues.

The global financial crisis of 2007 and the sovereign debt crisis in the euro area that begin in 2009 have highlighted shortcomings in EU governance. The intense debate that has been going on among economists over how to analyze these shortcomings and proposals for improved governance also marked the EUROFRAME Conference.

How can the Economic and Monetary Union be strengthened between countries that are still fundamentally different? How can we get out of the financial and economic crisis, the sovereign debt crisis, fiscal austerity and depression? Is it possible to develop a governance of the euro area that ensures the strength of the single currency, that avoids widening the disparities between Member States, and that gives the Members the flexibility needed, while forbidding non-cooperative policies, whether that means the excessive pursuit of competitiveness and trade surpluses or the irresponsible swelling of their public or foreign debt?

The articles in this issue provide readers with various viewpoints on possible pathways that Europe could take:

– Some authors think that we should stick to the original Treaty, abolish solidarity mechanisms, prohibit the Central Bank from buying the debt of member countries, and make it compulsory for them to find financing on the financial markets, which, stung by the Greek experience, will now be more vigilant and impose risk premiums on countries they consider lax. But is this compatible with the single currency? Are the markets really competent in macroeconomic matters? And will the euro zone members accept being reduced to the rank of countries without monetary sovereignty, whose public debt is considered risky and who do not control their interest rates?

– Other authors believe that we should gradually move towards a federal Europe, where the European authorities would be responsible for the fiscal policy of each MemberState; this would need to be accompanied by a

democratization of EU institutions, perhaps including even some form of political union. But can there be centralized management of countries in different economic circumstances with different economic and social structures, and which thus need differentiated strategies? Isn't the euro zone just too heterogeneous for this? Would every country agree to submit its social and economic choices to European trade-offs?

– Other authors believe that such heterogeneous countries cannot share a single currency; that the Northern countries will refuse to give an unconditional guarantee of public debt, even though this is a prerequisite for maintaining the euro zone's unity; that Europe is incapable of organizing a common but differentiated strategy; and that the differentials accumulated in terms of competitiveness require large exchange rate adjustments in Europe. Exchange rates need to be allowed to reflect the Members' different situations, *i.e.* sharp exchange rate falls in the Southern countries, and sharp rises in the Northern countries, by returning to the European Monetary System, or even to flexible exchange rates. Each country would then have to face up to its responsibilities: the Northern countries will have to boost domestic demand, while the Southern ones will have to use their gains in competitiveness to rebuild their export sectors. But no country is demanding this leap into the unknown – the financial consequences could be terrible.

– Finally, some authors, including ourselves, believe that public debts should once again be risk-free assets, guaranteed by the ECB, as part of a process of genuine coordination of economic policy by the Member States, while explicitly targeting full employment and the coordinated reduction of imbalances in the zone. But isn't such coordination a myth? Is a country going to agree to change its economic policy objectives to help the situation of its partners? Don't the European countries today mistrust each other too much to agree to guarantee the public debt of their

partners?

These are the questions addressed in this issue, which, as the European elections draw near, we hope will make a useful contribution to the debate on EU governance.

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[1] EUROFRAME is a network of European economic institutes, which includes: the DIW and IFW (Germany), WIFO (Austria), ETLA (Finland), OFCE (France), ESRI (Ireland), PROMETEIA (Italy), CPB (Netherlands), CASE (Poland) and NIESR (United Kingdom).

[2] This issue is published in English.

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

By Céline Antonin, Henri Sterdyniak and Vincent Touzé

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

**Regulating proprietary activities: a need born of the crisis**

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

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

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

The idea of separating banking activities is not new. In the past, many countries enacted legislation to separate commercial banks from investment banks (Glass-Steagall Act in 1933 in the United States, the 1945 Banking Act in France). These laws were revoked in the 1980s due to a growing belief in the superiority of the “universal bank” model, which allows

a single bank to offer a full range of financial services to individuals (loans, deposits, simple or complex financial investments) and especially to business (loans, hedging, issuance of securities, market-making activities). The crisis exposed two defects in this model: the losses incurred by a bank on its proprietary trading and other activities on the markets led to a loss in its equity capital, thereby calling into question the bank's lending activities and requiring the State to come to its rescue in order to ensure that bank credit didn't dry up. The universal bank, backed by the State's guarantee and sitting on a mass of deposits, did not have sufficient vigilance over its proprietary trading activities (as was shown by the cases of Kerviel, Picano-Nacci and Dexia).

## An ambitious European regulatory proposal

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

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

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

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

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

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

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

activities are compartmentalized.

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

### A reform that doesn't have a consensus

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

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

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

The proposal has encountered two contradictory criticisms. One is that it doesn't organize a genuine separation of deposit-

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

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

uncontrolled growth of banks' financial activities.

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

## A fourth pillar for the banking union?

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

However, the separation advocated by the Barnier proposal lends credibility to the banking union and its three pillars (SSM, SRM and deposit insurance). This project does contribute to convergence in banking regulations, from both a functional and a prudential perspective. The establishment of a consistent framework simplifies control by the European supervisor under the SSM (the ECB will monitor the banks' normal activities and ensure that they are not affected by speculative activities). The separation recommended by the Barnier proposal enhances the credibility of the SRM; there will no longer be any banks that are too big to go bankrupt, and investment bank losses will not rebound onto the lending

activities of deposit banks and will not have to be borne by the taxpayer. By reducing the risk that deposit banks might fail, the risk of a costly rescue plan for investors (bail-in) is also lowered, as is the risk of needing recourse to deposit insurance. In this sense, the draft regulations can be considered a fourth pillar of the banking union.

For more information:

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

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

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

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# Europe's banks: sustaining the renewal of confidence

By Céline Antonin and Vincent Touzé

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

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

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

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

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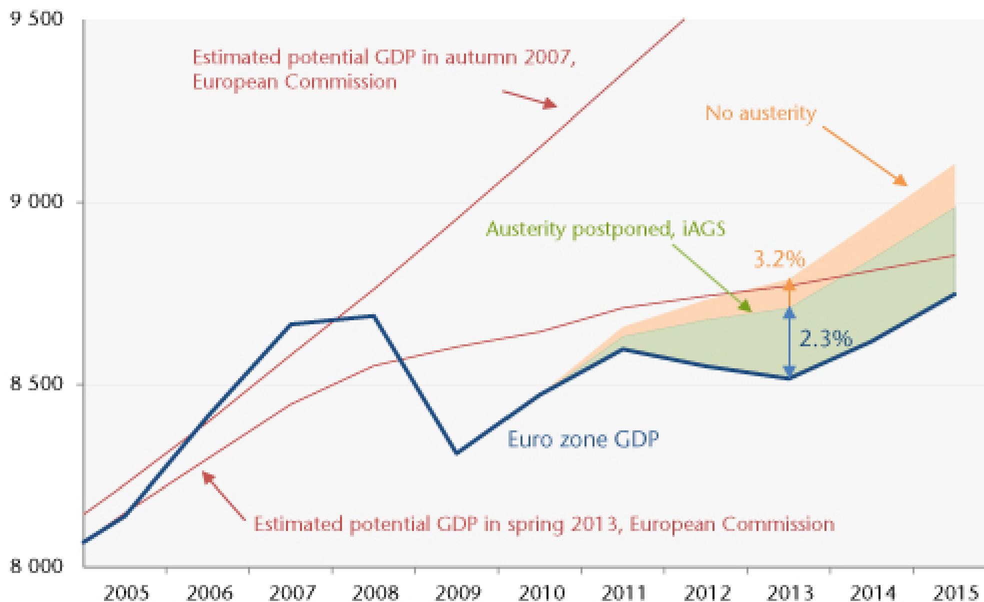
# From austerity to stagnation

By Xavier Timbeau

Since 2010, the European Commission has published the Annual Growth Survey to stimulate discussion on the occasion of the European semester, during which the governments and parliaments of the Member States, the Commission, and civil society discuss and develop the economic strategies of the various European countries. We considered it important to

participate in this debate by publishing simultaneously with the Commission an independent Annual Growth Survey (iAGS), in collaboration with the IMK, a German institute, and the ECLM, a Danish institute. In the 2014 iAGS, for instance, we estimate the cost of the austerity measures enacted since 2011. This austerity policy, which was implemented while the fiscal multipliers were very high and on a scale unprecedented since the Second World War, was followed simultaneously by most euro zone countries. This resulted in lopping 3.2% off euro zone GDP for 2013. An alternative strategy, resulting after 20 years in the same GDP-to-debt ratios (*i.e.* 60% in most countries), would have been possible by not seeking to reduce public deficits in the short term when the multipliers are high. In order to lower the fiscal multipliers again, it's necessary to reduce unemployment, build up agents' balance sheets and get out of the liquidity trap. A more limited but ongoing adjustment strategy, just as fiscally rigorous but more suited to the economic situation, would have led to 2.3 additional points of GDP in 2013, which would have been much better than under the brutal austerity we find ourselves in today. This means there would not have been a recession in 2012 or 2013 for the euro zone as a whole (see the figure below: GDP in million euros).

Impact of austerity on economic activity, 2011-2015




*Source:* iAGS 2014, Eurostat and European Commission.

It is often argued that the state of euro zone public finances left no choice. In particular, market pressure was so great that certain countries, like Greece for example, were concerned that they would lose access to private financing of their public debt. The amounts involved and the state of the primary deficit are advanced to justify this brutal strategy and convince both the markets and the European partners. However, the sovereign debt crisis, and hence market pressure, ended when the European Central Bank announced that no country would leave the euro and set up an instrument, Outright Monetary Transactions, which makes it possible under certain conditions to buy back public debt securities of euro zone countries and therefore to intervene to counter the distrust of the markets (see an analysis here). From that point on, what matters is the sustainability of the public debt in the medium term rather than demonstrating that in an emergency the populace can be compelled to accept just any old policy. Sustainability does however require an adjustment policy that is ongoing (because the deficits are high) and moderate (because fiscal policy has a major impact on activity). By choosing the difficult path of austerity, we paid a high price for the institutional incoherence of the euro zone, which was

exposed by the crisis. In the 2014 iAGS, we point out costs due to austerity that go beyond the loss of activity. On the one hand, inequality is increasing, and "anchored poverty", *i.e.* as measured from the median incomes of 2008, is increasing dramatically in most countries affected by the recession. The high level of unemployment is leading to wage deflation in some countries (Spain, Portugal and Greece). This wage deflation will result in gains in cost competitiveness but, in return, will lead the countries' partners to also take the path of wage deflation or fiscal devaluation. Ultimately, the adjustment of effective exchange rates either will not take place or will occur at such a slow pace that the effects of deflation will wind up dominant, especially as the appreciation of the euro will ruin the hopes of boosting competitiveness relative to the rest of the world. The main effect of wage deflation will be a greater real burden (*i.e.* relative to income) of private and public debt. This will mean a return to centre stage of massive public and private defaults, as well as the risk of the euro zone's collapse. It is possible nevertheless to escape the trap of deflation. Possible methods are explored and calculated in the 2014 iAGS. By reducing sovereign spreads, the countries in crisis can be given significant maneuvering room. The levers for this include the continuation of the ECB's efforts, but also a credible commitment by the Member states to stabilizing their public finances. Public investment has been cut by more than 2 points of potential GDP since 2007. Re-investing in the future is a necessity, especially as infrastructure that is not maintained and is allowed to collapse will be extremely expensive to rebuild. But it is also a way to stimulate activity without compromising fiscal discipline, since the latter must be assessed by trends not in the gross debt but in the net debt. Finally, the minimum wage should be used as an instrument of coordination. Our simulations show that there is a way to curb deflationary trends and reduce current account imbalances if surplus countries would increase their minimum wage faster in real terms than their productivity while

deficit countries would increase their minimum wage slower than their productivity. Such a rule, which would respect both national practices in wage bargaining as well as productivity levels and the specific features of labour markets, would lead to gradually reducing macroeconomic imbalances in the euro zone.

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# Shocks, unemployment and adjustment – the limits of the European union

By Christophe Blot

In an article published in 2013 in *Open Economies Review* [1], C. A. E. Goodhart and D. J. Lee compare the mechanisms for recovering from the crisis in the United States and Europe. Based on a comparison of the situation of three states (Arizona, Spain and Latvia) faced with a property crash and recession, the authors explore the reasons for the growing divergence observed among the euro zone countries, a divergence that is not found in the United States. Their analysis is based on the criteria for optimum currency areas, which enable the members of a monetary union to adjust to adverse shocks and to avoid a lasting difference in their unemployment rates during an economic slowdown or downturn. While Latvia is not formally part of a monetary union [2], its currency nevertheless has remained firmly anchored to the euro during the crisis. Thus none of the countries studied by Goodhart and Lee resorted to a nominal devaluation to absorb the financial and real shocks that they faced. The authors

conclude that while Arizona dealt with the shocks better than Spain, this was due both to the greater fiscal solidarity that exists between the states of the United States and to the greater integration of the US banking system, which helps to absorb shocks specific to each state.

In addition to *de jure* or *de facto* membership in a monetary union, Arizona, Spain and Latvia also all went through a real estate boom in the 2000s, followed by a correction that began in 2006 in Arizona and Latvia, and a year later in Spain (Figure 1). The real estate crisis was accompanied by a recession, with the same time lag persisting between Spain and the other two states. Latvia recorded the sharpest downturn in activity (-21% between 2007 and 2010). However, the downturns experienced by Arizona (-5.5% since 2007) and Spain (5% since 2008) were comparable. While the downward adjustment of the property market stopped in Arizona (recovery is underway in the US state), the recession is continuing in Spain. Overall, this difference in adjustment is reflected in a continuing increase in unemployment in Spain, whereas it has fallen by 2.8 percentage points in Arizona from the peak in the first quarter of 2010 (Figure 2).

Spain’s inability to pull out of the recession along with the increasing divergence of the economies in the euro zone raises the question of the capacity of the euro zone countries to adjust to a negative shock. The theory of optimum currency areas, originally developed by Mundell in 1961 [3], can help to evaluate the conditions in which a country may have an interest in joining a monetary union. The optimality of this choice depends on the country’s ability to absorb shocks without resorting to currency devaluation. Different adjustment mechanisms are involved. These consist mainly of the following: [4] the flexibility of prices and in particular of wages; labour mobility; the existence of fiscal transfers between the countries in the monetary union; and financial integration. Price flexibility corresponds to an internal

devaluation mechanism. As for depreciation, the point is to become more competitive – by lowering relative labour costs – to stimulate exports and growth during a negative shock. However, this type of adjustment generally takes much longer and is more costly, as is suggested by the recent examples of Iceland and Ireland.[5] Labour mobility makes for an adjustment whenever the recession leads people to migrate from a state with high unemployment to one where it is lower. The implementation of fiscal transfers occurs when various mechanisms in states where growth is slowing make it possible to benefit from stabilizing transfers from other states in the union or from a higher level of government. Finally, Goodhart and Lee also consider the stabilizing role of the local banking system. In this case, in the euro zone, the less the local banking system has been weakened by the real estate crisis or the public debt crisis, the greater is its capacity to absorb the shock.

The authors analyzed the adjustment of the economies in question in the light of these four criteria. They studied in particular the degree of price flexibility and labour mobility as a function of unemployment in the three states. Then they evaluated the importance of fiscal transfers and the architecture of the banking landscape. Their findings were as follows:

1. Price flexibility has played only a marginal role in adjustment, except in Latvia where rising unemployment has led to a decline in unit labor costs. These costs did not on the other hand react significantly to the rise in unemployment in Spain and Arizona.
2. Though migration is more marked in the United States than in Europe, the differences are still not able to explain the gap in the adjustment of unemployment rates. However, it appears that the role of migration as an adjustment mechanism has strengthened in Europe. Nevertheless, this is still insufficient to ensure the

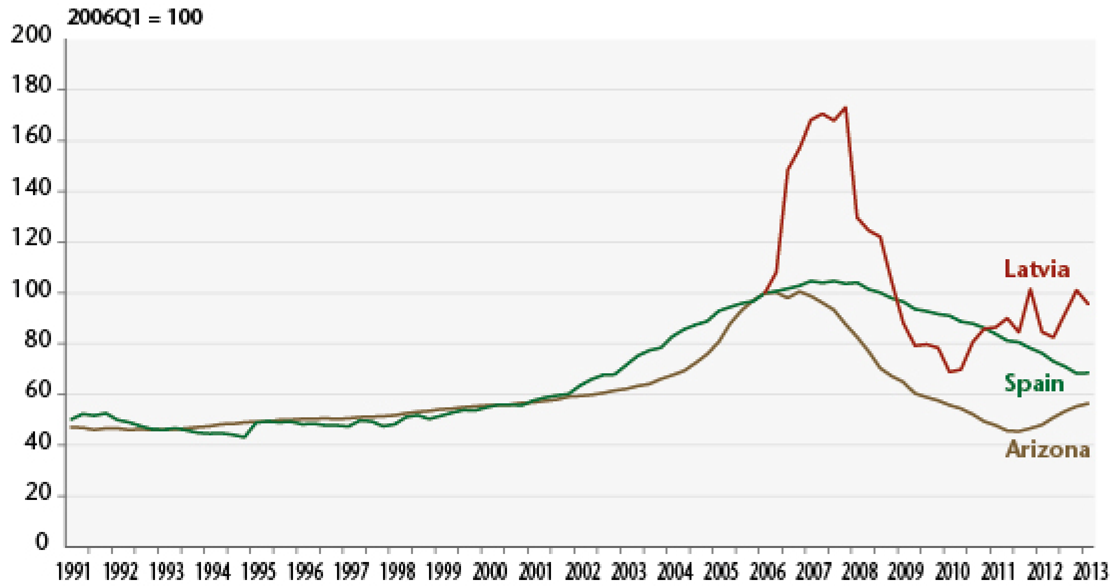
convergence of unemployment rates.

3. In 2009 and 2010, Arizona received substantial transfers from the federal government, whereas at the European level there is no automatic mechanism for transfers between states. Even so, Latvia received assistance from the IMF in 2009, while the euro zone countries came to the aid of Spain's banks. Nevertheless, in the absence of a more substantial EU budget, the European countries can benefit only from emergency assistance, which, while able to meet a specific need for funds, is not sufficient to play the role of an economic stabilizer.
4. Finally, the authors emphasize that the financial amplification of the shocks was on a lesser scale in Arizona in so far as the bulk of the banking business is conducted by national banks that are consequently less sensitive to local macroeconomic and financial conditions. The risk of credit rationing is thus lessened, which helps to better absorb the initial shock. In Spain, with the exception of a few banks with international operations, which enables them to diversify their risks, banking depends on local banks, which are therefore more vulnerable. This increased fragility pushes the banks to restrict access to credit, which reinforces the initial shock. Latvia is in an alternative position in that its financial activity is carried out mainly by foreign banks. The nature of risk thus differs, because local financial activity is disconnected from Latvia's macroeconomic situation and depends instead on the situation in the country where these banks conduct their principal activity (*i.e.* Sweden, to a great extent).

The crisis in the euro zone thus has an institutional dimension. From the moment the countries freely consented to surrender their monetary sovereignty, they in effect also abandoned the use of a currency devaluation to cushion recessions. However, it is essential that alternative

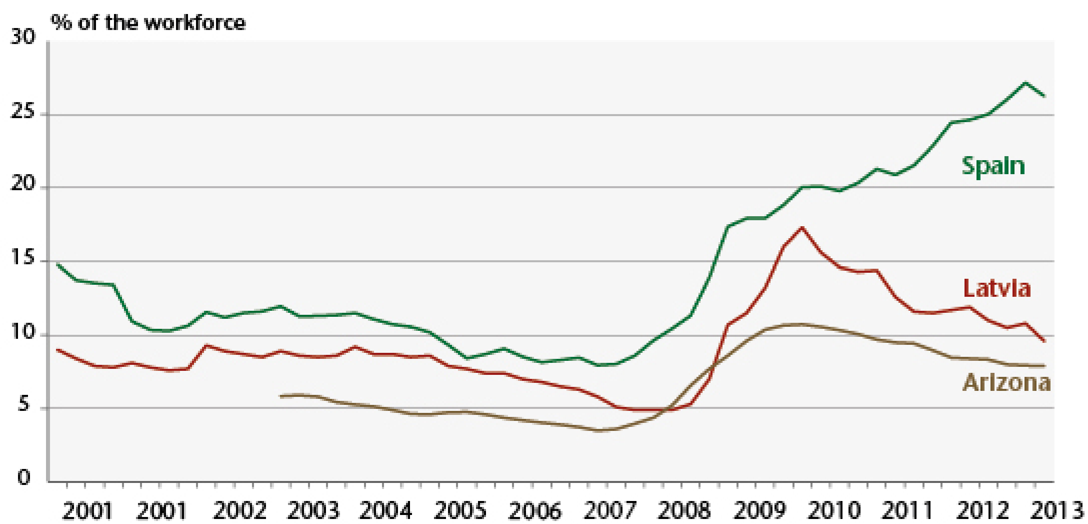
adjustment mechanisms are operative in order to ensure the “sustainability” of monetary unification. In this respect, the article written by Goodhart and Lee is a reminder that such mechanisms are still lacking in the euro zone. Negotiations over the EU budget have not offered any prospect for the implementation of fiscal transfers to stabilize shocks at the European level. The discussion on Eurobonds has stalled. Although the European Stability Mechanism (ESM) acts as a tool for solidarity between Member States, it meets a different need, because it involves only emergency financial assistance and is not a mechanism for automatic stabilization. Banking integration could also help dampen fluctuations. However, the crisis has led to greater fragmentation of European banking markets. The latest report on financial integration in Europe, published by the ECB, shows a 30% decrease in cross-border bank flows in the recent period. Similarly, despite the common monetary policy, the interest rates charged by European banks have recently diverged [6] (Figure 3). Thus, despite the European banking passport created by the European Directive of 15 December 1989 on the mutual recognition of authorizations of credit institutions, cross-border banking in Europe is still relatively undeveloped. The retail banking model is based on the existence of long-term relationships between the bank and its clients, which undoubtedly explains why the integration process is taking much longer than for the stocks, bonds and currency markets. It is nevertheless still the case that a banking union could be a further step in this difficult process of integration. This would promote the development of transnational activity, which would also help to de-link the problem of bank solvency and liquidity from the problem of financing the public debt.

**Figure 1 : Changes in real estate prices in real terms**

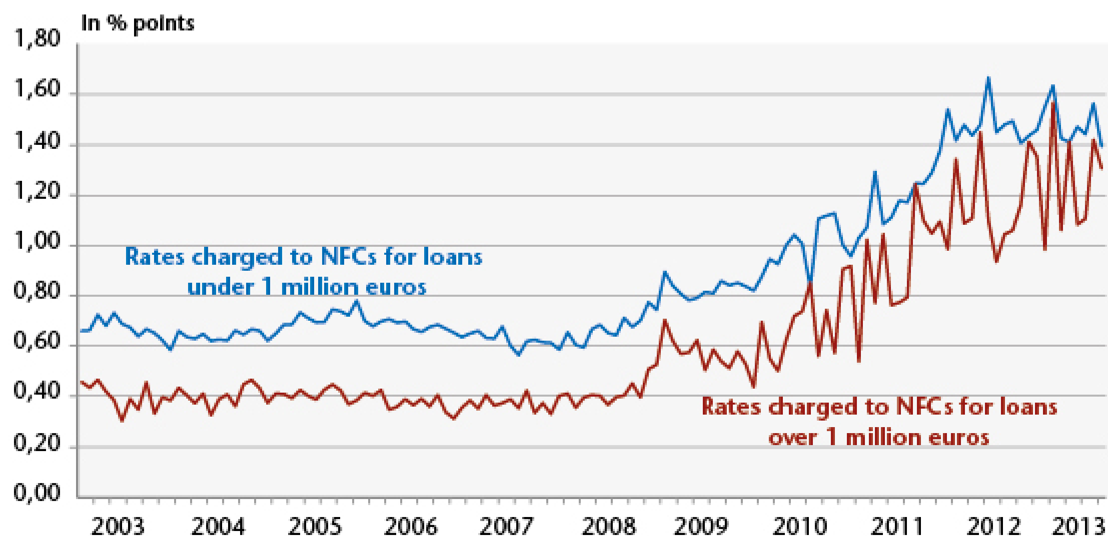



*Source* : Bank of International Settlements, Federal Housing Finance Agency.

**Figure 2 : Unemployment rates**




*Sources* : Bureau of Labor Statistics, Instituto Nacional de Estadisticas, Agence nationale pour l'emploi (Latvia).

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[1] "Adjustment mechanisms in a currency area", *Open Economies Review*, January 2013. A preliminary version of this article can be downloaded at: http://www.lse.ac.uk/fmg/workingPapers/specialPapers/PDF/SP212.pdf

[2] Latvia has been part of the European currency mechanism since 2005 and is to adopt the euro on 1 January 2014.

[3] "A theory of optimum currency areas", *American Economic Review*, vol. 51, 1961.

[4] One could also add the level of an economy's openness or the degree of diversification of production. Mongelli (2002) offers a detailed review of these various criteria. See: "New views on the optimum currency area theory: what is EMU telling us?", *ECB Working Paper*, no. 138.

[5] See Blot and Antonin (2013) for a comparative analysis of the cases of Ireland and Iceland.

[6] C. Blot and F. Labondance (2013) offer an analysis of the transmission of currency policy to the rates charged by the banks to non-financial companies (see here) and to real estate

loans (see here).

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# Solar power is cooling Sino-European relations

By Sarah Guillou

In early July 2013, yet another company in the solar industry, Conergy, declared bankruptcy. The departure of this German company, established in 1998, marks the end of a cycle for the solar industry. This bankruptcy adds to a series of closures and liquidations across every country that have highlighted the rising trade tension over solar panels between the United States and Europe on the one hand and China on the other (see *OFCE Note 32*: "The twilight of the solar industry, the darling of governments", from 6 September 2013). As this tension peaked, in May, the European Commission decided to threaten China with a customs duty of over 45%. A trade war has thus concluded a decade of government involvement, as if this were a matter of saving the public money invested. But what it signifies most is the industrial failure of a non-cooperative global energy policy.

**A promising, but chaotic, industrial start**

Government worship of solar power, which took off in the early 2000s on both sides of the Atlantic, but also in the emerging economies (and especially China), has undoubtedly propelled solar energy to the forefront of renewable energies, but it has also fueled a number of market imbalances and serious industrial turmoil. With the price of oil rising constantly from 2000 to 2010, the need to accelerate the energy transition along with the commitments of the Kyoto Protocol

led governments to support the production of renewable energy, with solar energy being the great beneficiary. The global industry experienced a tremendous boom, with growth of more than 600% from 2004 to 2011.

Public support, together with private investment, sparked massive market entries that destabilized the price of the main resource, silicon, the amount of which could not adjust as quickly. Fluctuations in the price of silicon due to imbalances in the market for photovoltaic panels created great instability in its supply, which was exacerbated by technological uncertainties facing companies trying to innovate in the field (such as the American firm, Solyndra, which finally filed for bankruptcy in 2013).

### The trade war for a star

The intensification of Chinese domination of the industry has in turn affected the competitive uncertainty. China is now the world's largest market, and the involvement of the Chinese government in the industry's development is unparalleled. Today ranked third in terms of installed capacity (after Germany and Italy), China is also the world's largest producer of solar panels. It now accounts for half of the world's output of panels, whereas it produced only 6% in 2005. Chinese producers have received massive support from central and local government, which has also helped to saturate the Chinese market.

In addition to this public support, China also enjoys a distinct advantage in labour costs, which makes the business of manufacturing solar panels very competitive – the more technologically-intensive steps are upstream in the industry, at the level of the crystallization and slicing of the silicon. In addition to this competitive advantage, Chinese producers have also been accused of dumping, *i.e.* selling below the cost of production. Their competitiveness is thus unrivalled … but increasingly under challenge. In October

2012, the United States decided to impose tariffs on imports of Chinese cells and modules, with anti-dumping duties varying from 18.3% to 250% (for new entrants), depending on the company.

Europe, which imports many more photovoltaic components from China than does the United States, initially opted for the approach of imposing anti-dumping duties, and launched an investigation in September 2012, triggered by a complaint from EU ProSun – a trade association of 25 European manufacturers of solar modules – on imports of panels and modules from China. In June 2013, the Commission finally decided to impose a customs duty of 11.2% on solar panels, while threatening to push this up to 47% if China does not change its position on pricing by August 6th.

## The Empire counter-attacks

The counter-attack was not long in coming: in July 2013, China decided to apply anti-dumping duties on imports of silicon from the United States and South Korea. A serious threat is also hanging over the head of Europe's firms, as China is one of the largest markets for the continent's silicon exporters (870 million dollars in 2011).

This trade war essentially reflects a defensive position taken by China's industrial rivals in the face of a support policy that they consider disproportionate and unfair, during a period when China has been nibbling away at the industrial jobs of its competitors for ten years. But one could question the industrial logic underlying this trade policy.

First, this policy contradicts previous government policies promoting solar energy. The trade-off between climate change goals (developing low-cost energy transition tools) and the profitability and sustainability of the industry seems to have been decided in favour of the latter. Second, while this now provides producers direct support, it could handicap

installers, engineering firms involved in pre-installation work, and manufacturers of panels using Chinese components. Finally, this is leading to serious exposure to potentially costly trade retaliation, which could mean exporters of poly-crystalline silicon or machinery used in the solar industry, or other industries such as wine or luxury cars.

Out of fear of a probable lack of approval by a majority of EU members or in order to "slay other dragons" more freely (the coming telecoms conflict), the agreement reached in late July by Commissioner Karel De Gucht and approved by the European Commission on August 2nd should not lead to trade retaliation nor disturb market supply too much. It commits nearly 90 Chinese producers not to sell below 56 cents per watt of power. This price is a compromise between what is considered consistent with the cost of Chinese production and the current average price on the market on the one hand and what is acceptable to European competitors on the other.

Finally, over the decade from 2002 to 2012 the solar photovoltaic industry has undeniably become global and highly competitive, despite clear-cut government interventionism. In reality, even the governments competed. Now they are settling their disputes by playing with international trade rules. Costly state support has propelled the growth of the sector beyond all expectations: by creating excess supply, the price of solar panels dropped sharply and accelerated the incredible boom in solar power. In 2013, solar power represented more than 2% of the electricity consumed in the European Union. This breakthrough by solar energy was accompanied by numerous entries and exits from the market, without so far giving rise to a significant business concentration. The choice of a public pull-back in favour of trade policy represents a new page in the history of this industry, which is no longer being driven so much by energy policy or even by industrial policy. There is obviously no dusk without a future dawn. But tomorrow's dawn will certainly see the rise of a different

“solar”. Europe’s future in the manufacture of solar panels will involve technological innovation aimed not so much at reducing costs as at improving performance.