

Important change of course at the Elysée Palace. Austerity is no longer the priority

By [Xavier Timbeau](#), Twitter: @XTimbeau

(published in [Le Monde on Thursday 16 January 2014](#), p. 17)

When he was elected François Hollande made fiscal discipline his main goal. The 2008 crisis was continuing to have an impact on the developed economies; in the face of a sovereign debt crisis, Europe's governments had been implementing austerity measures that were to cause a second recession, a "double dip", to use the language of economists. For example, when François Hollande came to power, the situation in France seemed disastrous: the public deficit was 5.2%, with a rise in the public debt of more than 600 billion euros since 2008 along with a 2-point rise in unemployment (to 9.6% of the workforce). The pressure was intense, and, the euro zone states were falling like dominos, with Spain and Italy in danger of following Greece, Portugal and Ireland. In this context, it seemed that only budgetary discipline could help Germany to support a faltering euro zone.

Yet the worst was still to come. By underestimating the magnitude of the fiscal multipliers (the impact of fiscal policy on activity), as was eventually recognized by the International Monetary Fund (IMF) and the European Commission, and as we had pointed out in July 2012, the consequences of generalizing this unprecedented fiscal effort throughout the European Union were dismissed.

What François Hollande had presumed would be a painful recovery preceding a rebound that would open up new possibilities proved instead to be a period of economic stagnation, where rising unemployment went in hand with bad

fiscal news. When the fiscal multiplier is high, nothing works. The budget efforts were weighing down economic activity, and there was no real re-absorption of the government deficits. If this infamous multiplier had been low, François Hollande's strategy – and that of the euro zone as a whole – would have worked. But the multiplier is not at our beck and call; it was the result of an economic situation in which the balance sheets of agents were degraded, with the banks suffocating and expectations dire.

The second part of François Hollande's five-year term, which the press conference of 14 January 2014 was to launch, is now much more complicated than expected. Instead of a recovery in public finances, the debt has barely been stabilized despite an incredible effort. Instead of a strong recovery, what we have is, in the understated language of the INSEE, a "sluggish recovery", which really amounts to continuing recession, with unemployment rising relentlessly. Our businesses are anaemic, and to try to restore their margins, the tax credit for competitiveness and employment (the "CICE"), inspired by the Gallois report, has not really injected new blood.

To lower the cost of labour without increasing the deficit, households, though exhausted, have to be hit again. The fiscal multiplier is still high, and growth, along with a reversal in the trend in unemployment, is being postponed. Worse, the commitment to Brussels to reduce the public deficit (a structural effort of 0.8 GDP point by the end of the five-years, *i.e.* 50 billion euros in total) will postpone a reduction in unemployment until after 2017. The patient may well die from the cure, and at best it will be Hollande's successor in the 2017 elections, which he's lost in advance, who might hope to reap the benefits of a policy that prioritized deficit reduction at the worst possible time.

The responsibility pact now proposed by François Hollande is setting out a different path, a different choice. Instead of austerity, a reduction in the cost of labour is to be financed

not by taxes but by fiscal spending (amounting to 1 GDP point). The bet is that the growth stimulated will bring in additional revenue to meet the commitments on the public deficit. A reduction in social charges of thirty billion euros was announced, replacing the current CICE (20 billion). This means an additional 10 billion euros that can be obtained by companies that are to engage in collective bargaining under the watchful eye of a bipartisan watchdog. While this does not simplify the complex CICE, it will promote social dialogue.

On the other hand, François Hollande confirmed that the target for cutting public expenditure remains, *i.e.* 16 billion euros in 2015 and 18 billion in 2016 and 2017, for a total of 50 billion, with no increase on previous announcements. The CICE was partially funded by an increase in VAT (6 billion euros from 2014) and environmental taxes (4 billion). Replacing the CICE with cuts in social charges gives room for finesse: if companies benefit from the lower labour costs to boost their profits, then taxes on these profits will reduce the bill for the state by 10 billion euros (one-third of 30 billion). If, however, they increase employment and wages or lower their prices or invest, then there will be an increase in activity and the financing will come through growth.

Compared with France's budget commitments to Brussels (an 0.8 point reduction in the structural deficit every year), there will be a 20 billion euro fiscal stimulus based on lowering labour costs by 2017. This GDP point could lead to the creation of 250,000 jobs by 2017 and allow a one-point drop in unemployment. This is a substantial change of course from the priority given up to now to deficit reduction. A choice has been made to focus on business and push companies to create new activity or jobs through a pact. This is a significant step, but there is still more to be done to put an end to austerity, to repair the social damage done and to take radical action to reduce unemployment.

TOFLIT18: for a better understanding of the French economy

By Loïc Charles and [Guillaume Daudin](#)*

Recurrent questions on our economies are, to quote a few: Which factors and actors are key for economic development? What private and public behaviors are particularly growth-enhancing? How important are institutions and policies in shaping trade, in promoting innovations and then growth?...There are different ways of enhancing our knowledge to answer these questions. The first way consists in laboratory experiments where a small-scale environment is created in order to understand “how the different pieces of the system work and interact” This is particularly appropriate for learning on social preferences and dealing with welfare issues. But, as soon as questions related to growth – such those mentioned above – are concerned, laboratory experiments do not appear very suitable. One other way of enhancing our knowledge consists in analyzing what happens today in our country and, possibly, to carry out international comparisons in order to disentangle between what is “good” and what is “bad” for the economy. Once one is engaged in that direction, why stop at comparison across space? Analyzing what happened several decades or centuries ago and to learn from these past experiences for the current period can also be very fruitful.

The project “Transformations of the French Economy through the Lens of International Trade, 1716-1821” ([TOFLIT18](#)) follows this direction. The 4-year project, granted funding by [ANR](#), was launched on the 1st January 2014.

In few words, the project aims at analyzing the French economy during the period that laid the economic ground for the entry of France and Europe in the modern industrial era. Its main tools are the retranscription, the use and the diffusion of French international trade statistics.

The French administrative trade statistics are the most comprehensive and coherent source of quantitative information available for the French economy at that time. These data were produced locally and aggregated at the national level by the Bureau de la Balance du Commerce from 1716 on ([Charles and Daudin ,2011](#)). Despite several administrative reshufflings, the techniques of gathering and presenting the statistics on French foreign trade went almost unchanged up to the 1820s: they provided the total value, and sometimes the unit values, of merchandise and partner-specific trade flows; we have already photographed an almost complete series of yearly statistics. These documents are unique as they provide quantitative information on several geographical levels. As such, they can be used to study the economic effects of international trade on the French economy as a whole, on the economy of a single region, of a port town as well as on the economic behaviors of individual agents, *e.g.* a merchant or a community of merchants from a single town/region. They can also be used to get a more accurate understanding of the interplay that existed between these different geographical levels.

The volume and dispersion of primary sources makes the process of collecting and putting them into a usable form both time-consuming and costly. Our [team](#) includes therefore social scientists with consolidated experience in the construction and management of large databases (notably [MARPROF](#), [NAVIGOCORPUS](#), [RICardo](#) and [SoundToll Registers Online](#)). They will bring their expertise to cross-test our dataset with other types of information on trade (shipping and merchants accounts). The collaboration of researchers who are currently

working on similar set of foreign trade statistics for important economic partners of France at that period— Great-Britain and the Austrian Netherlands – will allow both crosschecking and building comparative studies.

The result database will include the bilateral value (with 20-30 different partners) of trade flows at the national level from 1716 to 1821, a merchandise (600-1000 different goods) and partner breakdown from at least 1750 onward, unit values and quantities from 1771 to 1792 and regional trade data. The project will transfer this database in the public domain and make it easily useable by the research community. The collected data can partly substitute for the lack of domestic macroeconomic series.

We will use the data to improve our knowledge of the French economy and our understanding of the economic mechanisms at work, both at the national and regional level. Two main avenues of research will be privileged. First, we will investigate the evolution of French specialization, both across French regions and in comparison to other countries. How was it linked to the contrasted economic development of France and Britain? What does it tell us on the determinants of international trade? Second, we will study the effects of policy choices on the French economy: France went through several wars and politic upheavals. It also went through stark changes in its commercial policies: from mercantilism to mitigated free trade in the 1760s with its colonial empire, to a number of free-trade treaties in the 1780s, followed by the closing up of the economy under the Empire. What were the effects of these policy choices?

All these questions resonate particularly to our contemporary ears. More importantly, the answer to these questions can provide a renewed glance on the functioning of the (French) economy, both then and now.

For more details, please contact [Guillaume Daudin](#)

—
**Guillaume Daudin est chercheur associé à l'OFCE.*

Latvia: goodbye lats, hello euro!

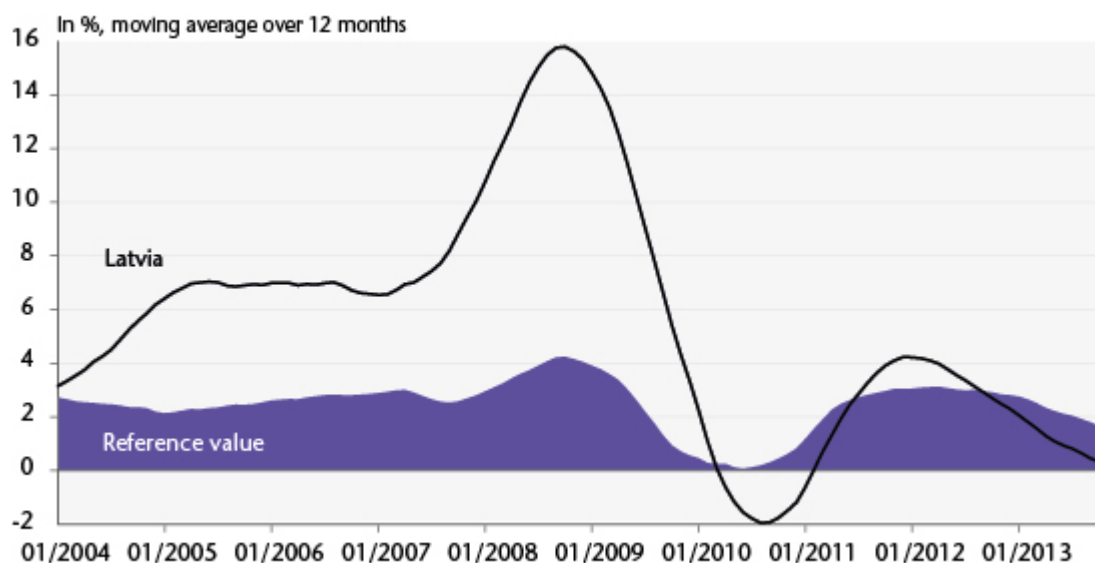
By [Céline Antonin](#)

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

At the end of 2008, facing an emergency situation, the country requested international assistance from the IMF and the European Union, which granted this in return for a drastic austerity plan. The aid came to some 7.5 billion euros, about one-third of the country's GDP. The national debt thus rose sharply between 2007 and 2012, from 9% of GDP to 40%. Latvia undertook a fiscal purge in order to boost its competitiveness and reduce its public deficit by drastically lowering public spending, wages and pension payments. This internal devaluation strategy led to sharp disinflation, which allowed Latvia to meet the ERM II goal for price stability (see chart). In accordance with IMF advice, the country has stuck to its goal of joining the euro zone quickly while categorically refusing to use the weapon of an external

devaluation to get out of the crisis. It has for instance adhered to its policy of maintaining a fixed exchange rate against the euro without interruption since 1 January 2005.

Figure : Price stability in Latvia with respect to inflation criteria



Sources : Eurostat, author's calculations.

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

So is the entry of Latvia of merely incidental importance? Not entirely. First, Latvia has still not erased the scars of the crisis; in 2012, GDP was below its 2007 level in real terms. Furthermore, while the unemployment rate has been cut almost in half since 2009, it still represents 11.9% of the workforce, and most importantly, this reduction has been due in part to high emigration. But above all, as was pointed out by the European Central Bank in its Convergence Report, nearly

one-third of bank deposits (a total of 7 billion euros) are held by non-residents, particularly from Russia. As with Cyprus, this poses a high risk to banking stability in a crisis situation, with the potential for capital flight. At a time when the proposed banking union is stumbling up against the heterogeneity of the euro zone's banking systems, this illustrates yet again that it is very difficult to reconcile the logic of economic integration with the political choice of enlargement. Whether at the level of the euro zone or at the level of the European Union, it is time for Europe to make a clear choice between these two opposing logics.

Is the French tax-benefit system really redistributive?

By [Henri Sterdyniak \[1\]](#)

France has set up benefits such as RSA income support, PPE in-work negative income tax, CMU universal health care, the minimum pension, housing allowances, and exemptions from social security contributions for low-wage workers. From the other side, it has a tax on large fortunes; social insurance and family contributions apply to the entire wage; and capital income is hit by social security contributions and subject to income tax. France's wealthy are complaining that taxation is confiscatory, and a few are choosing to become tax exiles.

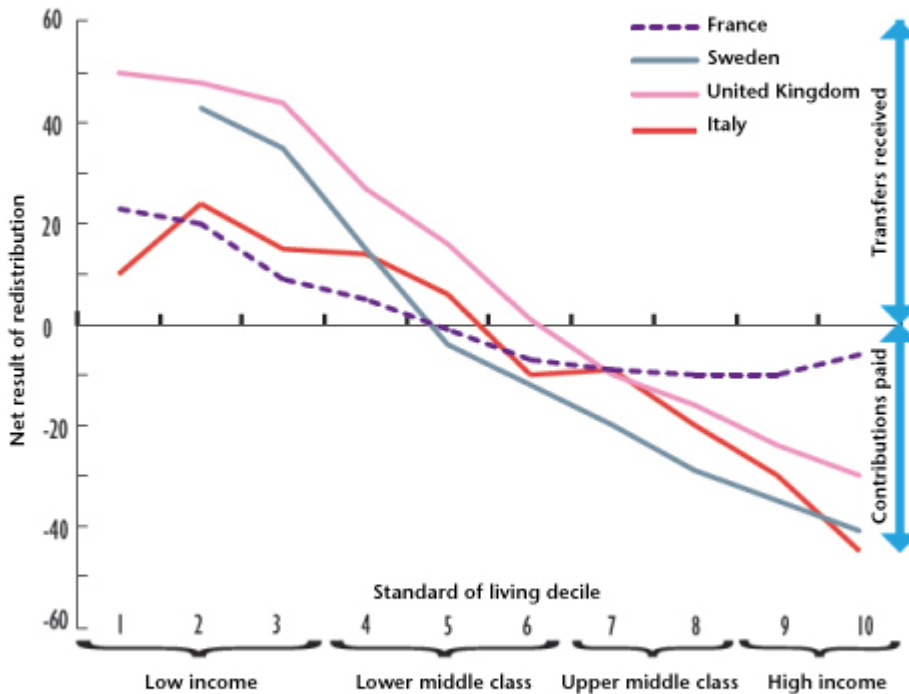
Despite this, some people argue that the French tax-benefit (or socio-fiscal) system is not very redistributive. This view was recently lent support by a study by Landais, Saez and Piketty: the French tax system is not very progressive and

even regressive at the top of the income hierarchy [2]: the richest 0.1% of households are taxed at a very low rate. But redistribution through the tax-benefit system is effected not just through taxes but also through social benefits. We must therefore look at both these aspects to evaluate how redistributive the system is. This is especially true as Landais, Saez and Piketty take into account the VAT paid on consumption financed by social benefits, but not the benefits themselves, meaning that the more a poor household benefits (and spends) from social benefits, the more it seems to lose on redistribution.[3]

Four researchers from Crédoc, the French Research Center for the Study and Monitoring of Living Standards, have published a study [4] that takes benefits into account. They nevertheless conclude: "The French tax system, taken as a whole, is not very redistributive." The study uses post-redistribution standard-of-living deciles to review the benefits received and the taxes paid by households (direct taxes, indirect taxes and social contributions) as a percentage of disposable income, and compares France, Italy, the United Kingdom and Sweden. In France, net transfers (levies less benefits) represent only 23% of household disposable income in the first standard-of-living decile (the poorest), against 50% in the United Kingdom (see figure). At the other end of the scale, in France transfers lower the disposable income of the richest households by only 6%, versus 30% in the UK, 40% in Sweden, and 45% in Italy. France is thus considered to have the lowest level of redistribution, with little distributed to poor people and low taxes on the rich.

Figure. According to the CREDOC, the French tax-benefit system is not very redistributive

Summary of transfers received and contributions paid, as a % of disposable income, by standard of living decile



Source: Credoc calculations using data from the Luxembourg Income Study, 2006.

Note: People in the lowest standard of living decile (i.e. the poorest 10%) receive a net gain from redistribution equal to 23% of their disposable income. This net gain is calculated as the difference between their social transfers (social, sickness and pension benefits) and their contributions (income tax, social charges, indirect taxes).

Yet the French tax-benefit system is considered by international institutions as one of those that minimize inequalities the most. For instance, the OECD (2011) wrote: "Redistribution through taxes and benefits reduces inequality by just over 30% in France, which is well above the OECD average of 25%".

The OECD provides statistics on income inequality (measured by the Gini coefficient) before and after transfers. Of the four countries selected by the Crédoc, it is France where the Gini is reduced the most as a percentage by transfers (Table 1), to an extent equivalent to the level in Sweden, and significantly greater than the reduction in Italy and the UK. Euromod winds up with a substantially similar classification (Table 2).

Table 1. Gini index of income distribution (in 2010) according to the OECD

| | Before transfers | After transfers | Impact of transfers |
|----------------|------------------|-----------------|---------------------|
| Germany | 0.496 | 0.286 | -42.3 |
| Denmark | 0.429 | 0.252 | -41.3 |
| France | 0.505 | 0.303 | -40.0 |
| Italy | 0.503 | 0.319 | -36.6 |
| United Kingdom | 0.523 | 0.341 | -35.2 |
| Sweden | 0.441 | 0.269 | -39.0 |
| United States | 0.499 | 0.380 | -23.8 |

Source: OECD (2013). The Gini index lies between 0 (perfect income equality) and 1. The distribution of income becomes more equal as the index approaches 0.

Table 2. Gini index of income distribution (in 2010) according to Euromod

| | Before transfers | After transfers | Impact of transfers |
|----------------|------------------|-----------------|---------------------|
| Germany | 0.518 | 0.380 | -48.1 |
| Denmark | 0.443 | 0.334 | -54.0 |
| France | 0.483 | 0.349 | -50.1 |
| Italy | 0.497 | 0.373 | -36.8 |
| United Kingdom | 0.524 | 0.477 | -38.0 |
| Sweden | 0.429 | 0.317 | -46.2 |

Source: Euromod, 2012.

Table 3. Poverty rate (60% threshold)

| | 2005 | 2012 |
|----------------|------|------|
| Germany | 12.2 | 16.1 |
| Denmark | 11.8 | 13.1 |
| France | 13.0 | 14.1 |
| Italy | 18.9 | 19.4 |
| United Kingdom | 19.0 | 16.2 |
| Sweden | 9.5 | 14.2 |

Source: Eurostat, 2012.

The *Portrait social* [Social Portrait] by the INSEE provides a careful summary of how redistributive the French socio-fiscal system is (Cazenave *et al.*, 2012). It seems that inequality is reduced significantly (Table 4) in France: the inter-decile ratio (D10/D1) falls from 17.5 before redistribution to 5.7 afterwards. [5] According to the INSEE, 63% of the reduction in inequality comes from social benefits and 37% from levies, which confirms the need to take benefits into account in order to assess redistribution.

Table 4. Standard of living fractiles before redistribution according to the INSEE*

| | D1 | Q1 | Q2 | Q3 | Q4 | Q5 | D10 |
|--------------------------------------|-------|--------|--------|--------|--------|---------|---------|
| Average income before redistribution | 4 128 | 7 266 | 15 591 | 21 474 | 28 626 | 55 292 | 72 195 |
| Average disposable income (DI) | 9 948 | 11 266 | 15 847 | 20 145 | 25 602 | 44 919 | 56 654 |
| Net transfers | 5 820 | 4 000 | 256 | -1 329 | -3 024 | -10 373 | -15 541 |
| Net transfers as % of DI | 59 | 36 | 2 | 7 | -12 | -23 | -27 |

* in euros per year per consumption unit. D1: the 10% of people with the lowest living standard; Q1: the 20% of people with the lowest living standard, etc.; D10: the 10% of people with the highest living standard.
Source: INSEE, 2013, Portrait social.

The vision presented by Crédoc of the redistributivity of the French tax-benefit system is thus unusual... and, to put it frankly, wrong.

The study is based on data from the *Budget des familles* [Family budget] survey that is not matched with fiscal data and which is generally considered less reliable than the Euromod survey or than the tax and social security figures used by the INSEE. This may explain some important differences between the Crédoc figures and those of the INSEE: for example, according to the INSEE, non-contributory transfers represent 61% of the disposable income of the poorest 10%, but only 31% according to Crédoc (Table 5).

Like the INSEE, the Crédoc study ignores employer national health insurance contributions (which hit high wages in France, unlike most other countries) and the ISF wealth tax (which exists only in France). Furthermore, it does not distinguish between contributory contributions (which give rights to a pension or unemployment benefits) and non-contributory contributions (such as health insurance or family contributions), which do not give rights. However, low-wage workers are not hit by non-contributory contributions in France, as these are more than offset by exemptions from social security contributions on low wages.

Table 5. Redistribution for the extreme deciles
A comparison of INSEE and CREDOC

| | D1 | | D10 | |
|--------------------------------------|------------|------------|------------|------------|
| | INSEE | CREDOC | INSEE | CREDOC |
| Primary income (pre-distribution) | 41.5 | 39 | 127.4 | 93 |
| Contributory benefits | | 38 | | 32 |
| Non-contributory benefits | 60.2 | 31 | 0.6 | 1 |
| Social contributions | -2.1 | -8 | -10.1 | -16 |
| Direct taxes | 0.4 | 0 | -17.9 | -10 |
| Total: Net disposable income | 100 | 100 | 100 | 100 |
| Indirect taxes | -22 | -36 | -10 | -13 |
| Net transfers (excl. indirect taxes) | +58.5 | +59 | -27.4 | 7 |
| Net transfers (incl. indirect taxes) | +36.5 | +23 | -37.4 | -6 |

Source: Authors' calculations based on INSEE (2013) and CREDOC (2013).

Most importantly, the study contains two errors that heavily distort the conclusions. The first methodological error is that, contrary to the INSEE, the authors include contributory transfers, in particular pensions [6], in social transfers. But for retirees, public pensions represent a very large part of their disposable income, particularly in France. Since the pension system ensures parity in living standards between retirees and active employees, then retirees show up in all the standard of living deciles and the tax-benefit system does not seem to be very redistributive, as it provides benefits to wealthy retirees. And contrariwise, if a country's pension system does not assure parity in living standards between retirees and active employees, then the tax-benefit system will seem more redistributive, as it provides pensions only to the poor.

So paradoxically, it is the generosity of the French system towards pensioners and the unemployed that makes it seem to be not very redistributive. Thus, according to Crédoc, the richest 10% receive contributory transfers representing 32% of their disposable income, which means that, in total, their net transfers represent only a negative 6% of their income. This is especially the case as Crédoc does not take into account the old-age pension contributions (*cotisations vieillesse*) incurred by businesses. If, as the INSEE does, pensions (and

more generally all contributory benefits) are considered as primary income, resulting from past contributions, the negative net transfers of the richest decile increase from -6% to -38%.

The other methodological problem is that Crédoc claims to take into account the weight of indirect taxes in disposable income (which INSEE does not). This comes to 36% for the poorest 10%, 23% in the middle of the income hierarchy, and only 13% for the best-off. The highly regressive nature of indirect taxes would make the whole tax system regressive: the poorest pay more than the rich. According to the figures from Landais, Saez and Piketty (2011), indirect taxation is definitely regressive (15% of the disposable income of the poorest, and 10% for the richest), but the gap is only 5%. According to the INSEE [\[7\]](#), the weight of indirect taxes in disposable income is 22% for the poorest, 16% in the middle income range and 10% for the richest. This difference comes from the structure of consumption (the poorest consume relatively more tobacco and petroleum products), and especially the savings rate, which increases as households earn more. In fact, the difference is undoubtedly overstated in an inter-temporal perspective: some households will consume today's savings tomorrow, so it is then that they will be hit by indirect taxation. In fact, the Crédoc study heavily overestimates the weight of indirect taxes by using an extravagant estimate of the household savings rate [\[8\]](#): the overall French household savings rate is -26.5%; only decile D10 (the richest 10%) have a positive savings rate; decile D1 has a negative savings rate of -110%, that is to say, it consumes 2.1 times its income. The poorest decile is thus hit hard by the burden of indirect taxes. But how likely is this savings rate?

National tax-benefit systems are complex and different. Comparisons between them need to be made with caution and rigour. To judge how redistributive the French system actually is, it is still more relevant to use the work of the INSEE,

the OECD or Euromod than this (too) unusual study.

[1] We would like to thank Juliette Stehlé, who provided assistance in clarifying certain points in this note.

[2] See Landais C., T. Piketty and E. Saez, *Pour une révolution fiscale* [For a tax revolution], Le Seuil, 2011.

[3] See also Sterdyniak H., “Une lecture critique de l’ouvrage *Pour une révolution fiscale*” [A critical reading of the work *Pour une révolution fiscale*], *Revue de l’OFCE*, no. 122, 2012. Note also that you cannot arrive at an overall judgment on the progressivity of the system from the case of a few super-rich who manage to evade taxes through tax schemes.

[4] Bigot R, É. Daudey, J. Muller and G. Osier: “En France, les classes moyennes inférieures bénéficient moins de la redistribution que dans d’autres pays” [In France, the lower middle classes benefit less from redistribution than in some other countries], *Consommation et modes de vie*, Crédoc, November 2013. For an expanded version, see: “Les classes moyennes sont-elles perdantes ou gagnantes dans la redistribution socio-fiscale” [Are the middle classes losers or winners from the tax-benefit redistribution], *Cahiers de Recherche*, Crédoc, December 2012.

[5] Also note that the INSEE underestimates somewhat the redistribution effected by the French system since it does not take into account the ISF wealth tax. It also does not include employers’ national health insurance, which in France is strongly redistributive as it is not capped. From the other side, it does not take account of indirect taxes.

[6] And replacement income such as unemployment benefits and sickness benefits.

[7] See Eidelman A., F. Langumier and A. Vicard: “Prélèvements

obligatoires reposant sur les ménages:

des canaux redistributifs différents en 1990 et 2010” [Mandatory taxes on households: different channels of redistribution in 1990 and 2010], *Document de Travail de la DESE de l’INSEE*, G2012/08.

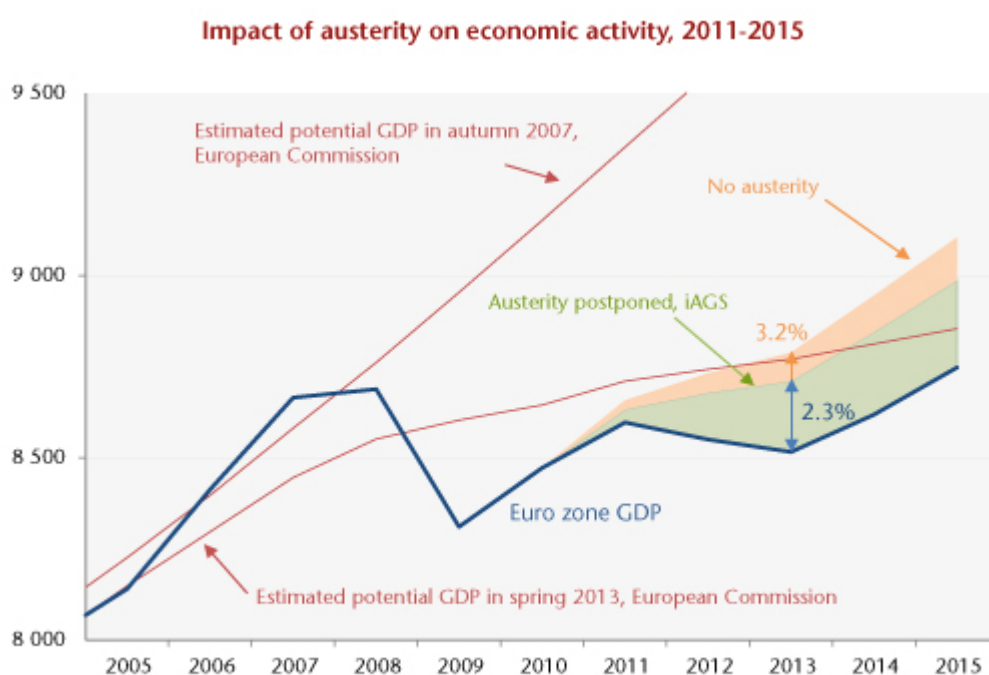
[8] Estimation from EUROMOD (2004): “Modelling the redistributive impact of indirect taxation in Europe”, *Euromod Working paper*, June.

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).



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.

The myth of fiscal reform

By [Henri Sterdyniak](#)

On 19 November, the French Prime Minister announced that he was suspending the implementation of the “ecotax” and working on a major tax reform. This has been raised frequently in public debate, without the reform’s content and objectives being spelled out. Conflicting proposals are in fact being presented.

Some advocate a sharp reduction in taxes, which could boost the French economy by encouraging employees to work harder, households to save more, and businesses to invest and hire,

which would make France more competitive. But public spending would have to be reduced further, even though the government has already committed to a 70 billion reduction by 2017. What spending should be cut in particular? Social benefits would have to be drastically reduced, which is not compatible with the maintenance of the French social model. Some want to shift the burden of social protection from businesses to households. The MEDEF for instance is calling for reducing taxes on business by 100 billion. This would require another sharp hike in taxes on households, leading to a collapse in consumption. Should France move in that direction, should it renew tax competition in Europe by lowering household income?

Others are proposing distributing the tax burden more equitably between income from labour and income from capital and strengthening the redistributive character of taxation. But France is already one of the world's most redistributive countries, with high taxes on big earners, large estates and capital income. All these are already heavily taxed, following increases made by the Fillon and then Ayrault governments.

Some propose chipping down tax and social niches, expanding the tax brackets and reducing rates. But doesn't this forget the incentive role of taxation? Many programmes, even complex ones, are legitimate for reasons of equity (such as the family quotient) or as employment incentives (such as exemption from social charges on low wages or for child care) or assistance to the working poor (e.g. the PPE in-work tax allowance) or as other incentives (such as the exemption of charitable donations or union dues). Some income is of course not taxed, such as certain capital income (life insurance or PEA plans) or unrealized capital gains (but it is difficult to tax gains that are merely potential) or implicit rents (such as enjoyed by those in owner-occupied apartments), but who would dare to touch these? The point is more a patient dismantling of niches, which has been underway for several years, rather than a major reform.

Making our taxation more ecological is certainly a pressing obligation. But is there really a double dividend in jobs and in ecology? Doesn't the environmental gain have a cost in jobs, purchasing power and competitiveness? Can we increase environmental taxation in France without a worldwide agreement, which looks unlikely today? Environmental taxation is necessarily complicated if we want to avoid hitting (too hard) farmers, industry, poor people, marginal regions, disadvantaged suburbs, etc. This is the lesson of the failure of the carbon tax (in 2009) and France's ecotax (in 2013).

We must of course fight against tax evasion by the wealthy and by large corporations, but this mainly involves tax harmonization at the European level, which is not without risk if it means that France must align with the lowest bidder on taxing wealth (ISF), the corporations (IS) or income (IR).

A large-scale tax reform, one that does not alter the tax burden, inevitably means winners and losers. Who the losers will be should be made clear: retirees, homeowners, savers?

A miracle project has shot to the surface: the merger of income tax and the CSG wealth tax. But neither the terms nor the objectives of this merger have been specified. It is running first of all into opposition on principle from the trade unions, who take a dim view of any merger of a State tax with the CSG tax, whose proceeds are allocated directly to social protection. A reform would lead towards putting the State in charge of sickness and family benefits (especially if at the same time a portion of employer contributions were taxed), with the risk that social benefits become adjustment variables with respect to the public finances.

The CSG tax currently hits employees harder than those on replacement income. A merger of CSG and income tax without specific compensation could thus be very costly for pensioners and the unemployed, and in particular for poor people who currently pay neither the CSG tax nor income tax. Conversely,

capital income currently incurs a total taxation – the CSG, the Contribution to the Reimbursement of the Social Debt (CRDS) and the main social charges – of 15.5%, which is significantly higher than the 8% paid by employees. This can of course be considered as offsetting the fact that, by definition, they are not hit by employer contributions. But, as we shall see, comparing levies on different forms of income is not so easy.

A merger like this could provide an opportunity for a complete re-think of the various programmes that have gradually led to narrowing the income tax base, and in particular certain tax loopholes. But some of these tax expenditures are essential, so it would be necessary to replace them with explicit subsidies or keep them in the merged tax. The merger would not in itself solve the problem of income that is currently exempt, whether this is implicit rent or certain capital gains.

Some want to merge all the programmes helping poor people (RSA income supplement, PPE tax benefit, housing allowance) through a negative tax administered by the tax authorities, thereby ignoring the need for the kind of detailed, personalized, real-time follow-up that France's Family Allowance Fund (CAF) is able to provide.

The lawmakers will have to decide the question of whether the merged tax should be calculated individually or jointly per family. This is an important issue: should the State recognize the right of individuals to pool their incomes and share this with their children? But should we really be launching this debate today? Is calling into question the family nature of our tax system all that urgent right now? Individual treatment would mean transferring the most significant charges, in particular at the expense of single-earner families or middle-class families. With an unchanged burden, this would imply a sharp rise in the tax burden on households. A uniform reduction in rates would be highly anti-redistributive, to the

detriment of families in particular and in favour of single people without children. Individualization should necessarily be accompanied by a strong increase in benefits for children (especially large families). This would lead to a more redistributive system in favour of poor families, but better-off families would lose out, which raises difficult questions about horizontal equity.

There is also the question of what kind of levy is used. We cannot move to a simple system of withholding at source without greatly reducing the progressive, family character of the French system. A company does not need to know the income of their employee's spouse or their other income. A reform would make it possible to withhold a first tranche of income tax (of 20% of income for example), while factoring in allowances (an individual deduction, possibly a deduction for a spouse with no income, a deduction for children). The balance would then be collected (or refunded) the following year according to the tax roll. The system would hardly be simplified. Contrary to what we are told by Thomas Piketty, a CSG-income tax merger is not the touchstone of tax reform.

Should we be concerned that the evocation of a tax reform is simply a sham, masking a refusal to address the real problems of the French economy: the difficulty of fitting into the new international division of labour; the growth of inequality in primary income due to globalization and the financialization of the economy; and the failure of the developed countries, especially the euro zone, to find new sources of growth after the financial crisis?

The problem is probably not so much the structure of taxation as it is the error in economic policy made at the level of the euro zone of adding fiscal austerity to the depressive shock caused by the financial crisis and, at the level of France, of raising taxes by 3 GDP points since 2010 (60 billion euros) to fill a public deficit attributable solely to the recession.

The French tax system takes in 46% of GDP; primary public expenditure represents 50%. At the same time, France is one of the few developed countries where income inequalities have not increased greatly in recent years. Our high level of public and social spending is a societal choice that must be maintained; the French tax system is already highly redistributive. Some reforms are of course necessary to further improve its redistributive character, to make it more transparent and socially acceptable. Nevertheless, what matters most is precisely the level of the formation of primary income. There is no miracle reform: the current system, the product of a long process of economic and social compromise, is difficult to improve.

Towards a major fiscal reform – at last!

By [Guillaume Allègre](#), [@g_allegre](#)

At the start of the week, Jean-Marc Ayrault announced an overhaul of the French tax system that would involve, among other things, a reconciliation between income tax and the CSG wealth tax. The OFCE will definitely take part in this debate, one that it has already tried to shed light on many times, in particular on the occasion of a [special “Tax Reform” issue of the Revue de l’OFCE](#), edited by Mathieu Plane and myself, and published in April 2012.

Several contributions [all in French] can be mentioned: Jacques Le Cacheux’s article in the *Revue* discusses the purposes and methods of tax reform (“[Sustainability and](#)

[economic justice](#)”), while reviewing what the fundamentals of fiscal policy actually are. Nicolas Delalande conducts a historical analysis of resistance to tax reform and assesses the constraints on the development and implementation of reform ([“The political economy of tax reform”](#)), all of which seem to be topical subjects today. He stresses that: “Indeed, it may be more difficult to bring together positive support for a measure than to temporarily rally disparate opponents with sometimes conflicting motivations, especially if this involves creating new taxes or affecting established situations.” Mathieu Plane raises the question of the consequences of a tax increase (which did indeed occur in 2012-2013): “In a context of rising unemployment, will it be possible to generate a new large-scale fiscal shock without plunging France into a new crisis? The determination to reduce public deficits solely through structural adjustment is hurting growth and unemployment” ([“Public finances: towards a new tax increase?”](#)). While the government is now announcing it wants a reform that does not change the tax burden, the question of the impact of fiscal adjustments (this time through cuts in public spending) on growth and, ultimately, the social acceptability of a structural reform of the tax system is still posed for the period 2014-2017. Will the government be able to implement a structural reform in a context where unemployment is high and not falling?

The merger of the CSG tax and income tax raises a number of questions that were already discussed in an article in the *Revue de l’OFCE* in 2007 ([“Towards the merging of income tax and the CSG?”](#)). The legislature needs to decide the issue of either joint taxation of spouses or individualisation for the merged tax as well as how to take children into account ([“Should the family quotient be defended?”](#)). This is a particularly sensitive topic, as it affects the representation of the family and the relationship between the State and the family. It has been the subject of controversy even within the OFCE ([“Reforming the marital quotient”](#), [“In defence of the](#)

[family quotient](#)").

By intermingling private interests (what charges for which households?) and social interests (what instruments for what purpose?), the tax issue has always been at the centre of democratic debate. The role of the OFCE is to contribute to this debate with solid arguments backed by data. OFCE researchers will continue to offer their own vision of a “good” tax reform, while discussing its objectives, impact and sustainability in a transparent and rigorous fashion.

The trend in unemployment: no reversal in sight

By [Bruno Ducoudré](#)

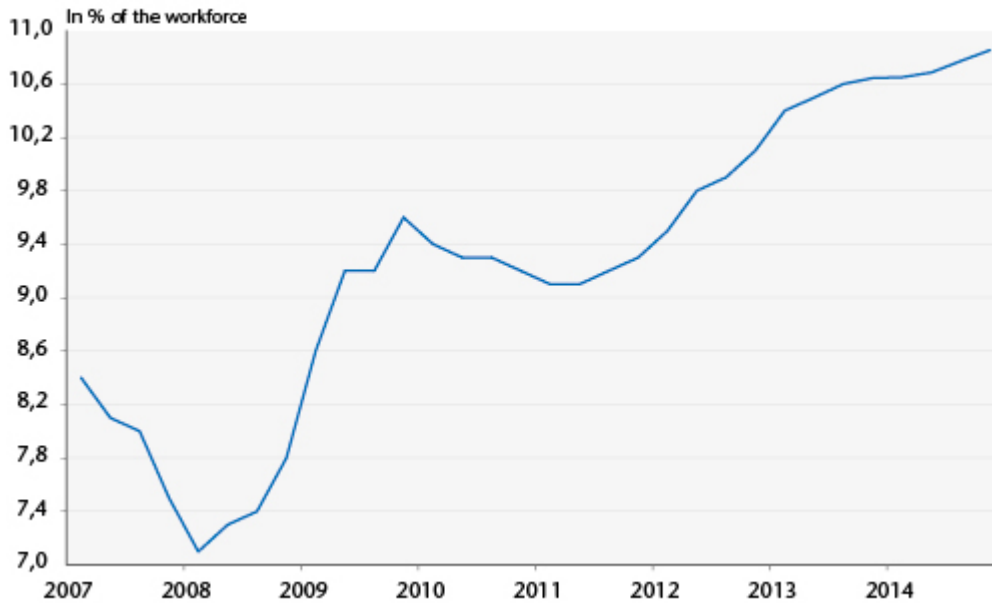
The government has announced that the trend in unemployment will be reversed by the end of 2013. The number of jobseekers registered in category A with France’s Pôle Emploi job centre at the end of September increased by 60,000. The number fell during August by 50,000, mainly due to a “bug” in sending SMS texts, which led to an unusually large rise in the number of terminations due to the claimant’s failure to stay up to date (up 72,000 over the previous month). An increase in enrolments for the month of September due to the re-registration of jobless people who had been unduly terminated was therefore expected. The number of jobseekers registered in category A thus rose by 10,000 between July and September 2013, which meant that the trend is still upwards but at a more moderate pace than earlier in the year. These large variations in the very short term in the numbers registered with the ANPE job

centre make it impossible to give a precise idea of upcoming trends in employment and unemployment. Our analysis of the labour market up to 2014, which is set out in the latest [OFCE forecasts of October 2013](#), suggests that no significant improvement in unemployment is expected by the end of 2014.

In an attempt to reverse the trend in unemployment, the government has planned for the rapid expansion of subsidized jobs in the non-profit sector (Emplois d'avenir, Contrats Uniques d'Insertion – Contrats d'Accompagnement dans l'Emploi (CUI-CAE)). Joining these programmes are the CICE tax credit for competitiveness and employment together with “generation contracts” in the commercial sector, whose impact on employment will begin to be felt in 2014. All these measures to promote employment will help to stabilize the unemployment rate by late 2013/early 2014, with continuing job losses in the private sector until the end of the year. The unemployment rate will then begin to rise again until the end of 2014, since job creation in the non-profit sector will be insufficient to absorb the increase in the labour force.

In retrospect, an initial reversal of the trend in unemployment began in 2010 and was then interrupted in 2011, as unemployment started to rise again under the impact of a series of austerity measures. The unemployment rate was creeping toward the record levels hit in 1997, rising from 9.1% in early 2011 to 10.5% in the second quarter of 2013 (Figure 1). After a bad year in 2012 (66,000 jobs lost), the labour market continued to deteriorate in the first half of 2013, as job losses in the private sector continued at the same pace as in the second half of 2012 (-28,000 jobs on average each quarter). The number of unemployed thus continued to increase (+113,000). To try to stop this downward spiral and reverse the rise in unemployment, the government is relying in the short term on expanding the Emplois d'avenir and CUI- CAE subsidized job programmes.

Figure 1. Unemployment rate (ILO definition)



Sources: INSEE, quarterly accounts; OFCE forecast e-mod.fr 2013-2014, October 2013.

The gradual introduction of Emplois d'avenir jobs has resulted in 31,566 hires between January and August 2013 in France. A total of 70,000 hires are expected in 2013 in mainland France and 70,000 more in 2014. There is, however, a deadweight loss for this type of programme: according to [Fontaine and Malherbet \(2012\)](#), 20% of the jobs created through the Emplois d'avenir scheme would have existed even in the absence of the subsidy. The net impact is thus expected to be 56,000 jobs created in 2013 and in 2014. The impact of this job creation will be especially important since these involve long-term contracts (1-3 years). People hired in 2013 will still be in their jobs in 2014, and the Emplois d'avenir jobs created in 2014 will indeed constitute net job creation.

As for the CUI- CAE programme, the number of contracts budgeted at the beginning of 2013 was the same as the previous year (340,000 for the whole of France, including 310,000 for mainland France), with 50% of these in the first half year. In order to reverse the trend in unemployment by the end of the year, in June 2013 the Ayrault government announced an extension of 92,000 contracts in the non-profit sector. This brings to 262,000 the number of contracts signed in the second half year, and 432,000 for the year. As in 2013, 340,000

contracts are planned in the 2014 Budget Bill (PLF), but the budget allocation is nearly 20% larger, which will fund an increase in the stock of CUI-CAE. These will increase until the first half of 2014, reaching 250,000 by end 2014. The government is thus reactivating the social treatment of unemployment through greater use of short-term subsidized jobs (7-12 months), but at a level comparable to that seen in 2007 and in 2010.

In contrast, there will still be significant job losses in the private sector up to year-end 2013 due to companies being overstaffed (see our [October 2013 forecasts](#)). Subsidized jobs in the non-profit sector (+82,000 in the last quarter of 2013 compared to the last quarter of the previous year) will nevertheless stabilize the unemployment rate at around 10.6% in late 2013 / early 2014.

Table. Employment and unemployment

Annual change, in thousands, at last quarter

| Year on year | 2009 | 2010 | 2011 | 2012 | 2013* | 2014* |
|-------------------------|------|------|------|------|-------|-------|
| Observed workforce | 210 | 45 | 178 | 200 | 83 | 116 |
| Total employment | -321 | 128 | 130 | -66 | -91 | 41 |
| - Private sector | -347 | 65 | 104 | -64 | -121 | -12 |
| - Subsidized non-profit | 38 | 44 | -74 | 6 | 82 | 96 |
| - Other jobs | -12 | 19 | 100 | -8 | -52 | -44 |
| Unemployment | 531 | -83 | 48 | 266 | 174 | 75 |
| Unemployment rate | 9,6 | 9,2 | 9,3 | 10,1 | 10,6 | 10,9 |

* OFCE October 2013 forecast.

Sources INSEE and Ministry of Labour, OFCE forecasts.

Total employment began rising again in 2014 (41,000 jobs), driven by the creation of subsidized jobs in the non-profit sector, but also by the expansion of the generation contract and CICE programmes. The CICE, which is open to all businesses, will be equivalent to 6% of payroll, excluding employer social security contributions, and corresponds to wages of less than 2.5 times the minimum wage (SMIC). According to the assessment made by [Mathieu Plane \(2012\)](#) using

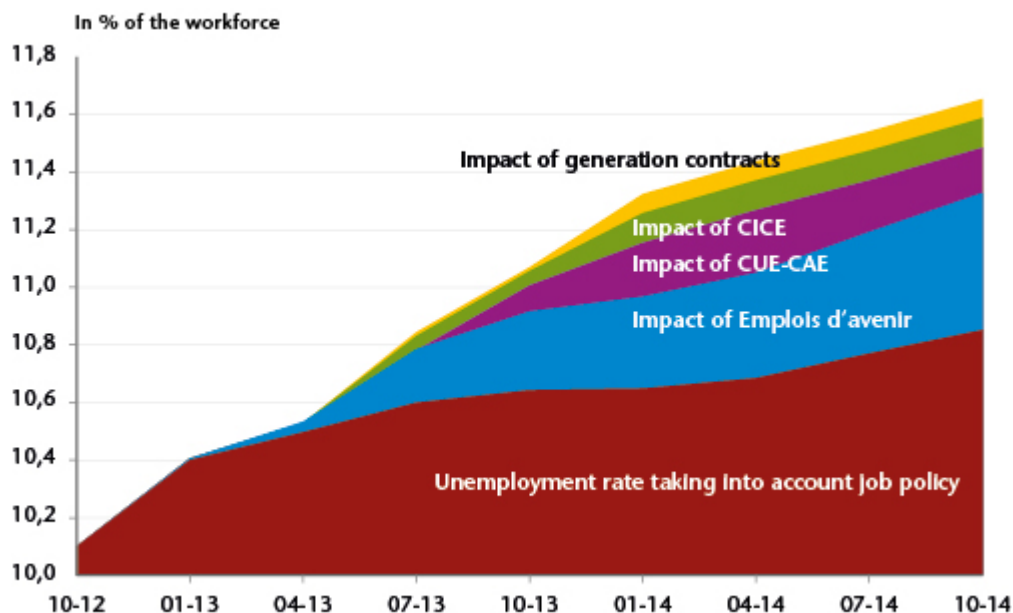
the e-mod.fr model, the CICE will decrease labour costs in the private sector by on average 2.6%, which should result in the creation of jobs, both by promoting the substitution of labour for capital and through gains in competitiveness. In total, by 2018, five years after its establishment, the CICE will have created 152,000 jobs, thus lowering the unemployment rate by 0.6 percentage point. At the horizon of our forecast, it will have created 46,000 jobs, or half the government's forecast (91,000).

The generation contract covers unemployment among both younger (under age 26) and older workers (over 57). It consists of the creation of a permanent contract (CDI) for a young person, linked to the promise of non-dismissal of an older worker for a period of 5 years. In return for this commitment, the company will receive a lump sum grant of up to 4,000 euros per year for 3 years. This type of measure runs the risk of generating significant deadweight effects.[\[1\]](#) Overall, the measure will result in 99,000 new jobs in the private sector, with the signing of 500,000 generation contracts over the 5-year period. In September 2013, 10,000 generation contracts were signed. Under the assumption of a gradual ramp-up by the end of 2013 (20,000 contracts signed), with 100,000 contracts signed in 2014, this should correspond to the net creation of nearly 4,000 jobs in 2013 and about 20,000 jobs in 2014.

Despite this, unemployment will continue to rise over the two years (+174,000 in 2013 and +75,000 in 2014 compared to the same quarter of the previous year), due to a still dynamic workforce (+116,000 in 2014 after +83,000 in 2013) and a lack of net job creation in the private sector (see the table above). Given the subsidized jobs in the non-profit sector as well as the private sector programmes, the unemployment rate in mainland France will temporarily stabilize at 10.6 % in the fourth quarter of 2013, before gradually creeping up to 10.9% of the workforce in mainland France by late 2014. By the end of 2014 it will surpass the historic peak reached in the first

half of 1997 (10.8% of the workforce), with no prospect of reversing the trend over our forecast horizon. However, without the impact of the jobs programmes, the unemployment rate would have increased much more, to 11.6 % at end 2014 (Figure 2).

Figure 2. Impact of employment measures on the unemployment rate



Sources: INSEE, OFCE forecasts October 2013.

[1] See the OFCE Note of July 2012 on [“An assessment of the 2012-2017 five-year economic plan”](#). Companies will benefit from this aid, including for the jobs they would have created even in the measure’s absence. The way the measure is implemented should limit the deadweight loss: aid linked to the implementation of the generation contract will for instance be reserved for companies with fewer than 300 employees. Companies with over 300 employees, where the risk of a windfall effect is greatest, will be obliged to set up the programme on pain of financial penalty. In addition, the lump sum of 2000 euros represents a total exemption from employer social charges at the level of the SMIC, and above that decreases in proportion to the salary. This helps to limit the windfall effect, since the elasticity of employment to labour costs is higher for low wages.

Is it pointless to separate banking activities?

[Jean-Luc Gaffard](#) and [Jean-Paul Pollin](#)

It is at the European level that the last chance for a structural reform of the banking system can be found, that is to say, a separation between investment banking and retail banking. If we are to believe the banking industry and certain academic circles, such a separation is at best useless and at worst harmful. Separating risky activities from non-risky activities, or non-speculative activities from speculative activities, would, it is held, prove illusory. All banking activity is risky, if not speculative. After all, the subprime crisis in the United States, the crisis of the savings banks in Spain, and the crisis of Northern Rock in the United Kingdom were all the result of reckless risk-taking in the granting of property loans to households. Furthermore, universal banks have to some extent helped to save overly specialized institutions. In these conditions, a minimalist law on separation such as the French law or a more binding law such as proposed in the Vickers report in the UK or like the one envisaged by the Liikanen Group would be of little use in terms of achieving stability. It would be better, then, to trust to prudential regulation, which should indeed be strengthened. This is particularly true since commercial banks should be able to develop market activities to meet the needs of their customers.

First of all, the existence of economies of scope that would

justify bringing together commercial banking and investment banking have never been proven. Moreover, the “business models” of the two are very different, to the point that joining them may involve a risk of weakening the commercial bank’s capacity to do its job. Furthermore, the argument set out above ignores in particular the systemic dimension of the financial and banking crisis. When the savings banks went bankrupt in the United States in the early 1990s, the consequences were circumscribed because the financial system was relatively closed. With the subprime crisis, the real problem came from contagion that was directly related to the close connectivity that had arisen within the financial system.

This is not a matter of simply recognizing that any banking activity entails risk, but rather of taking into account the impact of the contagion that market activity is primarily responsible for. It is especially transactions in derivatives that give rise to the interconnections between financial intermediaries. These are multiple, poorly identified connections created by market activities, which have had devastating consequences on the traditional lending activity of banks because of reckless risk-taking and losses in market transactions (and not just in “proprietary trading” operations).

Naturally, in the face of systemic risk, prudential regulation does need to be strengthened. But however important it may be to regulate functions, this is undoubtedly less important than regulating the financial institutions themselves. Revenues from commercial banking are de facto relatively regular, apart from periods of severe crises, while those from an investment bank are much more volatile. An investment bank needs a commercial bank to withstand market fluctuations (and enjoy any available government guarantee), but the reverse is not true. The problem comes down to whether it is appropriate to take the risk of destabilizing the heart of the banking system

in order to strengthen the pursuit of activities whose social utility is not always clear, and which should find their own means of survival.

Wisdom would thus have it that the financial system should be compartmentalized so as to limit any contagion. Regulations should specify the types of assets in which each category of institutions could invest as well as the type of commitments that they can make. This is what stands out from the legislative and regulatory arsenal developed in the United States and Europe following the Great Depression, an arsenal that was largely dismantled in France in 1984 and the United States in 1999 when the Glass-Steagall Act was terminated. This is what should be put on the agenda again by returning to an effective separation between commercial banks and investment banks. Not only would this separation create a certain seal between the various compartments of the financial system, but it would also help to avoid the dilemma associated with institutions that are “too big to fail”. The aim is to protect the commercial bank from market risk. It is also to put an end to the implicit subsidies that universal banks have from the State, which are no longer really justified by separation and which can endanger the public purse. All these measures should be conducive to growth.

For more on this subject, please read [OFCE Note no. 39 of 19 November 2013](#) [in French] by Jean-Paul Pollin and Jean-Luc Gaffard, “Pourquoi faut-il séparer les activités bancaires?” [Why banking activities need to be separated].

The chiaroscuro of the ECB's "forward guidance" *

By [Paul Hubert](#) and Fabien Labondance

"The Governing Council expects the key interest rates to remain at present or lower levels for an extended period of time." With this pronouncement on 4 July 2013 at the press conference following the monthly meeting of the European Central Bank Board of Governors, Mario Draghi initiated the adoption by the ECB of a new communication strategy called "forward guidance". Since then these words have always been included in his speech following announcements of the ECB's monetary policy, and he has repeated them again [today \[1\]](#). What should we expect? Forward guidance has recently been adopted by several central banks, but the methods chosen by the ECB differ and indicate that this measure will have only limited effectiveness in the euro zone.

Communication has become an integral part of the conduct of monetary policy since interest rates have been kept at a minimum level. More specifically, forward guidance consists of announcing and making a commitment to the future path of key interest rates. By doing this, the central banks want to increase the transparency of their activities and anchor expectations. The aim is to clarify both their strategy and their predictions about trends in the economy. In the present case, the central banks want to affirm their desire not to raise interest rates in the near future. They also hope to influence private expectations about short-term rates, and thus long-term rates, in order to strengthen the transmission of monetary policy, and thus support the economy.

From the theory...

The promoters of the forward guidance strategy, foremost among

them Eggertsson and Woodford (2003), suggest that monetary policy can be made more effective by adopting a policy of stable interest rates that is well known in advance. This proposal is justified by the fact that demand for credit is highly dependent on expectations of long-term interest rates, which depend on expectations of short-term rates. Hence, by announcing the future levels of interest rates in advance, the central bank declares its intentions and dispels any uncertainty about its future decisions. This strategy is especially relevant in a situation of a liquidity trap, when nominal interest rates are close to zero, as is the case today. The traditional tool of central banks is then constraint, as nominal interest rates cannot be negative. Central banks can thus no longer influence the cost of the loans granted, but they can on the other hand influence volumes through unconventional measures [\[2\]](#). The channel of expectations and the transmission of signals to private agents then become paramount and complement quantitative easing.

It is important to note that the effect of forward guidance on long-term rates and thus on the economy passes through the term structure of the interest rates. Several theories attempt to explain how rates vary in accordance with the term. The term structure of interest rates can be considered from the viewpoint of the theory of expectations, which assumes that long-term rates reflect a combination of expected future short-term rates, and thus that the different maturities are perfect substitutes. For its part, the theory of a liquidity premium implies that long-term interest rates include a premium linked to the existence of one or more long-term risks. Finally, another theory is based on the assumption of market segmentation and stipulates that financial instruments with different maturities cannot easily be substituted and that their prices move independently. If investors wish to hold liquid assets, they will prefer short-term instruments over long-term ones, and their prices will vary in opposite directions. Only in the case of the first two theories will

forward guidance have the desired effect on long-term rates.

...to the practice

This kind of strategy had already been implemented by some central banks even before the 2008 financial crisis, in particular in New Zealand since 1997, in Norway since 2005, and in Sweden since 2007. The United States also implemented this communication strategy several times when rates were very low. The Federal Open Market Committee (FOMC) implicitly introduced forward guidance in its communications in August 2003. At a time when its target rate was at a historic low, the FOMC stated that "...policy accommodation can be maintained for a considerable period". This terminology, specific to forward guidance, remained in FOMC communiqués until the end of 2005. It reappeared in December 2008, and in greater detail in August 2011, when Ben Bernanke, chairman of the US Federal Reserve (or the "Fed"), announced that economic conditions warranted maintaining the federal funds rate at a low level until at least mid-2013. Since then, the announcement on 13 September 2012 that the Fed will not raise its rates before mid-2015 continues this same strategy.

To understand what impact the ECB's forward guidance might have, it is important to distinguish two types of forward guidance: one for which the action of the central bank is subject to a time period, and another which depends on economic variables, including thresholds that trigger an action on the bank's part. In the case of the Fed, the first statements mentioned above refer to a period of time, but since December 2012 it has conditioned its commitment to future rate changes on cyclical thresholds that act as triggers. The Fed has also announced that "this exceptionally low range for the [Fed Funds](#) rate will be appropriate at least as long as the unemployment rate remains above 6-1/2 percent, inflation between one and two years ahead is projected to be no more than a half percentage point above the Committee's 2 percent longer-run goal, and longer-term inflation

expectations continue to be well anchored". The arrival of new FOMC members in January 2014 could, however, change the timing of the next monetary tightening. Likewise, in August 2013 Mark Carney, Governor of the Bank of England (BoE), set out a forward guidance strategy indicating his intention not to raise rates so long as the unemployment rate had not fallen below 7%. This commitment is nevertheless conditional on containing inflation, on stable inflation expectations and on the neutral impact of this commitment on financial stability.

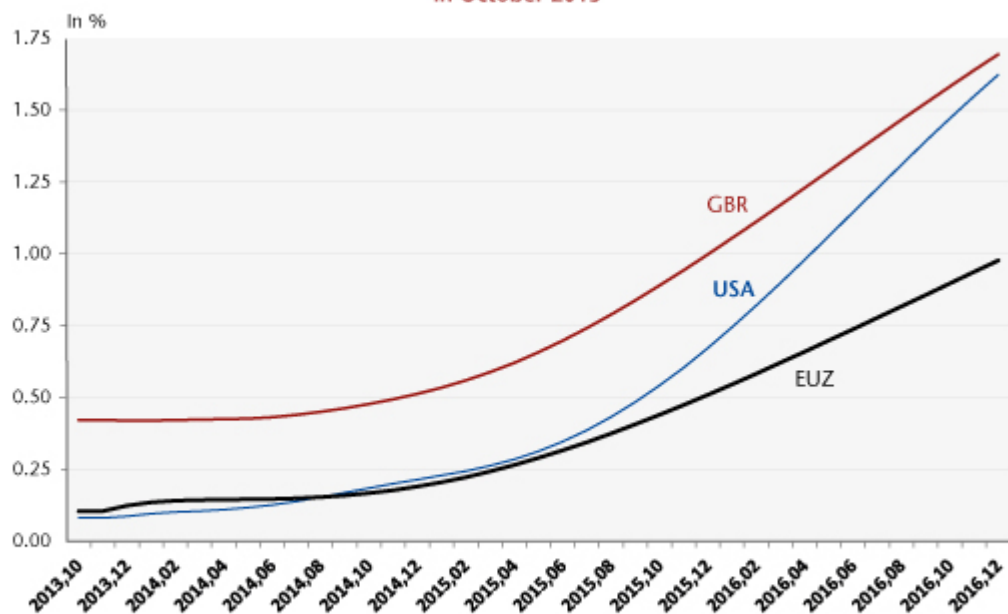
There is a major disadvantage to conditioning forward guidance on a time period, as has been adopted by the ECB (and as will be described later): changes in economic conditions over the time period in question could render the commitment obsolete. The announcement thus has very little credibility. Conditioning forward guidance on thresholds for economic variables does not have this drawback. One criterion for the credibility of commitments conditioned on thresholds is, however, that the underlying variables chosen are observable (GDP rather than output gap) and that they do not suffer from measurement errors (inflation rather than inflation expectations), so that private agents can assess whether the central bank is acting in accordance with its commitments. Then and only then will the agents have confidence in the declarations and will the central bank be in a position to influence expectations of long-term rates. The relative advantages and disadvantages of the two types of forward guidance explain why the Fed switched from one to the other and why the BoE has also made a commitment linked to thresholds.

The establishment of forward guidance conditioned on a threshold for a macroeconomic variable may, however, contribute to muddying the waters on the ranking of the central bank's objectives. If several variables are targeted simultaneously and they begin to diverge, what will the bank decide? The Fed does not prioritize its objectives. As the

economy emerges from crisis it is quite possible that the Fed may decide to ensure the strength of GDP, or to lower unemployment rather than inflation. For its part, the BoE follows a strategy of inflation targeting. It has therefore defined conditions (“knockouts”) on inflation, inflation expectations and financial stability, which, when they are not met, will lead to an end to forward guidance and therefore to any commitment to keep rates unchanged. The hierarchy of objectives would thus be well respected and the BoE’s credibility maintained.

How effective can forward guidance be? Kool and Thornton (2012) express serious doubts as to the results obtained through forward guidance. They assess the predictability of short-term and long-term rates in countries where this strategy has been adopted and show that forward guidance improves the ability of private agents to forecast future short-term rates only for periods of under one year, without improving the predictability of rates in the longer term. The chart below shows the expectations of 3-month rates by the financial markets in October 2013 for the coming months. Since benchmark rates change by a minimum of 0.25%, this figure indicates that no change in rates is expected for the time being, apart perhaps from the United States for the one-year horizon.

Graphique. Current 3-month rates and anticipated 3-month rates at various dates, in October 2013



Note : The short-term rate anticipations that we consider are produced from forward rate agreements (FRAs) or futures contracts on anticipated market rates at a given date for different horizons (1 month, 2 months, etc.).

Source : Datastream.

The timid adoption by the ECB

With regard to the ECB, which for its part sets a hierarchy of goals by giving priority to inflation, the introduction of forward guidance constitutes a conditional commitment to a period of time (“... for an extended period of time”) without any reference to thresholds. From this point of view, it goes against the current of the Fed and the BoE, which adopted conditional commitments to numerical thresholds. For the record, prior to July 4th the ECB gave clues to its decision in the following month in the form of expressions that were easily recognizable to observers. Thus, the insertion of the word “vigilance” in the ECB President’s speech at his press conference announced a probable tightening of monetary policy [3]. By adding forward guidance to its basket of tools, the ECB wants to be less enigmatic. In particular, it seems that it wanted to respond to concerns over a possible rise in interest rates.

However, Benoit Coeuré, a member of the ECB Executive Board,

said that this strategy does not call into question the rule, repeated many times at press conferences, that the ECB will never commit to future policies (“no pre-commitment rule”) and that forward guidance is to be re-evaluated at each meeting of the Board of Governors. Jens Weidmann, a member of the ECB’s monetary policy committee as president of the Bundesbank, confirmed that the ECB’s forward guidance “is not an absolute advanced commitment of the interest rate path”, while Vitor Constancio, ECB Vice-President, added an extra dose of confusion by saying that the ECB’s forward guidance “is in line with our policy framework as it does not refer to any date or period of time but is instead totally conditional on developments in inflation prospects, in the economy and in money and credit aggregates – the pillars of our monetary strategy”.

So how effective can a policy be that is poorly defined, that does not seem to have a consensus within the ECB Governing Council, and whose key to success – the credibility of the commitment – is openly questioned? Not very effective.

Bibliographic references

Eggertsson, G. and M. Woodford (2003). “Optimal monetary policy in a liquidity trap”, *NBER Working Paper* (9968).

Kool, C. and D. Thornton (2012). “How Effective is Central Forward Guidance?”, *Federal Reserve Bank of Saint Louis Working Paper Series*.

Rosa, C. and G. Verga (2007). “On the Consistency and Effectiveness of Central Bank Communication: Evidence from the ECB”, *European Journal of Political Economy*, 23, 146-175.

* This text draws on a study, “Politique monétaire: est-ce le début de la fin?” [“Monetary policy: Is it the beginning of the end?”], forthcoming in [The OFCE outlook for the global economy in 2013-2014 \[in French\]](#).

[\[1\]](#) Today’s 25-basis point cut in the benchmark rate is consistent with the ECB’s strategy of forward guidance.

[\[2\]](#) Unconventional measures refer to monetary policy practices that are not classified as traditional policy (*i.e.* changes in interest rates). These are measures that result in a change in the content or magnitude of the central bank balance sheet through purchases of government or private securities, which is generally referred to as “quantitative easing”.

[\[3\]](#) Rosa and Verga (2007) offer a description of these expressions.