The euro is 20 – time to grow up

By Jérôme Creel and Francesco Saraceno [1]

At age twenty, the euro has gone through a difficult adolescence. The success of the euro has not been aided by a series of problems: growing divergences; austerity policies with their real costs; the refusal in the centre to adopt expansionary policies to accompany austerity in the periphery countries, which would have minimized austerity’s negative impact, while supporting activity in the euro zone as a whole; and finally, the belated recognition of the need for intervention through a quantitative easing monetary policy that was adopted much later in Europe than in other major countries; and a fiscal stimulus, the Juncker plan, that was too little, too late.

Furthermore, the problems facing the euro zone go beyond managing the crisis. The euro zone has been growing more slowly than the United States since at least 1992, the year the Maastricht Treaty was adopted. This is due in particular to the inertia of economic policy, which has its roots in the euro’s institutional framework: a very limited and restrictive mandate for the European Central Bank, along with fiscal rules in the Stability and Growth Pact, and then in the 2012 Fiscal Compact, which leave insufficient room for stimulus policies. In fact, Europe’s institutions and the policies adopted before and during the crisis are loaded down with the consensus that emerged in the late 1980s in macroeconomics which, under the assumption of efficient markets, advocated a “by the rules” economic policy that had a necessarily limited role. The management of the crisis, with its fiscal stimulus packages and increased central bank activism, posed a real challenge to this consensus, to such an extent that the economists who were supporting it are now questioning the direction that the discipline should take. Unfortunately, this questioning has only marginally and belatedly affected Europe's decision-makers.

On the contrary, we continue to hear a discourse that is meant to be reassuring, i.e. while it is true that, following the combination of austerity policies and structural reforms, some countries, such as Greece and Italy, have not even regained their pre-2008 level of GDP, this bitter potion was needed to ensure that they emerge from the crisis more competitive. This discourse is not convincing. Recent literature shows that deep recessions have a negative impact on potential income, with the conclusion that austerity in a period of crisis can have long-term negative effects. A glance at the World Economic Forum competitiveness index, as imperfect as it is, nevertheless shows that none of the countries that enacted austerity and reforms during the crisis saw its ranking improve. The conditional austerity imposed on the countries of the periphery was doubly harmful, in both the long and short terms.

In sum, a look at the policies carried out in the euro zone leads to an irrevocable judgment on the euro and on European integration. Has the time come to concede that the Exiters and populists are right? Should we prepare to manage European disintegration so as to minimize the damage?

There are several reasons why we don't accept this. First, we do not have a counterfactual analysis. While it is true that the policies implemented during the crisis have been calamitous, how certain can we be that Greece or Italy would have done better outside the euro zone? And can we say unhesitatingly that these countries would not have pursued free market policies anyway? Are we sure, in short, that Europe's leaders would have all adopted pragmatic economic policies if the euro had not existed? Second, as the result of two years of Brexit negotiations shows, the process of disintegration is anything but a stroll in the park. A country's departure from the euro zone would not be merely a Brexit, with the attendant uncertainties about commercial, financial and fiscal relations between a 27 member zone and a departing country, but rather a major shock to all the European Union members. It is difficult to imagine the exit of one or two euro zone countries without the complete breakup of the zone; we would then witness an intra-European trade war and a race for a competitive devaluation that would leave every country a loser, to the benefit of the rest of the world. The costs of this kind of economic disorganization and the multiplication of uncoordinated policies would also hamper the development of a socially and environmentally sustainable European policy, as the European Union is the only level commensurate with a credible and ambitious policy in this domain.

To say that abandoning the euro would be complicated and/or costly, is not, however, a solid argument in its favour. There is a stronger argument, one based on the rejection of the equation "euro = neoliberal policies". Admittedly, the policies pursued so far all fall within a neoliberal doctrinal framework. And the institutions for the European Union's economic governance are also of course designed to be consistent with this doctrinal framework. But the past does not constrain the present, nor the future. Even within the current institutional framework, different policies are possible, as shown by the (belated) activism of the ECB, as well as the exploitation of the flexibility of the Stability and Growth Pact. Moreover, institutions are not immutable. In 2012, six months sufficed to introduce a new fiscal treaty. It headed in the wrong direction, but its approval is proof that reform is possible. We have worked, and we are not alone, on two possible paths for reform, a dual mandate for the ECB, and a golden rule for public finances. But other possibilities could be mentioned, such as a European unemployment insurance, a European budget for managing the business cycle, or modification of the European fiscal rules. On this last point, the proposals are proliferating, including for a rule on expenditures by fourteen Franco-German economists, or the replacement of the 3% rule by a coordination mechanism between the euro zone members. Reasonable proposals are not lacking. What is lacking is the political will to implement them, as is shown by the slowness and low ambitions (especially about the euro zone budget) of the decisions taken at the euro zone summit on 14 December 2018.

The various reforms that we have just mentioned, and there are others, indicate that a change of course is possible. While some policymakers in Europe have shown stubborn persistence, almost tantamount to bad faith, we remain convinced that neither European integration nor the euro is inevitably linked to the policies pursued so far.

[1] This post is an updated and revised version of the article "Le maintien de l'euro n'est pas synonyme de politiques néolibérales" [Maintaining the euro is not synonymous with neoliberal policy], which appeared in *Le Monde* on 8 April 2017.

The ECB is still worried about the weakness of inflation

By Christophe Blot, Jérôme Creel and Paul Hubert

The President of the European Central Bank, Mario Draghi, recently announced that the increase in the ECB's key interest rate would come "well past" the end of the massive purchases of bonds (scheduled for September 2018), mainly issued by the euro zone countries, and at a "measured pace". The increase in the key rate could therefore occur in mid-2019, a few weeks before the transfer of power between Mario Draghi and his successor.

In his quarterly hearing with MEPs, Mario Draghi proved to be cautious about the intensity and sustainability of the economic recovery [1]. Listening to him, the euro zone has not necessarily closed its output gap (actual GDP would have remained below its potential) despite the recovery in recent quarters. This is not the time to change the direction of monetary policy at the risk of weakening the recovery. It is also undeniable that the effects of the recovery are only materializing slowly and gradually in wage increases, which partly explains why the euro zone inflation rate remains below its mid-term target.

The ECB President has also been confident that companies are gradually anchoring their price (and wage) expectations on the ECB's inflation target of 2% per year. Mario Draghi also appeared very confident in the effectiveness of monetary policy. He announced that the measures undertaken since 2014 would contribute to a (cumulative) increase of 2 percentage points, respectively in real growth and inflation between 2016 and 2019.

If the ECB's forecast of inflation back to its target in 2019 is contradicted by Hasenzagl et al. (2018), we find these same determinants of European inflation. In a recent study, we also show that the two main determinants of inflation in the euro area are inflation expectations and wage growth. Without anchoring the former on the medium-term target of the ECB and without a second-round effect of monetary policy on wages, inflation will not return to its target in the short term. Structural reforms may have increased potential GDP, as argued by Mario Draghi, but they have so far more certainly weighed on wage and price developments.

[1] Once a quarter, a monetary dialogue is organized between the President of the ECB and the members of the Monetary Affairs Committee of the European Parliament. This dialogue allows the President of the ECB to explain the direction of monetary policy in the euro area and to express his point of view on topics defined upstream. Une fois par trimestre un dialogue monétaire est organisé entre le Président de la BCE et les membres de la Commission des Affaires monétaires du Parlement européen. Ce dialogue permet au Président de la BCE d'expliquer l'orientation de la politique monétaire dans la zone euro et d'exprimer son point de vue sur des sujets définis en amont.

The 2018 European economy: A hymn to reform

By Jérôme Creel

The OFCE has just published the 2018 European Economy [in French]. The book provides an assessment of the European Union (EU) following a period of sharp political tension but in an improving economic climate that should be conducive to reform, before the process of the UK's separation from the EU takes place.

Many economic and political issues crucial to better understanding the future of the EU are summarized in the book: the history of EU integration and the risks of disintegration; the recent improvement in its economic situation; the economic, political and financial stakes involved in Brexit; the state of labour mobility within the Union; its climate policy; the representativeness of European institutions; and the reform of EU economic governance, both budgetary and monetary.

The year 2018 is a pivotal year prior to the elections to the European Parliament in spring 2019, but also before the 20th anniversary of the euro on 1 January 2019. The question of the euro's performance will be central. However, in 2018 gross domestic product will finally begin to increase at well above its pre-crisis level, thanks to renewed business investment and the support of monetary policy, henceforth unhindered by fiscal policy.

The year 2018 will also mark the beginning of negotiations on the future economic and financial relationship of the United Kingdom and the EU, after at end 2017 the two parties found common ground on arrangements for the UK leaving the Union. The EU's renewed growth will reduce the potential costs of the divorce with the British and could also lessen Europeans' interest in this issue.

Brexit could have served as a catalyst for reforming Europe; the fact that the mechanisms for this may now seem less crucial to the EU's future functioning should not take away from the reforms needed by the EU, as if these were superfluous. In the political and monetary fields, there is a great need to strengthen the democratic representativeness of EU institutions (parliament, central bank) and to ensure the euro's legitimacy. In the fields of fiscal and immigration policy, past experience has demonstrated the need for coordinated tools to better manage future economic and financial crises.

There is therefore an urgent need to revitalize a project that is over sixty years old, one that has managed to ensure peace and prosperity in Europe, but which lacks flexibility in the face of the unpredictable (crises), which lacks vigour in the face of the imperatives of the ecological transition, and which is singularly lacking in creativity to strengthen the convergences within it.

What role for central bank balance sheets in the conduct of monetary policy?

By Christophe Blot, Jérôme Creel and Paul Hubert

By adjusting the size and composition of their balance sheets, the central banks have profoundly changed their monetary policy strategy. Although the implementation of these measures was initially envisaged for a period of crisis, questions are now arising about the use of the balance sheet as an instrument of monetary policy outside periods of crisis.

The central banks' securities purchase policy has resulted in significantly expanding the size of their balance sheets. In September 2017, the balance sheets of the Federal Reserve and the European Central Bank amounted, respectively, to nearly 4,500 billion dollars (23.3% of US GDP) and 4,300 billion euros (38.5% of euro zone GDP), while in June 2007 they were 870 billion dollars (or 6.0% of GDP) and 1,190 billion euros (12.7% of GDP). The end of the financial crisis and the economic crisis calls for a gradual tightening of monetary policy, which is already underway in the United States and forthcoming in the euro zone. The Federal Reserve, for instance, has raised the key interest rate five times since December 2015, and in October 2017 it began to reduce the size of its balance sheet. However, no precise indication has been given as to the size of the bank's balance sheet once the process of normalization has been completed. Beyond simply size, there is also the question of the role that these balance sheet policies will play in the conduct of monetary policy in the future.

Initially, the measures taken during the crisis had to be exceptional and temporary. The aim was to satisfy a need for substantial liquidity and to act directly on the prices of certain assets or on the long end of the yield curve at a time when the standard monetary policy instrument – short-term interest rates – was constrained by the zero lower bound (ZLB). The use of these measures over a prolonged period – the last ten years – suggests, however, that the central banks could continue to use their balance sheets as a tool of monetary policy and financial stability, including in so-called "normal" periods, that is to say, even when there is enough maneuvering room to lower the key rate. Not only have these unconventional measures demonstrated some effectiveness, but their transmission mechanisms do not seem to be specific to periods of crisis. Their use could thus both enhance the effectiveness of monetary policy and improve the central banks' ability to achieve their macroeconomic and financial stability objectives. We develop these arguments in a recent publication that we summarize here.

In an article presented at the 2016 Jackson Hole conference, Greenwood, Hanson and Stein suggested that the central banks could use their balance sheets to provide liquidity to meet a growing need in the financial system for liquid, risk-free assets. The extra reserves thus issued would increase the stock of safe assets that could be drawn on by commercial banks, enhancing financial stability. The central banks could also intervene more regularly in the markets to influence the price of certain assets or risk premiums or term premiums. What is involved here is not necessarily a matter of increasing or reducing the size of the balance sheet, but of modulating its composition in order to correct any distortions or to strengthen the transmission of monetary policy by intervening in all segments of the rate curve. During the sovereign debt crisis, the ECB launched a Securities Market Programme (SMP) aimed at reducing the risk premiums on the yields of several countries (Greece, Portugal, Ireland, Spain and Italy) and at improving the transmission of the common monetary policy to these countries. In 2005, the Chairman of the Federal Reserve encountered an enigma on the bond markets when noting that long-term rates did not seem to be responding to the ongoing tightening of US monetary policy. The use of targeted purchases of securities with longer maturities would no doubt have improved the transmission of the monetary policy, as was being sought at that time by the Federal Reserve.

In practice, the implementation of a strategy like this in “normal” times raises several issues. First, if the balance sheet policy complements the interest rate policy, the central banks will have to accompany their decisions with the appropriate communications, specifying both the overall direction of monetary policy and the reasons justifying the use and the goal of such a policy. It seems that they managed to do this during the crisis, even as the number of programmes proliferated; there is therefore no reason to think that suddenly communications like this would become more difficult to implement in a “normal” period. Furthermore, using the balance sheet as a monetary policy instrument more frequently would result in holding more, and potentially riskier, assets. In these circumstances, there would be a trade-off between the efficacy that could be expected from monetary policy and the risks being taken by the central bank. It should also be noted that using the balance sheet does not necessarily mean that its size would be constantly growing. Central banks could just as easily choose to sell certain assets whose price was deemed to be too high. However, in order to be able to effectively modulate the composition of the central bank's assets, its balance sheet must be large enough to facilitate its portfolio operations.

It should be recognized that economists have not yet fully analyzed the potential effects of balance sheet policies on macroeconomic and financial stability. But the remaining uncertainty should not prevent the central banks from making use of balance sheet policies, as only experience can lead to a comprehensive assessment of the power of balance sheet policies. The history of the central banks is a reminder that the objectives and instruments used by central banks have changed steadily [1]. A new paradigm shift thus seems possible. If balance sheet policies are able to enhance the effectiveness of monetary policy and improve financial stability, central banks should seriously consider their use.

For more, see: Christophe Blot, Jérôme Creel, Paul Hubert, "What should the ECB 'new normal' look like?", *OFCE policy brief* 29, 20 December.

[1] See Goodhart (2010).

The ECB on neutral ground?

By Christophe Blot and Jérôme Creel

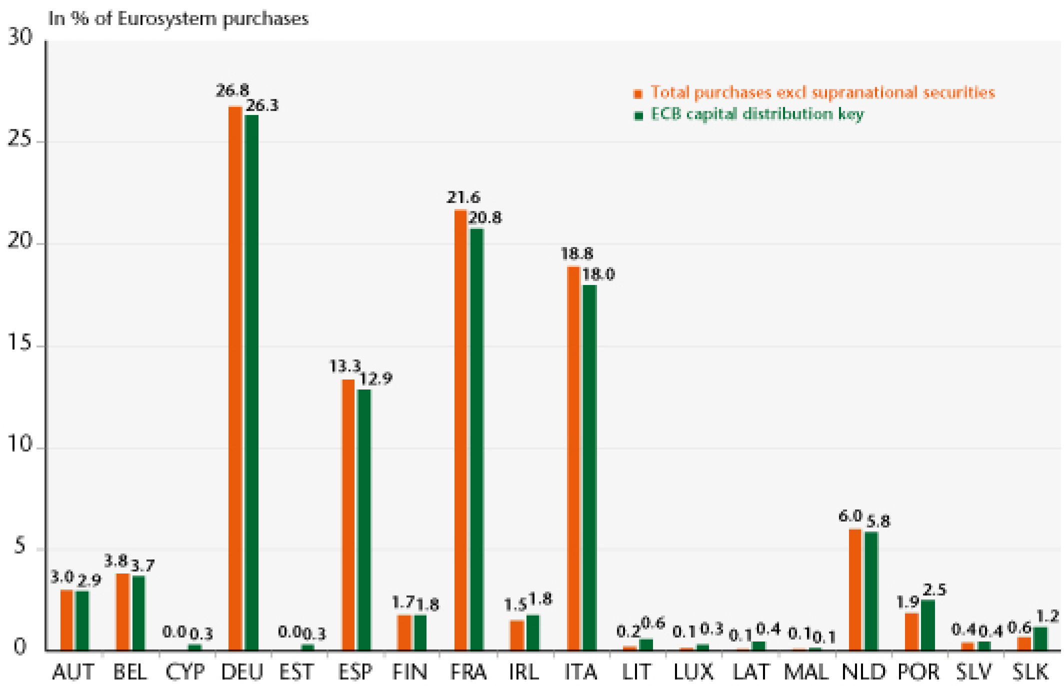
The involvement of the European Central Bank (ECB) in the fiscal management of the euro area member states has been a subject of ongoing controversy. Since the implementation of the ECB programme to purchase sovereign debt, it has been accused of profiting off of troubled states and taking the risk of socializing losses. The rise of these controversies results from the difficulty in understanding the relationship between the ECB, the national central banks (NCBs), and the governments. The European monetary architecture comes down to a sequence of delegations of power. Decisions on the conduct of monetary policy in the euro area are delegated to an independent institution, the European Central Bank (ECB). But, under the European subsidiarity principle, the implementation of monetary policy is then delegated to the national central banks (NCBs) of the euro area member states: the ECB and NCBs taken together are called the Eurosystem. While up to now this dimension of the organization of the euro area's monetary policy has not attracted much attention, debate has recently arisen in the course of the implementation of the quantitative easing programme. According to commentators and journalists, some national central banks are profiting more than others from the policy of buying and supporting their national public debts, which are riskier than the debt in more "virtuous" countries[1]. The profiting banks are viewed as escaping the ECB's control and not strictly applying the policy decided in Frankfurt.

In a recent paper prepared as part of the European Parliament's Monetary Dialogue with the ECB, we show that these concerns are unfounded for the simple good reason that, on average, since the beginning of the implementation of this policy, the theoretical distribution key has been respected (graphic). This distribution key stipulates that purchases of bonds by the Eurosystem are to be made pro rata to a state's participation in the ECB's capital. Remember that part of the purchases – 10 of the 60 billion in monthly purchases made under the programme – are made directly by the ECB[2]. The other purchases are made directly by the NCBs. As each central bank buys securities issued by its own government, the NCBs' purchases of public bonds do not entail risk-sharing between member states. Any profits or losses are kept on the NCBs' balance sheets or transferred to the national governments in accordance with the agreements in force in each country.

This distribution of public bond purchases, which is intended to be neutral in terms of risk management, isn't entirely so, but not for the reasons that seem to have worried the European Parliament's Committee on Economic and Monetary Affairs. This distribution favours the maintenance of very low rates of return on the debts of certain member states. In fact, by not basing itself on the financing needs of the member states or on the size of their public debts, it can produce distortions by reducing the supply of public bonds available on the secondary markets. Such may be the case in Germany, Spain and the Netherlands, whose shares of the European public debt are smaller than their respective shares in the ECB's capital (table). Conversely, the purchases of Italian bonds are smaller with the current distribution key than they would be with a distribution key that took into account the relative size of the public debt. The ECB's policy therefore has less impact on the Italian debt market than it does on the German market.

This orientation could also constrain the ECB's decision about continuing quantitative easing beyond December 2017. Let's agree that the ECB's best policy would be to continue the current policy beyond December 2017, but to stop it once and for all in July 2018. Given the current distribution rules, this policy would be subject to all countries having exchangeable government bonds until July 2018, including those who issue public debt only rarely because they have low financing needs. It could be that it is impossible to continue this policy under the rules currently adopted by the ECB, because some countries do not have sufficient debt available. It would then be necessary to implement a different policy by drastically reducing the monthly purchases of short-term securities (say in January 2018), while possibly pursuing this policy for a longer time period (beyond the first half of 2018). The decision not to use risk-sharing in the management of European monetary policy is therefore far from being neutral in the way this policy is actually implemented.

Figure. Distribution by the cumulative securities purchases by the national central banks



Source: BCE.

Table. Weighting by country using different measures

In %

	ECB capital distribution key	Weighting based on relative size of…	
		...GDP	…the public debt
BEL	3.5	3.9	4.6
DEU	25.6	29.2	21.8
EST	0.3	0.2	0.0
IRL	1.6	2.6	2.0
GRC	2.9	1.6	3.2
ESP	12.6	10.3	11.3
FRA	20.1	20.7	21.9
ITA	17.5	15.5	22.6
CYP	0.2	0.2	0.2
LAT	0.4	0.2	0.1
LTH	0.6	0.4	0.2
LUX	0.3	0.5	0.1
MAL	0.1	0.1	0.1
NLD	5.7	6.5	4,4
AUT	2.8	3.2	3.0
PRT	2.5	1.7	2.5
SLV	0.5	0.4	0.3
SLK	1.1	0.8	0.4
FIN	1.8	2.0	1.4

Sources: ECB and Eurostat.

[1] Mario Draghi was questioned about the distribution of the public sector purchase programme (PSPP) at the press conference he held on 8 September 2017.

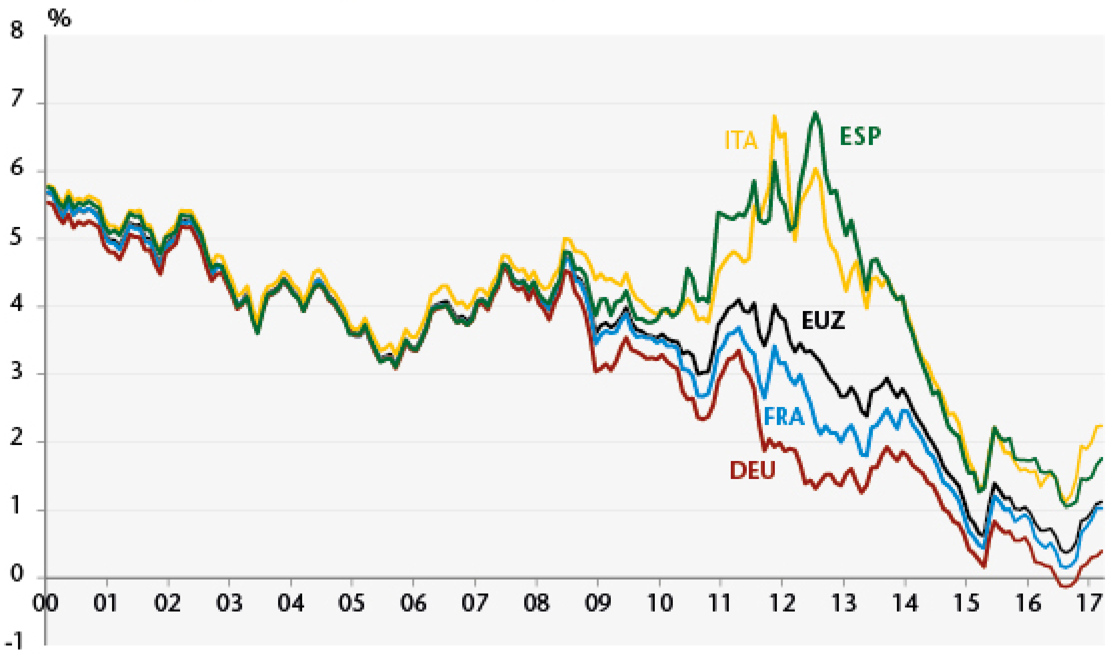
[2] There is risk-sharing on this sum: the gains or losses are shared by all the NCBs in proportion to their contribution to the ECB’s capital.

What factors are behind the recent rise in long-term interest rates?

By Christophe Blot, Jérôme Creel, Paul Hubert and Fabien Labondance

Since the onset of the financial crisis, long-term sovereign interest rates in the euro zone have undergone major fluctuations and periods of great divergence between the member states, in particular between 2010 and 2013 (Figure 1). Long-term rates began to fall sharply after July 2012 and Mario Draghi's famous "whatever it takes". Despite the implementation and expansion of the Public Sector Purchase Programme (PSPP) in 2015, and although long-term sovereign interest rates remain at historically low levels, they have recently risen.

Figure 1: Long-term sovereign interest rates in the euro zone



Source : European Central Bank.

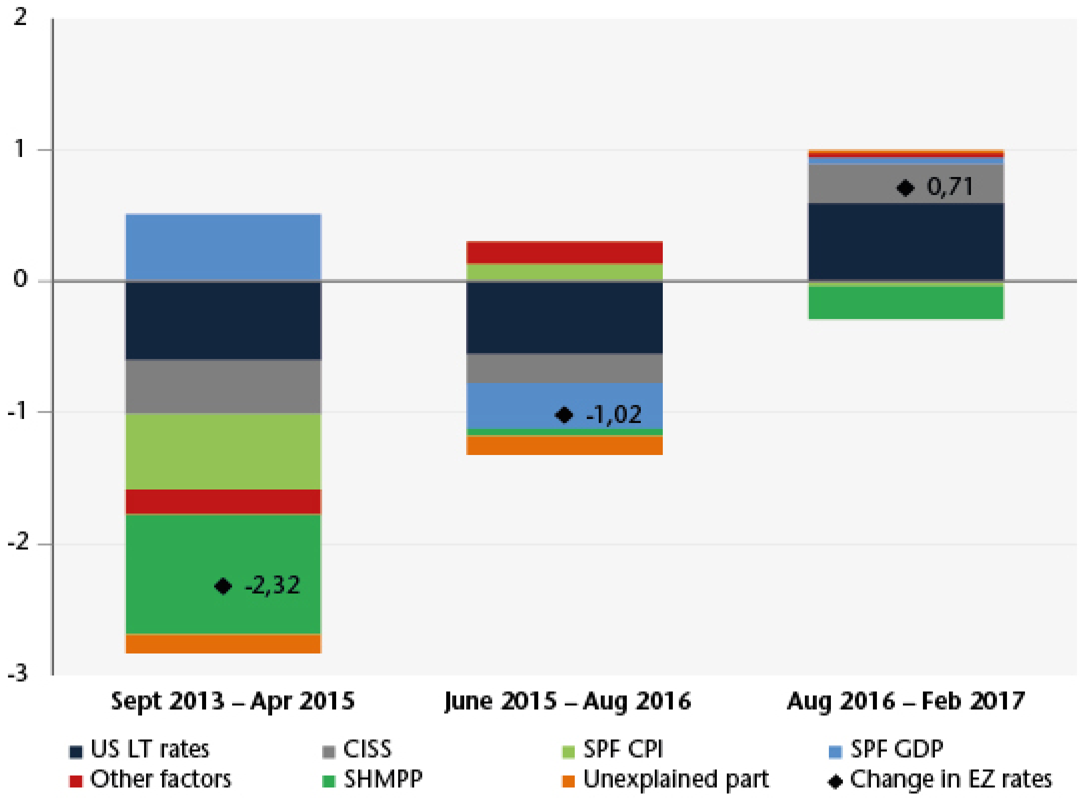
There may be several ways of interpreting this recent rise in long-term sovereign interest rates in the euro zone. Given the current economic and financial situation, it may be that this rise in long-term rates reflects the growth and expectations of rising future growth in the euro zone. Another factor could be that the euro zone bond markets are following the US markets: European rates could be rising as a result of rising US rates despite the divergences between the policy directions of the ECB and of the Fed. The impact of the Fed's monetary policy on interest rates in the euro zone would thus be stronger than the impact of the ECB's policy. It might also be possible that the recent rise is not in line with the zone's fundamentals, which would then jeopardize the recovery from the crisis by making debt reduction more difficult, as public and private debt remains high.

In a recent study, we calculate the contributions of the different determinants of long-term interest rates and highlight the most important ones. Long-term interest rates can respond to private expectations of growth and inflation, to economic fundamentals and to monetary and fiscal policy, both domestic (in the euro zone) and foreign (for example, in the United States). The rates may also react to perceptions of different financial, political and economic risks[1]. Figure 2 shows the main factors that are positively and negatively affecting long-term interest rates in the euro zone over three different periods.

Between September 2013 and April 2015, the euro zone's long-term interest rate decreased by 2.3 percentage points. During this period, only expectations of GDP growth had a positive impact on interest rates, while all the other factors pushed rates down. In particular, the US long-term interest rate, inflation expectations, the reduction of sovereign risk and the ECB's unconventional policies all contributed to the decline in euro zone interest rates. Between June 2015 and August 2016, the further decline of about 1 percentage point was due mainly to two factors: the long-term interest rate and the expectations of GDP growth in the United States.

Between August 2016 and February 2017, long-term interest rates rose by 0.7 percentage point. While the ECB's asset purchase programme helped to reduce the interest rate, two factors combined to push it up. The first is the increase in long-term interest rates in the United States following the Fed's tightening of monetary policy. The second factor concerned political tensions in France, Italy and Spain, which led to a perception of political risk and higher sovereign risk. While the first factor may continue to push up interest rates in the euro zone, the second should drive them down given the results of the French presidential elections.

Figure 2: Contributions to changes in long-term sovereign rates in the euro zone



Note: SPF corresponds to the Survey of Professional Forecasters and measures private agent expectations of inflation (CPI – Consumer Price Index) and of GDP (Gross Domestic Product). The CISS (Composite Indictor of Systemic Stress) is an indicator of stress on the financial markets. The SHMPP (Securities Held for Monetary Policy Purposes), in the Weekly financial statements published by the ECB, measures the amount of purchases of bonds made by the ECB as part of its unconventional policy.

Source: calculation OFCE.

[1] The estimate of the equation for the determination of long-term rates was calculated over the period January 1999 – February 2017 and accounts for 96% of the change in long-term

rates over the period. For details on the variables used and the parameters estimated, see the study.

The European economy in 2017 – or, the post-Brexit EU

By Jérôme Creel

The just released *L'économie européenne 2017* provides a broad overview of the issues being posed today by the European Union project. Brexit, migration, imbalances, inequality, economic rules that are at once rigid and flexible… the EU remains an enigma. Today it gives the impression of having lost the thread of its own history or to even to be going against History, such as the recent international financial crisis or in earlier times the Great Depression.

A few months after the bankruptcy of Lehman Brothers, the G-20 Summit of the heads of State and Government held in London in April 2009 drew up a list of recommendations to revive the global economy. These included implementing active fiscal and monetary policies, supporting the banks and improving banking regulation, rejecting the temptation of protectionism, fighting against inequality and poverty, and promoting sustainable development.

These recommendations were in contrast to the policies implemented shortly after the Great Depression back in the 1930s. At that time, economic policies started with restrictive measures, thereby fueling the crisis and rising inequality. Protectionism in that epoch became not just a temptation but a reality: tariff and non-tariff barriers were erected in an effort to protect local business from international competition. We know what happened later: the rise of populism and extremism that plunged Europe, and then the world, into a terrible war. The economic lessons learned from the catastrophic management of the 1930s crisis thus contributed to the recommendations of the London G-20 Summit.

What now remains of these lessons in Europe? Little, ultimately, other than a resolutely expansionary monetary policy and the establishment of a banking union. The first is meant to alleviate the current crisis, while the second is intended to prevent a banking crisis in Europe. While this is of course not nothing, it is based on a single institution, the European Central Bank, and is far from sufficient to answer all the difficulties hitting Europe.

Brexit is one of these: as the first case of European disintegration, the departure of the United Kingdom poses the issue of the terms of its future partnership with the European Union (EU) and re-raises the question of protectionism between European states. The temptation to turn inwards is also evident in the way that the refugee crisis has been managed, which calls for the values of solidarity that have long characterized the EU. Differences between EU Member States in terms of inequality, competitiveness and the functioning of labour markets require differentiated and coordinated policies between the Member States rather than the all-too homogeneous policies adopted up to now, which fail to take an overall view.

This is particularly true of the policies aimed at reducing trade imbalances and those aimed at cutting public debts. By applying fiscal rules to manage the managing public finances, even if these are not perfectly respected, and by imposing quantitative criteria to deal with economic and social imbalances, we lose sight of the interdependencies between the Member States: fiscal austerity is also affecting our partners, as is the search for better price competitiveness. Is this useful and reasonable in a European Union that is soon to be the EU-27, which is seeing rising inequalities and struggling to find a way to promote long-term growth?

L'économie européenne 2017 takes stock of the European Union in a period of severe tensions and great uncertainty, following a year of average growth and before the process of separation between the EU and the UK really begins. During this period, several key elections in Europe will also serve as stress tests for the EU: less, more or better Europe – it will be necessary to choose.

Slowing growth: due to the supply side?

By Jérôme Creel and Xavier Ragot

The weakness of the recovery in 2014 and 2015 raises the need for a structural re-examination of the state of France's productive fabric. Indeed, an analysis of investment dynamics, the trade balance, productivity gains and business margins, and to a lesser extent companies' access to credit, indicates the existence of some disturbing trends since the early noughties. In addition, the persistence of the crisis inevitably poses the question of the unravelling of France's productive fabric since 2007 due to a combination of low growth, weak investment and numerous bankruptcies.

The contributions gathered in *Revue de l'OFCE* no.142 have a double ambition: first, to put France's businesses and economic sectors at the heart of reflection about the ins and outs of the current slowdown in growth, and second, to question the basis for theoretical analyses of future growth in light of the situation of France and Europe. Based on the various contributions, nine conclusions emerge:

1) Growth potential, a concept that aims to measure an economy's medium-term productive capacity, has fallen in France since the crisis. While the level of potential growth is high over the long term, on the order of 1.8%, it has fallen since the crisis by about 0.4 point, according to the new measurement provided by Eric Heyer and Xavier Timbeau.

2) The main point is to figure out whether this slowdown is temporary or permanent. This is important for growth forecasts but also with respect to France's European commitments, which depend on its growth potential. One important conclusion is that a very large portion of the current slowdown is transitory and linked to France's economic policy. As Bruno Ducoudré and Mathieu Plane demonstrate, the low level of investment and employment can be explained by the macroeconomic environment and in particular by the current sluggish economy. Business behaviour does not seem to have changed during the crisis. The analysis by Ducoudré and Plane also shows that the determinants of investment differ in the short term and the long term. A 1% increase in economic activity increases investment by 1.4% after one quarter, whereas a 1% increase in the margin rate has very little impact in that same period. However, over the long term (10 years), a 1% increase in activity boosts investment by about 1%, while a 1% increase in the margin rate boosts investment by 2%. So promoting investment means supporting economic activity in the short term, while boosting margins will have an impact over the longer term.

3) France's productive fabric will take time to recover from the effects of the crisis because of three major obstacles: the weakness of investment, of course, but also the decline in

the quality of investment and finally the disruption of production following on from the poor allocation of capital during the crisis, including its territorial dimension. Sarah Guillou and Lionel Nesta show that the low level of investment makes it impossible to go upmarket, which has meant less technical progress since the crisis. Jean-Luc Gaffard and Lionel Nesta then show that regional convergence has slowed since the crisis, and that economic activity has tended to decline in the most productive areas.

4) The concept of growth potential as a tool for macroeconomic management has emerged from the crisis in a profoundly weakened state. Whatever the methods used, ongoing revisions of growth potential make the idea of a system of rules-based European guidance dangerous, according to Henri Sterdyniak. There is a need to rediscover European economic policy that is discretionary in character. In addition, fiscal policy that is more contingent on macroeconomic and financial conditions needs to be better coordinated with the climate issue, as Jérôme Creel and Eloi Laurent argue.

5) The notion of secular stagnation, that is to say, a lasting weakening of growth, has led to intense debate. Two visions of secular stagnation are discussed. The first vision, associated with Robert Gordon, insists that technological progress has been exhausted. The second flows from the analysis of Larry Summers and stresses the possibility of a permanent demand deficit. Jérôme Creel and Eloi Laurent show the limitations of the analysis of Robert Gordon for France; in particular, French demographics are more an advantage for French growth than a hindrance. Gilles Le Garrec and Vincent Touzé show the possibility of a long-term demand deficit that would hinder capital accumulation, due to the central bank's inability to make further interest rate reductions. In this kind of environment, support for demand is necessary to get out of an unfavourable equilibrium between low inflation and high unemployment, which leads to a negative perception of growth

potential. Changing expectations may require large-scale policies to stimulate economic activity, along with an acceptance of high inflation over the long term.

6) The analyses presented here therefore recognize the profound difficulties with France's productive fabric and recommend better coordination of public policy. Support for demand is needed rapidly in order to restore investment, followed by an ongoing progressive policy to boost the margins of companies exposed to international competition – so, according to Jean-Luc Gaffard and Francesco Saraceno, not a competitive shock, but rather support for business that takes into account the time profile of productive investment.

7) In the longer term, part of what can be characterized as the French supply-side problem is the result of poor European adjustments, including the discrepancy in wages between Europe's major economies. The divergence between France and Germany since the mid-1990s has been impressive. Mathilde Le Moigne and Xavier Ragot show that German wage restraint is a singularity among European countries. They offer a quantification of the impact of this wage moderation on France's foreign trade and economic activity, and conclude that German wage restraint has contributed to an increase of more than 2 points in France's unemployment rate. A supply policy could also go by the name of a policy for European re-convergence.

8) The deep-going modernization of the productive fabric will depend on spaces for cooperation, collective learning and collaboration so as to nourish the creativity made possible by new technologies. These spaces need to recognize the importance of difficult-to-value intangible assets. In economies with an ageing workforce, advances in robotics and artificial intelligence should lead to enhancing potential productivity, according to Sandrine Levasseur. Cooperation also needs to be strengthened in two areas: the company and the territory. Within companies, partnership governance should

help limit short-termist financial tendencies. With respect to territory, the definition of regional innovation systems should be the focus of a modern industrial policy, according to Michel Aglietta and Xavier Ragot.

9) Guillaume Allègre concludes that it is not so much the level of production that is disturbing as the inequitable distribution of the fruits of growth, however small these may be. The emerging consensus on the negative impact of inequality on economic growth should not obscure the real debate, which does not concern just the income gap, but also what that income makes it possible to consume, i.e. equal access to goods and services of equal quality. The key question is thus the content of production, more than simply growth.

Financialisation and financial crisis: vulnerability and traumatic shock

By Jérôme Creel, Paul Hubert, Fabien Labondance

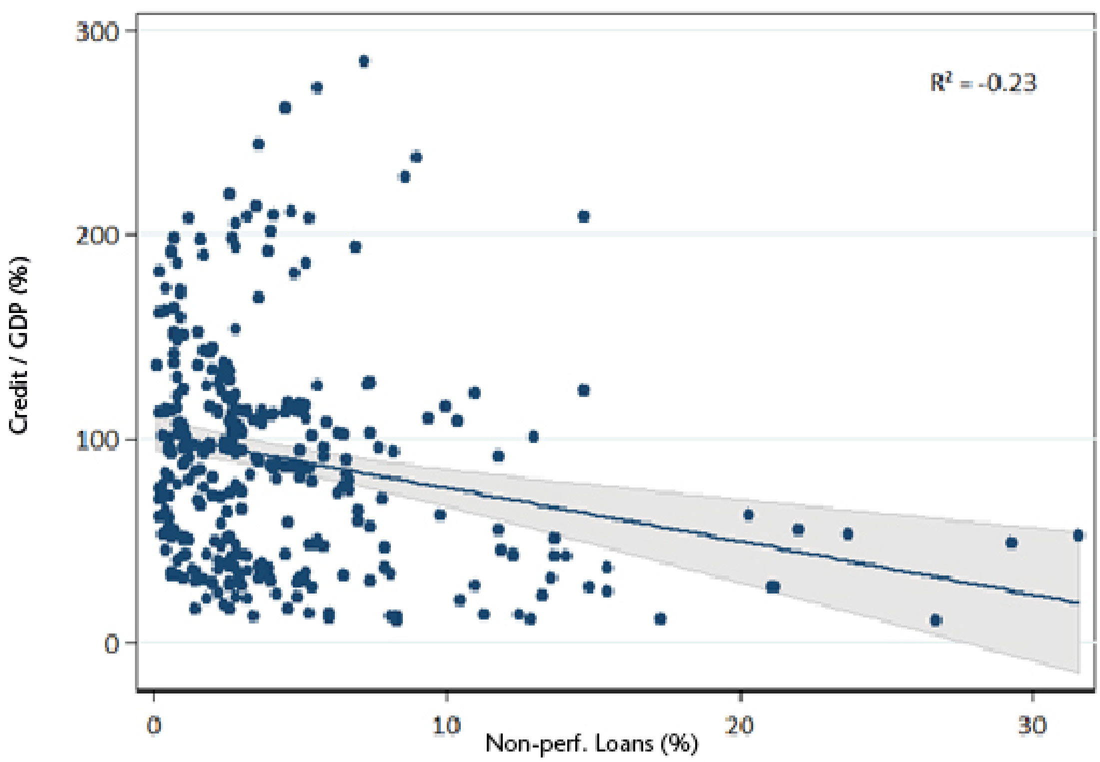
Since the mini-crash that took place in the Shanghai stock market in August, financial instability has resurfaced in the markets and the media and, once again, the link with financialisation has been evoked. The Chinese crisis resulted from a combination of real estate and stock market bubbles that were fed by the abundant savings of a middle class in search of high-yield investments. It feels like we've gone back almost ten years when what is considered the excessive financialisation of the US economy – with abundant savings from the emerging countries enabling the build-up of widespread US consumer debt – is treated as the cause of the financial instability and crisis that was triggered in the summer of 2007.

Is there really a link between, on the one side, increasing indebtedness and the great variety of financial investments, and on the other, volatile stock prices and a deterioration in the quality of bank loans? And if there is, what is the direction of the dynamics: from financialisation to financial instability, from financial instability to financialisation, or both at once? A rise in indebtedness could well lead to increasingly risky lending to agents who wind not being able to repay them, which would then lead to a financial crisis: this is one possible case. The occurrence of a crisis would change the behaviour of households and firms, causing them to reduce debt: this is the second case, in which financial instability reduces the financialisation of the economy. Depending on which is the case, the public policies needed differ. In the first, we need to monitor the degree of the economy's financialisation and target, for example, a maximum ratio of bank credit to GDP in order to prevent the rise and bursting of speculative bubbles. In the second case, there are two possibilities: to treat the causes, and thus to monitor the quality of loans to households and business so as to ensure the proper allocation of capital in the economy; or to treat the consequences by supporting productive investment to annihilate any rationing of credit.

In the course of the debate on the links between financialisation and financial instability, and on the consequences to be drawn in terms of public policy, the European situation is interesting for two reasons: the European Union has set up a system for monitoring external imbalances, including financial ones, from 2011, and a banking union since 2014. In a recent [working paper](), we look at this debate for several groups of countries in the European Union over the period 1998-2012.

At first glance, the relationship between these two concepts is not easy to demonstrate, as can be seen in the graph below. It shows a scatter plot that for each year and for each European country gives the levels of financialisation (approximated here by the share of credits / GDP) and of financial instability (approximated here by non-performing loans). The correlation between these variables is -0.23.

Figure. Financialisation and financial instability



Note: Non-performing loans, or bad debt, expressed as a percentage of total loans granted by banks.
Credit/GDP: total amount of bank credit expressed as a percentage of GDP.

Source : Creel et al. (2015) based on GFDD databases.

We test the two typical cases discussed above. We call the first case the vulnerability effect. As financialisation develops, it engenders a sort of euphoria that leads to granting loans that are increasingly risky, which fosters financial instability. This hypothesis derives from the work of Minsky (1995) [1]. We simultaneously test the potentially negative relationship between financial instability and financialisation, which we call the trauma effect. The very occurrence of financial instability as well as its impact encourages economic agents to take less risk and to shed debt. Our estimates show that the link between financial instability and financialisation is not uni-directional. Contrary to what is suggested by the simple correlation coefficient, the sign of the relationship is not the same when looking at the effect of one variable on the other, and vice versa. Both the vulnerability and the trauma effect have been at work in the European countries. A macro-prudential policy intended to monitor the policy on granting bank loans, in terms of their volume and quality, therefore does indeed seem necessary in Europe.

We also tested the possibility that these effects are non-linear, that is to say, that they depend on reference values. The vulnerability hypothesis depends both on the level of financialisation (the higher it is, the stronger the relationship) and on time. This last point shows us that the positive relationship between financialisation and financial instability shows up at the moment of crisis for countries that are already heavily financialised. Finally, in the countries on the EU periphery [2], long-term interest rates and inflation rates greatly influence the financial instability variable. Consequently, it seems that for these countries there is a need for strong coordination between banking supervision and macroeconomic surveillance.

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[1] Minsky H. P. (1995), “Sources of Financial Fragility: Financial Factors in the Economics of Capitalism”, paper prepared for the conference, *Coping with Financial Fragility: A Global Perspective*, 7-9 September 1994, Maastricht, available at Hyman P. Minsky Archive. Paper 69.

[2] This group consists of Spain, Ireland, Italy, Greece, Portugal and the countries from the Eastern enlargements in 2004 and 2007. The establishment of this group is explained in the working paper.

The redistributive effects of the ECB’s QE programme

By Christophe Blot, Jérôme Creel, Paul Hubert, Fabien Labondance and Xavier Ragot

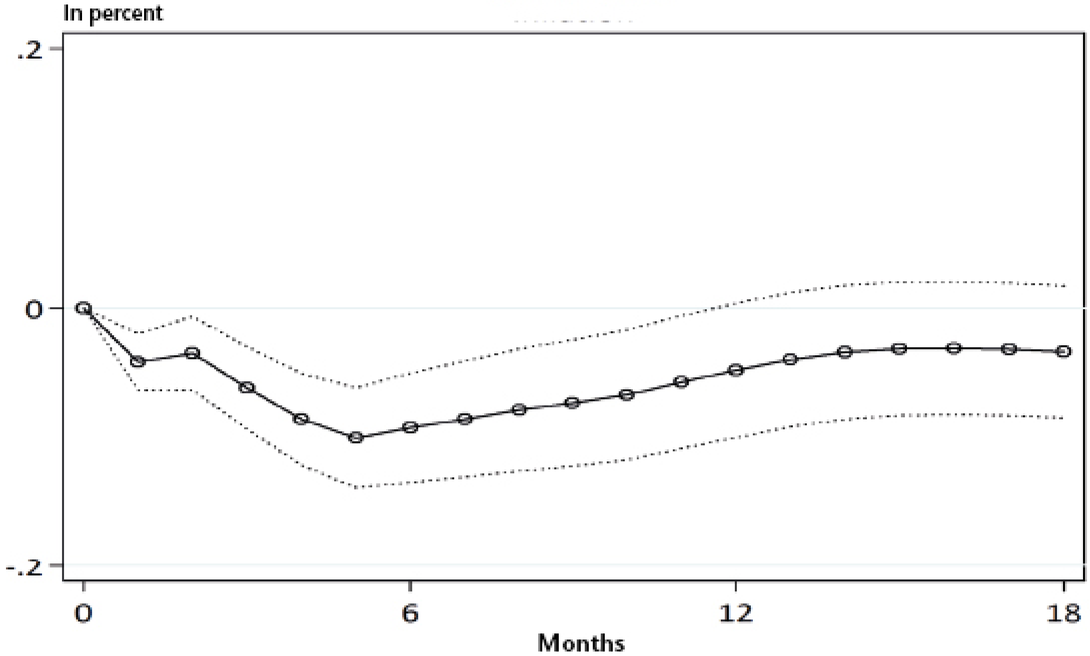
Rising inequality in income and wealth has become a key issue in discussions of economic policy, and the topic has inserted itself into evaluations of the impact of monetary policy in the US and Japan, the precursors of today’s massive quantitative easing programmes (QE). The question is thus posed as to whether the ECB’s QE policy has had or will have redistributive effects.

In a paper prepared for the European Parliament, Blot et al. (2015) point out that the empirical literature gives rise to two contradictory conclusions. In the US, the Fed’s base rate cuts tend to reduce inequality. Conversely, in Japan an expansionary QE type policy tends to increase inequality. So what’s the situation in Europe?

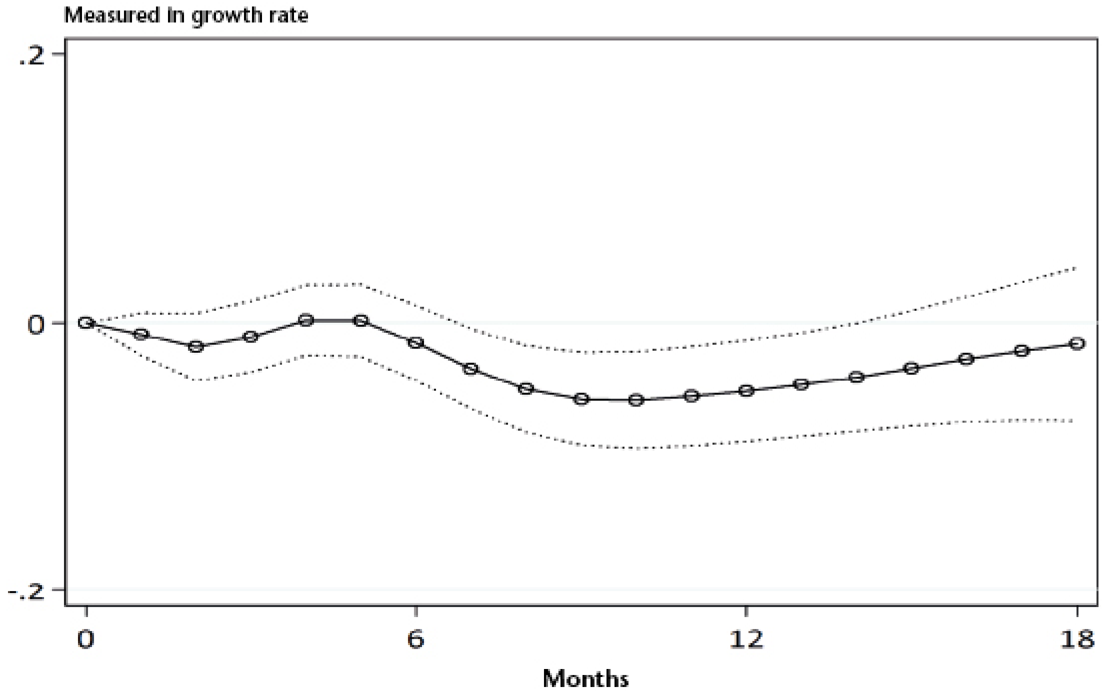
Based on macroeconomic data aggregated for the euro zone as a whole, Blot et al. (2015) show that while European monetary policy, conventional and unconventional, have indeed had an impact on the unemployment rate, the number of hours worked and the rate of inflation (see graphs), this was limited. This result suggests that the ECB’s expansionary monetary policy has tended to reduce inequality, but not by much. So when the ECB finally decides to wind up its expansionary policy, we can expect a slight increase in inequalities to follow. Because of this effect, though small, Blot et al. (2015) suggest that the ECB should be held accountable not just for price stability or economic growth, but also for the impact of its policies in terms of inequality and the mechanisms needed to take this into account.

Figures. The impact of a restrictive monetary policy shock (0.2 percentage point hike in the implicit interest rate) in the euro zone…

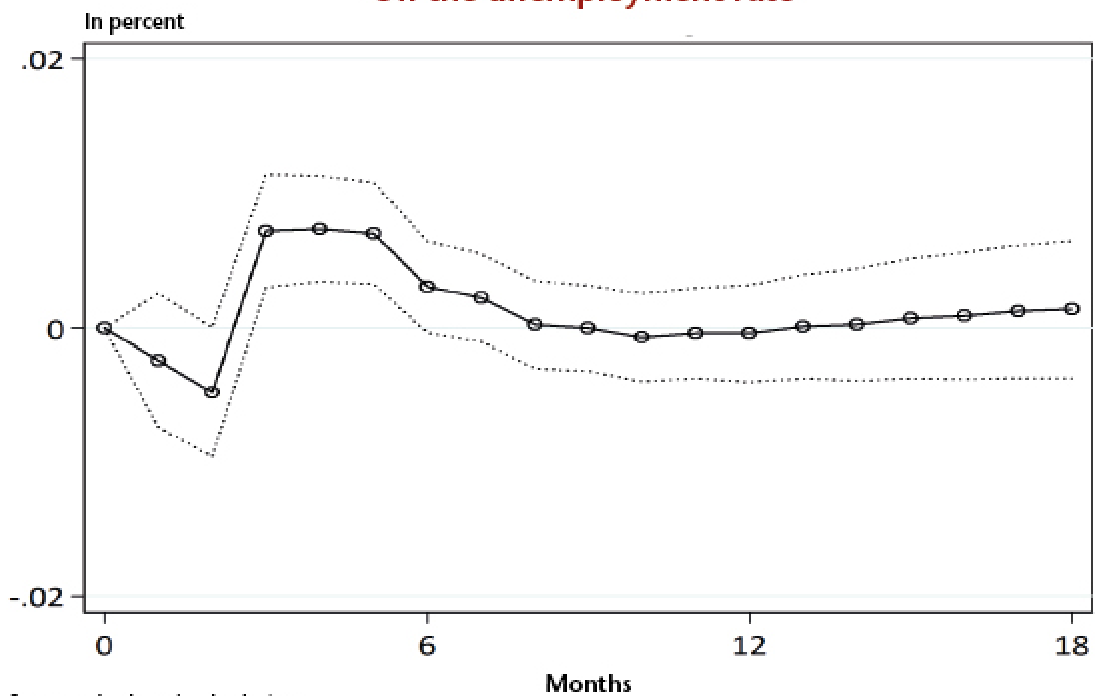
On inflation



On hours worked



On the unemployment rate



Source: Authors' calculations.