# The euro zone: confidence won't be enough

By Céline Antonin, Christophe Blot and Danielle Schweisguth

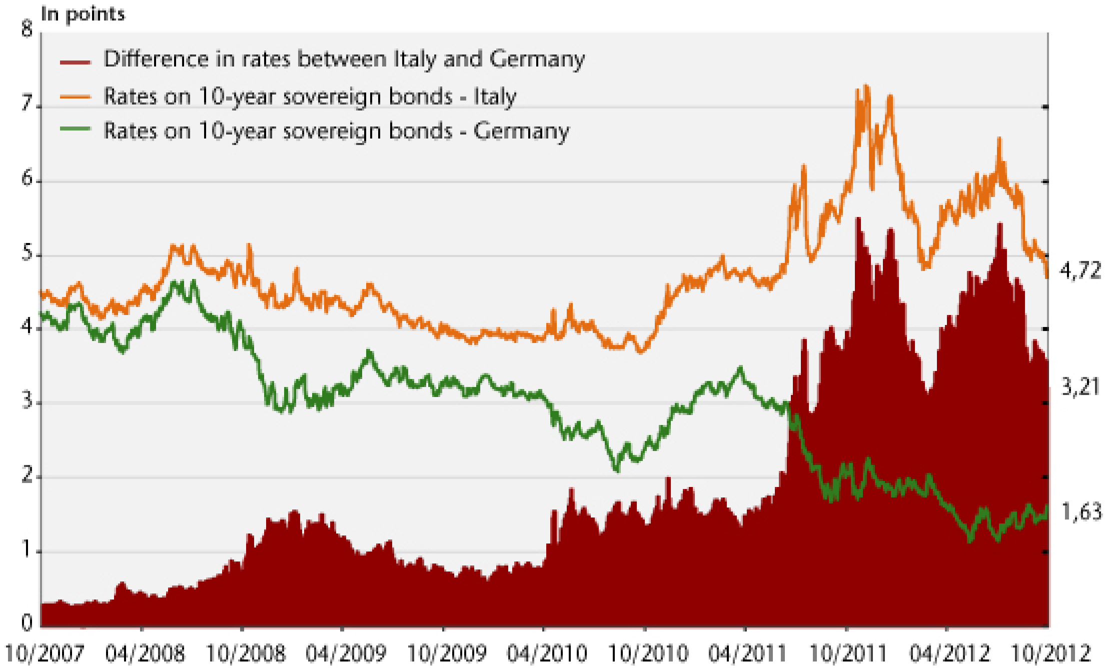
*This text summarizes the OFCE's October 2012 forecasts for the economy of the euro zone.*

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

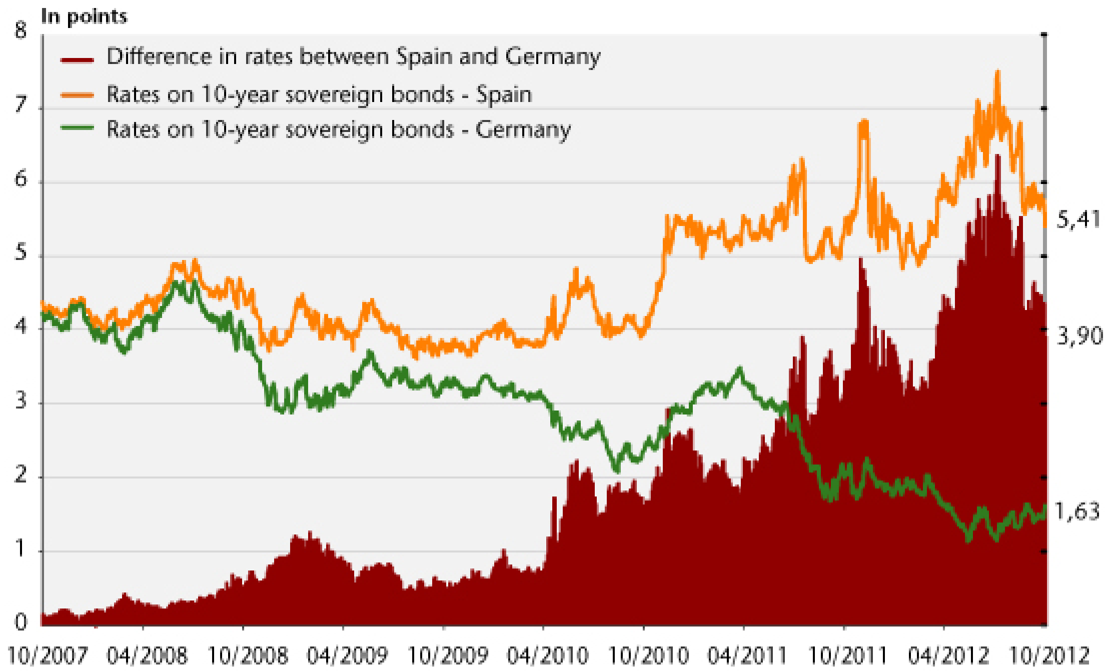
Since the end of 2011, Europe has adopted a new treaty (the Treaty on stability, coordination and governance, the TSCG) which is being ratified in the 25 signatory countries. The new law is specifically intended to strengthen both budgetary discipline – through the adoption of national golden rules –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

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

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




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




*Source* : Datastream.

Tableau. Fiscal stimulus in the euro zone countries

In GDP points

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

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

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

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# France: will the war of the 3% take place?

By Eric Heyer

*This text summarizes the OFCE's October 2012 forecasts for the French economy.*

The French economy is expected to see average annual growth of 0.1% in 2012 and 0.0% in 2013. This performance is particularly poor and far from the path that an economy recovering from a crisis would normally experience.

Four years after the onset of the crisis, the French economy has real potential for a rebound: this should lead to spontaneous average growth of about 3.0% per year in 2012 and 2013, making up some of the output gap built up since the start of the crisis. But this spontaneous recovery is being hampered, mainly by the establishment of budgetary savings plans in France and throughout Europe. The fiscal consolidation strategy imposed by the European Commission is likely to slice nearly 6 percentage points off GDP in France during 2012 and 2013.

**Table 1. The brakes on growth in France**

En points of GDP

| Rythm | ... quaterly | | ... annually | |
|---|---|---|---|---|
| | 2012 | 2013 | 2012 | 2013 |
| **Spontaneous recovery** | 0,8 | 0,8 | 2,1 | 3,1 |
| *Budget impact* | *-0,4* | *-0,4* | *-1,6* | *-1,7* |
| *Oil shock* | *-0,05* | *0,0* | *-0,2* | *0,0* |
| *External environment* | *-0,4* | *-0,3* | *-1,4* | *-1,2* |
| *Achievement* | | | *-1,0* | *-0,2* |
| **Growth forecasts** | -0,04 | 0,04 | 0,1 | 0,0 |

Sources : INSEE, OFCE calculations.

By setting a pace that is far from its potential, the expected growth will increase the output gap accumulated since 2008 and will lead to a further deterioration on the labour market. The unemployment rate will rise steadily and hit 11% by late 2013.

Moreover, the reduction of the budget deficit expected by the Government due to the implementation of its consolidation strategy – the target for the general government deficit is 3% of GDP in 2013 – will be partially undermined by the shortfall in tax revenue due to weak growth. The general government deficit will come to 3.5% in 2013.

Under these conditions, should the government do whatever it can to fulfil its commitment to a 3% deficit in 2013?

In a context of financial uncertainty, being the only State not to keep its promise of fiscal consolidation is a risk, *i.e.* of being punished immediately by an increase in the financial terms on the repayment of its debt. This risk is real, but limited. The current situation is that of a “liquidity trap” and abundant savings. The result is a “flight to quality” phenomenon on the part of investors seeking safe investments. But among these are both German and French government bonds. Under these conditions, reducing the government deficit by 1 GDP point instead of 1.5 point would have very little impact on French bond rates.

However, maintaining a target of a 3% deficit in 2013 could have a dramatic impact on economic activity and employment in France. We simulated a scenario in which the French government maintains its budgetary commitment regardless of the costs and the economic situation. If this were to occur, it would require the adoption of a new programme of budget cuts in the coming months in the amount of 22 billion euros.

This strategy would cut economic activity in the country by 1.2% in 2013. It would lead to a further increase in the unemployment rate, which would reach 11.7% at year end, nearly 12%. As for employment, this obstinacy would intensify job losses, costing nearly 200,000 jobs in total.

A darker scenario is also possible: according to our forecasts, and taking into account the draft budget bills known and approved, no major European country would meet its deficit reduction commitments in 2013. By underestimating the difficulty of reaching inaccessible targets, there is a high risk of seeing the euro zone countries locked into a spiral where the nervousness of the financial markets would become the engine driving ever greater austerity. To illustrate this risk, we simulated a scenario in which the major euro zone countries (Germany, France, Italy and Spain) implement new austerity measures to meet their deficit targets in 2013. Adopting such a strategy would result in a strong negative shock to economic activity in these countries. For the French economy, it would lead to additional austerity that either at the national level or coming from its euro zone partner countries would cause a severe recession in 2013. French GDP would fall by more than 4.0%, resulting in a further increase in the unemployment rate, which would approach 14%.

**Table 2. Illustrative scenarios of risks to French growth**

In %

| | 2011 | 2012* | 2013* |
|---|---|---|---|
| **Central scenario** | | | |
| GDP | 1,4 | 0,1 | 0,0 |
| Gov't deficit *(in GDP points)* | -7,1 | -4,4 | -3,5 |
| Unemployment rate | 9,4 | 10,2 | 11,0 |
| Market employment | 104 | -95 | -166 |
| **Scenario where France alone meets its budget commitments** | | | |
| GDP | | | -1,2 |
| Gov't deficit (in GDP points) | | | -3,0 |
| Unemployment rate | | | 11,7 |
| Market employment *(in 1000s)* | | | |
| Change | | | -361 |
| Deviation from central scenario | | | -195 |
| **Scénario where euro zone countries meet their budget commitments** | | | |
| GDP | | | -4,6 |
| Gov't deficit *(in GDP points)* | | | -3,0 |
| Unemployment rate | | | 18,8 |
| Market employment *(in 1000s)* | | | |
| Change | | | -910 |
| Déviation from central scenario | | | -744 |

* OFCE forecast October 2012
*Sources* : INSEE ; OFCE calculations *e-mod.fr.*

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# The debacle of austerity

By [Xavier Timbeau]()

*This text summarizes the OFCE's October 2012 forecasts.*

The year 2012 is ending, with hopes for an end to the crisis disappointed. After a year marked by recession, the euro zone will go through another catastrophic year in 2013 (a -0.1% decline in GDP in 2013, after -0.5% in 2012, according to our forecasts – see the table). The UK is no exception to this trend, as it plunges deeper into crisis (-0.4% in 2012, 0.3% in 2013). In addition to the figures for economic growth, unemployment trends are another reminder of the gravity of the situation. With the exception of Germany and a few other developed countries, the Western economies have been hit by high unemployment that is persisting or, in the euro zone, even rising (the unemployment rate will reach 12% in the euro zone in 2013, up from 11.2% in the second quarter of 2012). This persistent unemployment is leading to a worsening situation for those who have lost their jobs, as some fall into the ranks of the long-term unemployed and face the exhaustion of their rights to compensation. Although the United States is experiencing more favourable economic growth than in the euro zone, its labour market clearly illustrates that the US economy is mired in the Great Recession.

Was this disaster, with the euro zone at its epicentre, an unforeseeable event? Is it some fatality that we have no choice but to accept, with no alternative but to bear the consequences? No – the return to recession in fact stems from a misdiagnosis and the inability of Europe's institutions to respond quickly to the dynamics of the crisis. This new downturn is the result of massive, exaggerated austerity policies whose impacts have been underestimated. The determination to urgently rebalance the public finances and restore the credibility of the euro zone's economic management, regardless of the cost, has led to its opposite. To get out of this rut will require reversing Europe's economic policy.

The difficulty posed by the current situation originates in widening public deficits and swelling public debts, which reached record levels in 2012. Keep in mind, however, that the deficits and public debts were not the cause of the crisis of 2008-2009, but its consequence. To stop the recessionary spiral of 2008-2009, governments allowed the automatic stabilizers to work; they implemented stimulus plans, took steps to rescue the financial sector and socialized part of the private debt that threatened to destabilize the entire global financial system. This is what caused the deficits. The decision to socialize the problem reflected an effort to put a stop to the freefall.

The return to recession thus grew out of the difficulty of dealing with the socialization of private debt. Indeed, in the euro zone, each country is forced to deal with financing its deficit without control of its currency. The result is immediate: a beauty contest based on who has the most rigorous public finances is taking place between the euro zone countries. Each European economic agent is, with reason, seeking the most reliable support for its assets and is finding Germany’s public debt to hold the greatest attraction. Other countries are therefore threatened in the long-term or even immediately by the drying up of their market financing. To attract capital, they must accept higher interest rates and urgently purge their public finances. But they are chasing after a sustainability that is disappearing with the recession when they seek to obtain this by means of austerity.

For countries that have control of their monetary policy, such as the United States or the United Kingdom, the situation is different. There the national savings is exposed to a currency risk if it attempts to flee to other countries. In addition, the central bank acts as the lender of last resort. Inflation could ensue, but default on the debt is unthinkable. In contrast, in the euro zone default becomes a real possibility, and the only short-term shelter is Germany, because it will be the last country to collapse. But it too will inevitably collapse if all its partners collapse.

The solution to the crisis of 2008-2009 was therefore to socialize the private debts that had become unsustainable after the speculative bubbles burst. As for what follows, the solution is then to absorb these now public debts without causing the kind of panic that we were able to contain in the summer of 2009. Two conditions are necessary. The first condition is to provide a guarantee that there will be no default on any public debt, neither partial nor complete. This guarantee can be given in the euro zone only by some form of pooling the public debt. The mechanism announced by the ECB in September 2012, the Outright Monetary Transaction (OMT), makes it possible to envisage this kind of pooling. There is, however, a possible contradiction. In effect this mechanism conditions the purchase of debt securities (and thus pooling them through the balance sheet of the ECB) on acceptance of a fiscal consolidation plan. But Spain, which needs this mechanism in order to escape the pressure of the markets, does not want to enter the OMT on just any conditions. Relief from the pressure of the markets is only worthwhile if it makes it possible to break out of the vicious circle of austerity.

The lack of preparation of Europe’s institutions for a financial crisis has been compounded by an error in understanding the way its economies function. At the heart of this error is an incorrect assessment of the value of the multipliers used to measure the impact of fiscal consolidation policies on economic activity. By underestimating the fiscal multipliers, Europe’s governments thought they could rapidly and safely re-balance their public finances through quick, violent austerity measures. Influenced by an extensive economic literature that even suggests that austerity could be a source of economic growth, they engaged in a program of unprecedented fiscal restraint.

Today, however, as is illustrated by the dramatic revisions by the IMF and the European Commission, the fiscal multipliers are much larger, since the economies are experiencing situations of prolonged involuntary unemployment. A variety of empirical evidence is converging to show this, from an analysis of the forecast errors to the calculation of the multipliers from the performances recorded in 2011 and estimated for 2012 ([see the full text of our October 2012 forecast]()). We therefore believe that the multiplier for the euro zone as a whole in 2012 is 1.6, which is comparable to the assessments for the United States and the United Kingdom.

Thus, the second condition for the recovery of the public finances is a realistic estimate of the multiplier effect. Higher multipliers mean a greater impact of fiscal restraint on the public finances and, consequently, a lower impact on deficit reduction. It is this bad combination that is the source of the austerity-fuelled debacle that is undermining any prospect of re-balancing the public finances. Spain once again perfectly illustrates where taking this relentless logic to absurd lengths leads: an economy where a quarter of the population is unemployed, and which is now risking political and social disintegration.

But the existence of this high multiplier also shows how to break austerity's vicious circle. Instead of trying to reduce the public deficit quickly and at any cost, what is needed is to let the economy get back to a state where the multipliers are lower and have regained their usual configuration. The point therefore is to postpone the fiscal adjustment to a time when unemployment has fallen significantly so that fiscal restraint can have the impact that it should.

Delaying the adjustment assumes that the market pressure has been contained by a central bank that provides the necessary guarantees for the public debt. It also assumes that the interest rate on the debt is as low as possible so as to ensure the participation of the stakeholders who ultimately will benefit from sustainable public finances. It also implies that in the euro zone the pooling of the sovereign debt is associated with some form of control over the long-term sustainability of the public finances of each Member State, *i.e.* a partial abandonment of national sovereignty that in any case has become inoperative, in favour of a supranational sovereignty which alone is able to generate the new manoeuvring room that will make it possible to end the crisis.

OFCE growth forecasts, October 12

Annual growth in GDP, %

| | 2011 | 2012 | 2013 |
|---|---|---|---|
| Euro zone | 1,5 | -0,5 | -0,1 |
| Germany | 3,1 | 0,8 | 0,6 |
| France | 1,7 | 0,1 | 0,0 |
| Italy | 0,5 | -2,4 | -1,1 |
| Spain | 0,4 | -1,4 | -1,2 |
| Netherlands | 1,1 | -0,2 | 0,3 |
| Belgium | 1,8 | -0,1 | 0,9 |
| Finland | 2,8 | 0,8 | 1,1 |
| Austria | 2,7 | 1,0 | 0,5 |
| Portugal | -1,7 | -2,8 | -1,2 |
| Greece | -6,2 | -6,2 | -3,7 |
| Ireland | 0,8 | -0,4 | -0,1 |
| United Kingdom | 0,9 | -0,4 | 0,3 |
| United States | 1,8 | 2,2 | 0,9 |
| Japan | -0,7 | 2,4 | 1,3 |

*Sources* : National calculations, OFCE forecasts October 2012.

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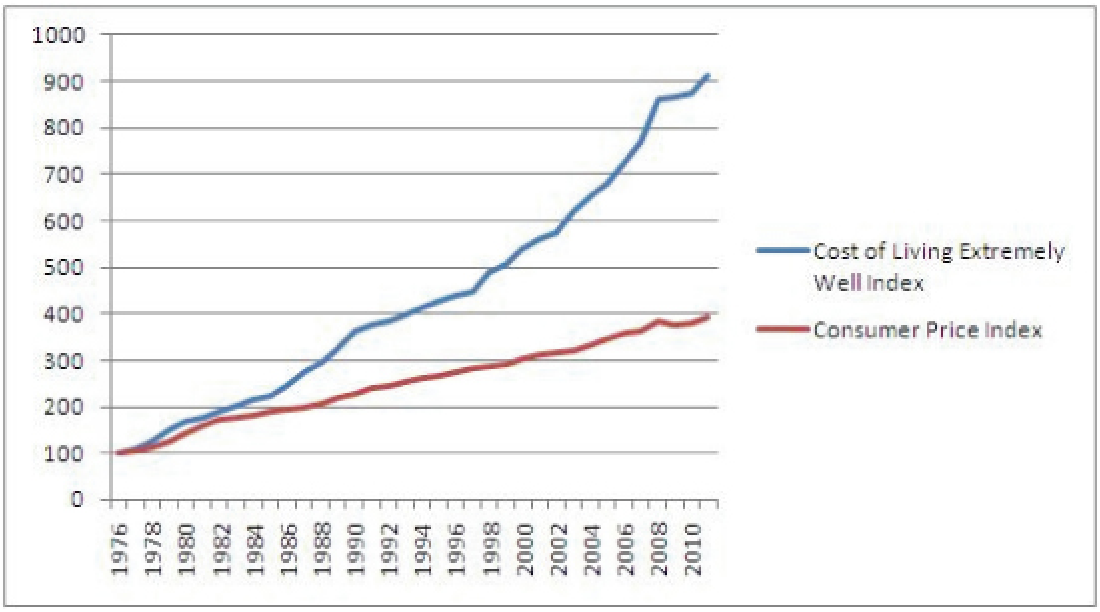
# The Insolent health of the luxury sector: a false paradox

By Jean-Luc Gaffard

The luxury industry has been spared the spreading crisis, which in the media’s eyes seems to be posing a paradox. This situation in fact corroborates the diagnosis that rising inequality is the true breeding ground of the crisis.

LVMH, the global leader in the luxury sector, saw its sales jump 26% in the first half of 2012. Richemont, the global number two and owner of such brands as Cartier, Montblanc, Van Cleef & Arpels and Jaeger-LeCoultre, saw its operating income increase by 20% during the second half-year ending 30th September. The Italian firm Prada announced a 36.5% increase in its turnover in the first half of 2012 (37.3% in Europe). The luxury division of PPR, the other French company in the sector, saw sales go up by 30.7% in the first half year.

These results contrast sharply with the situation in other industries. They are the result of a rise in prices that is nothing less than staggering. The price index for luxury goods as calculated since 1976 (the "Forbes Cost of Living Extremely Well") rose 800% in 35 years, compared with 300% for the price index for consumer goods.




In an article on the subject ("The more expensive the product, the more desirable", 8 August 2012), *Le Monde* reported that the price of a Burberry gabardine raincoat has multiplied by 5.6 and that the price of a Rolex YachtMaster has rocketed from 5,488 to 39,100 euros. These soaring prices simply reflect the great and growing willingness to pay of the richest strata, for whom price is simply a mark of differentiation and desirability.

In these circumstances, the stock market success of companies in the luxury industry is hardly surprising. Nor is it surprising to see the stock market success of companies at the other end of the spectrum, those that produce low-end, cheap goods. This effect, called the hourglass effect, is starkly revealing of the reality of the crisis, which is clearly rooted in widening inequalities in income and wealth.

The healthy state of luxury firms, which are creating jobs at a time of rising unemployment, is obviously a source for rejoicing. But if we simply left things at this remark about the sector, we would be missing the essential point. First, it must be recognized that the industries in question are responding to higher demand much more by raising prices, and not the quantities produced, for the simple reason that the number of wealthy people, even if growing significantly with the arrival of the nouveaux riches in China and elsewhere, is still limited. We are a long way from the fundamental mechanism driving growth, whereby gains in productivity push prices down and have an impact on income that is substantial enough to stimulate demand on an ever increasing scale. We also have to recognize the other side of the coin of this genuine increase in inequality, namely, the fall in median income and the corresponding weakening of the large middle class, whose demand for midrange products and services was a foundation for growth.

It is also worth noting recent trends in the luxury industry, which has successfully striven to produce brands that are lower cost versions of goods that were previously reserved for the rich. As shown by some studies, the diversification of the luxury industry is being accompanied by a sociological change indicating that middle-class households are developing a greater preference for these types of goods (see J. Hoffmann and I. Coste-Manière, *2012 Luxury Strategy in Action*, Palgrave Macmillan). This might be a long-term development if it is remembered that preferences are not homothetic, in other words, that lower incomes are not leading back to the map of preferences as it existed previously (before incomes had increased). Many households are trying to maintain the kind of consumption that they have become accustomed to, ultimately at the cost of higher indebtedness, if by chance that is permitted by the financial system. However, the business segment preserved in this way may prove to be fragile, and the performance of the luxury industry could continue to be driven by the conspicuous consumption of genuine luxury products. It is not surprising, then, to observe that, with the continuation of the crisis and its consequent impact on the consumption of the middle class, a company like PPR is planning to hive off certain brands, notably FNAC, in order to focus on the luxury segment.

There is nothing paradoxical about the insolent health of the luxury industry. It goes hand in hand with the heightening difficulties facing industries and companies whose products and services are intended for those on middle-incomes. The constantly increasing divergence in performance between industries and firms depending on their positioning range is merely another sign of a deepening crisis.

# The governance of public finances: from the Fiscal pact to France's Organic law

by Henri Sterdyniak

So the French government has had Parliament enact an "Organic law relating to the planning and governance of public finances" (*loi organique relative à la programmation et à la gouvernance des finances publiques)*, which translates into French law the European Fiscal pact (the Treaty on stability, coordination and governance) that France had made a commitment to ratify. This Law can be assessed from two points of view: from the perspective of how well it conforms to the Treaty or from the viewpoint of its own relevance, *i.e.* will it improve France's fiscal policy?

In fact, the government has chosen – as the Constitutional Council had provided it with the possibility of so doing – a minimalist approach to taking into account the Treaty. The new budgetary procedure is not incorporated into the Constitution, and as we shall see, the Treaty provides for certain automatic binding procedures that the Organic law tempers or does not mention.

The Organic Law has three sections, dealing respectively with the budget plan (*loi de programmation des finances publiques – LPFP*), the High Council on the Public Finances (*Haut Conseil des finances publiques*), and a correction mechanism.

**The Budget Plan**

Article 1 of the Organic Law stipulates: "In accordance with the objective of balanced government accounts as set out in Article 34 of the Constitution, the LPFP sets the medium-term targets of the government administrations referred to in

Article 3 of the TSCG.”

Article 34 of the Constitution, adopted on 31 July 2008, set out only a medium-term non-binding target. It has had little influence on the fiscal policy adopted since then. In times of crisis, the multi-year guidelines quickly cease to have an influence. This was the case, for example, in 2009. The 2009 deficit, which was set at 0.9% of GDP by the four-year budget plan passed in January 2008, and 3.9% of GDP according to the January 2009 plan, ultimately amounted to 7.5%. Should we give up this flexibility?

Moreover, how can the budget plan “set a target” when the target flows from Article 3 of the Treaty, which clearly states that the target should be a structural deficit of less than 0.5% of GDP and that a path for an adjustment to ensure a rapid convergence toward equilibrium will be proposed by the European Commission?

Doesn’t the ambiguity of this article actually reflect an attempt to reconcile the irreconcilable: the sovereignty of Parliament in budgetary matters with France’s commitment to follow the recommendations of the Commission?

Article 1 of the Organic Law continues: “The budget plan (LPFP) determines the trajectory of the successive annual actual balances and structural balances… The structural balance is the cyclically-adjusted balance net of one-off and temporary measures.” Article 3 states that the period covered is at least three years.

Thus, the Law takes no account of the experience of the Stability and Growth Pact (SGP): it is impossible to fix a trajectory for the public finances, in terms of the structural and actual deficit, for a period of three years. In January 2008, France was committed to having a balanced budget in 2012. It won’t even get close. Should commitments be made that are impossible to keep?

This is impossible for two reasons. First, unpredictable economic fluctuations make it necessary to constantly adapt economic policy. In case of a deep crisis, as since 2009, it is necessary to make use of both economic stabilizers and discretionary measures (which increase what is called the structural deficit). If taken seriously, the Treaty prohibits any policy to boost activity during a downturn in activity. In the autumn of 2008, according to the Commission France had a structural deficit of 3.2% of GDP. If the Treaty had been in force, it would have had to reduce this quickly to 2.5% in 2009. In fact, France has moved to a structural deficit of 6% of GDP, according to the Commission's assessment, in other words, 3.5 percentage points higher. Is the government wrong to have promoted activity, or to have come to the rescue of the banks? Should it have embarked on a tough austerity policy to offset the fall in tax revenue?

The text is, of course, ambiguous. On the one hand, it sets out that the structural deficit does not include "one-off and temporary" measures. Assistance to banks is undoubtedly a one-off, but why not all the 2009 stimulus measures, or in the opposite direction, the 75% income tax assessment which is scheduled for 2 years? Who decides? On the other hand, the Treaty recognizes that a country may deviate from its target or its adjustment path in the event of "exceptional circumstances" which, since the revision of the Growth and Stability Pact, can be interpreted as negative growth or a large output gap. However, the Commission refuses to recognize that most euro zone countries have actually been in this situation since 2009, and it is insisting on imposing rapid deficit reduction policies on them.

On the other hand, a State has no economic reason to set itself a standard for balancing the public purse. According to the true "golden rule of public finance", which was stated by the economist Paul Leroy-Beaulieu in the late nineteenth century, it is legitimate to finance public investment through debt. In the case of France, a structural deficit of around 2.4% of GDP is legitimate.

As in the Treaty, Article 1 of the Organic Law refers to the structural balance, the balance that would exist if France were at its potential output, the maximum output consistent with stable inflation. But the size of this potential output, which cannot simply be observed, is a subject of debate among economists. Different methods produce different results, which are subject to sharp revisions. France's structural balance in 2012 is 3.6% according to the French government, 3% according to the European Commission, 2.8% according to the OECD, and according to us 0.5%, since the crisis has caused us to lose 8% of GDP compared to our growth trend. The Treaty requires the use of the Commission's method. Is this scientifically legitimate? Can France call into question this assessment?

Article 5 states that the potential growth assumptions should be presented in an appendix, but the definition of potential growth is even more questionable than that of potential output. For example, the latest budget bill (*projet de loi de finances – PLF*) expects potential growth of 1.5% per year up to 2017 for France, thus abandoning forever the expectation of making up the 8 points of activity lost to the crisis.

The Organic Law simply forgets Article 4 of the Treaty (which requires a country with a debt of over 60% of GDP to reduce the gap by one-twentieth per year). It also ignores Article 5, which states that a country subject to an Excessive Deficit Procedure (EDP) is to be placed under supervision, and has to submit to the EU Council and Commission annual budget plans and a list of the structural reforms that it will implement in order to make a sustainable correction to its deficit. It is this article that obliges France, like many other EU countries, to do all it can to get down to a 3% deficit by 2013, regardless of the economic situation, since, in case of an EDP, the constraint pertains to the actual balance and not the structural balance. It forgets Article 7, which states that, in this context, the decisions of the Commission are obligatory (member countries can oppose it only with a qualified majority, with the country concerned not voting).

The LPFP will cover a period of four to five years, but will be voted upon again each year, so that the constraint thus introduced can be changed by a vote on a new budget plan. This has been the case in France for as long as the Fiscal Pact has existed. Thus, the LPFP does not introduce any supplementary constraint itself, other than what is already required by European legislation.

**The High Council of Public Finance**

The Organic Law sets up a High Council of Public Finance, which will advise on the macroeconomic forecasts underlying the budget bill (LPF), the bill financing social security, the adjustment budget bills, the stability program that France must provide to the European authorities, and the budget plan (LPFP). It will assess whether France has been meeting its European commitments, and verify that the LPF (budget bill) is consistent with the trajectory announced in the budget plan (LPFP). It will give its opinion on any evocation of “exceptional circumstances”.

Chaired by the President of France’s Court of Audit (Cour des comptes), the High Council consists of four members from the Court of Audit and four members appointed for their expertise in public finance by the Presidents of the National Assembly, the Senate and the two finance commissions. This predominance of the Court of Audit is problematic. The judicial officers from the Court of Audit are not *a priori* experts in macroeconomics, and they are often, based on their function, more concerned with balancing the public finances than with growth and employment. For instance, the latest reports from the Court of Audit underestimate the output gap, support the thesis that the fiscal multiplier is close to zero, and believe that it is better to reduce public spending than to increase taxes. We would like to be certain that the composition of the High Council and its work and reports reflect the diversity of opinion that exists on fiscal policy.

More fundamentally, it is questionable whether the High Council has room for flexibility in its assessments. Will it have the right to conclude that the path of adjustment is too restrictive, and that the medium-term objective is not realistic? What strategy will be advocated by the High Council in the event of an economic slowdown: an expansionary policy to support growth or an austerity policy to restore the public finances?

Assume, for example, that the government has a budget for 2013 based on growth of 1.2%, resulting in a deficit of 3%. The High Council believes that growth will instead be only 0.6%, causing a decline in tax revenues, and thus a deficit of 3.3%. It will advocate doing whatever is necessary to achieve a 3% deficit. Assuming that the fiscal multiplier is 1, it will be necessary to come up with 12 billion in tax increases (or spending cuts), or 0.6% of GDP, to have an *ex post* deficit of 3%, but no growth. There is thus a great risk that this will lead to pro-cyclical policies. This will of course be mitigated when France is longer be subject to an EDP, as the High Council can then reason in terms of the structural deficit, but this will persist because everything will then depend on evaluating the structural deficit.

Lastly, there is the question of what legitimacy the High Council will have. The choice of fiscal policy must be subject to democratic procedures. The assessment of economic policy is part of a scientific, democratic debate. Should it be entrusted to a High Council, composed mainly of judicial experts, rather than economists on the one hand and representatives of the nation on the other?

The High Council will of course only give advice, which neither the government nor parliament are obliged to follow, but the risk is great that these opinions will affect the financial markets and the Commission and that it would be risky for the government to ignore them.

**The correction mechanism**

To ensure that countries do indeed follow the adjustment path, the Treaty requires countries to provide an automatic correction mechanism if deviations are observed with respect to this path. In the minds of the negotiators of the North European countries and members of the Commission, this mechanism should provide that if a deviation of 1% of GDP is seen in year N, the Constitution provides that, automatically, a certain tax (*e.g.* VAT) would be raised by 0.5 GDP point and certain expenditures (*e.g.* social benefits) would be reduced by 0.5 GDP point.

In fact, Chapter 3 of France’s Organic Law provides that the High Council is to report such a gap, the government is to set out the reasons for this discrepancy and then take it into account in drawing up the next budget bill. Parliament’s rights are respected, but fortunately the character of being automatic is not guaranteed.

**Conclusion**

In the spirit of its founders, the fiscal treaty must put an end to the possibility of autonomous national fiscal policies. Fiscal policies should become automatic. The goal of fiscal policy should be balancing the budget, just as the goal of monetary policy should be fighting inflation; growth and employment are to be sought by means of free market structural reforms.

The Organic Law seems to be an ambiguous compromise. France is ratifying the Treaty, but implementing it only reluctantly. It’s a safe bet that, as with the Stability Pact, there will be great tension in the euro zone between purists who demand the strict application of the Treaty and those who do not want to sacrifice growth to it.

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# The crisis in the United Kingdom: are women less affected than men?

By Hélène Périvier

In most European countries the crisis has hit the employment of men more than women. The United Kingdom is no exception: in the population aged 15 and older, between 2008 and 2011 men’s employment declined by 1.6%, against a loss of only 0.3% for women. One could therefore conclude that women have been better sheltered than men from the storm that is battering the labour market in the UK, and more generally in Europe. In absolute terms this is indisputable, but from a larger perspective nothing is less certain.

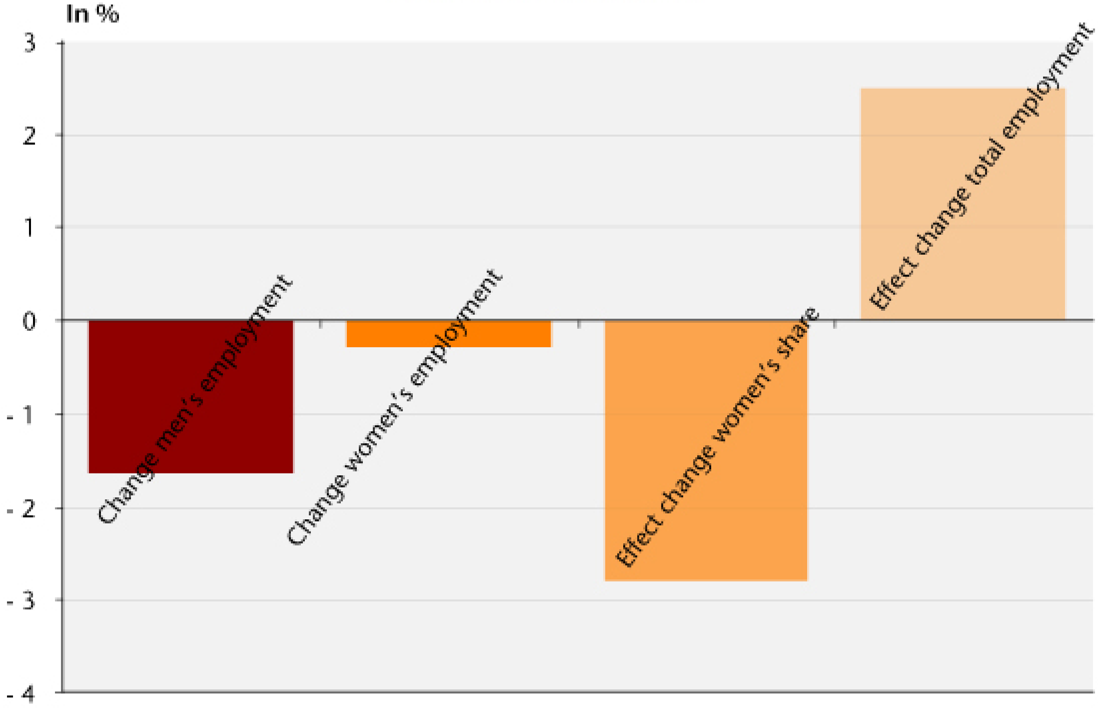
The gendered impact of the crisis on employment is largely due to the segmentation of the labour market: women and men are not involved in the same sectors of activity; the sectors in which women are over-represented have been less affected by the crisis because of the nature of these jobs. In the UK, women hold 78% of the jobs in “Health care and social work” and 72% in the field of ▯▯”education”. These fields rely heavily on public or semi-public sector employment and are less exposed to the vagaries of the economic cycle: between 2008 and 2011, employment in the “health and social work” sector increased by almost 8%, and over 12% in education. Conversely, women represent only 11% of workers in construction and 14% in industry, the sectors that have borne the brunt of the job cuts (respectively, -19.6% and -17.3% over the same period). Women thus appear to have been protected from the effects of the crisis in employment due to their over-representation in sectors where employment is less responsive to economic fluctuations. The story could end there, but things are never as simple as they seem, because this explanation remains valid only if the proportion of women in each sector had remained the same during the crisis. But it hasn’t.

A statistical breakdown of changes in employment can help to distinguish what part of the change in employment is due to the change in total employment and what part is due to the change in the proportion of women in each sector. It is clear from Figure 1 that if the proportion of women in each sector had remained constant between 2008 and 2011, then women’s employment would not have decreased by 0.3% over the period but instead would have increased by 2.5%; the decline in the employment of women over the period, though low, is due to a change in their share in certain sectors.

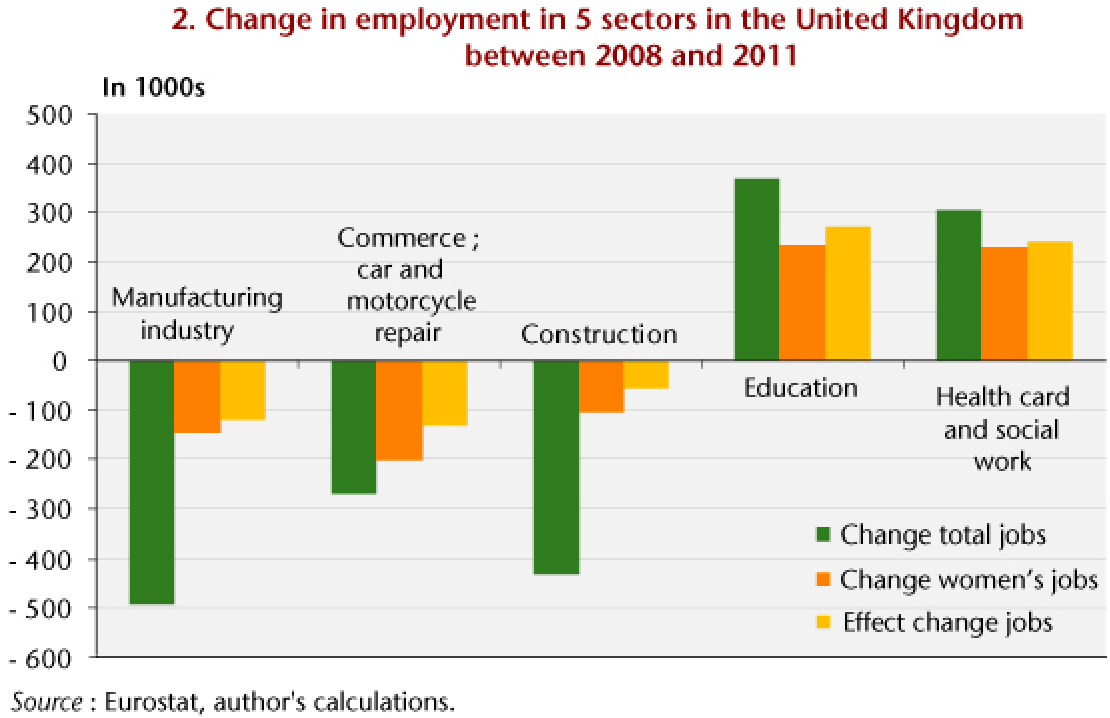
If we look more closely at the sectors that weigh more heavily in the total number of jobs, we find that in construction and industry women were more affected by job cuts then they should have been given their under-representation in these sectors in 2008. In particular, the collapse of employment in construction and industry has disproportionately affected women. The sectors where women have a heavy presence benefited on the contrary from strong job creation from 2008 to 2011: 370,000 more jobs in education and almost 305,000 more in health care and social work. But the jobs created did not benefit women as much as they should have given their share in these types of activity in 2008. Figure 2 shows that in education, the number of jobs held by women would have increased by 271,000 if their share in education had remained the same, whereas the number of additional jobs between 2008 and 2011 that went to women was only 231,700.

In summary, then, in sectors hit especially sharply by the crisis women were over-affected by the job destruction, and in sectors where employment remained dynamic they benefited less than they should have. So ultimately, in terms of absolute employment women suffered less than men, but relatively speaking they were affected more. The segmentation of the labour market that has a significant effect on job equality between men and women has not proved to be an effective shield for women's employment during the crisis.

1. Breakdown of changes in employment in the United Kingdom between 2008 and 2010




*Source* : Eurostat, author's calculations.

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# Does inequality hurt economic performance?

By [Francesco Saraceno]

Economic theory has long neglected the effects of income distribution on the performance of the economy. Students were taught right from Introduction to Economics 101 that the subject of efficiency had to be separated from considerations of equity. The idea is that the size of the cake had to be expanded to the maximum before it is shared. It was implicit in this dichotomy that economists should address the issue of efficiency and leave the question of distribution (or redistribution) to the politicians. In this framework, the economist's role is simply to ensure that choices about the channels for redistribution through taxation and public spending do not affect growth by interfering with the incentives of economic agents. Echoes of this view can be found both in the debate about the taxation of very large incomes envisaged by the French Government as well as in authors like Raghuram Rajan who justify inequality with references to technical progress and international trade, a view refuted by Paul Krugman.

Since the work of Simon Kuznets in the 1950s, some economists have of course questioned whether excessive inequality might not inhibit economic growth, in particular by blocking the accumulation of human capital. But this has long been a minority view among economists. Indeed, the dramatic increase in inequality documented among others by Atkinson, Piketty and Saez as well as by institutions such as the OECD and the IMF failed to give rise to a deep-going reflection about the relationship between inequality and economic performance.

It was the crisis that revived this concern. Growing inequality is now suspected of being a source of increasing household debt and speculative bubbles, leading to the accumulation of internal and external imbalances that have set off the current crisis. This is the argument developed by authors like Joseph Stiglitz and James Galbraith.

Today the dichotomy between efficiency and distribution is no longer tenable. Inequality is becoming an essential theme in economic analysis, for both the short and long terms. To stimulate discussion on this topic, the OFCE and the SKEMA Business School are holding a workshop on "Inequality and Economic Performance" in Paris on 16 and 17 October 2012.

# The crisis and market sentiment

By Anne-Laure Delatte

Fundamental factors alone cannot explain the European crisis. A new OFCE working document shows the impact of market beliefs during this crisis. In this study, we search for where market sentiments are formed and through what channels they are transmitted. What is it that tipped market optimism over into pessimism? Our results indicate that: 1) there is a strong self-fulfilling dynamic in the European crisis: fear of default is precisely what leads to default, and 2) the small market for credit derivatives, credit default swaps (CDS), insurance instruments that were designed to protect against the risk of a borrower's default, is the leading catalyst of market sentiment. This result should be of great concern to the politicians in charge of financial regulation, since the CDS market is opaque and concentrated, two characteristics that are conducive to abusive behaviour.

What role do investors play during a crisis? If massive sales of securities reveal the weaknesses of a certain business model, then it would be dangerous to limit them: it would be killing the messenger. But if these massive sales are triggered by a sudden turnaround in market sentiment, by investors' panic and distrust of a State, then it is useful to understand how market beliefs are formed so as to better control them when the time comes.

To answer this question in the context of today's European crisis, we have drawn on work on the crisis in the European Monetary System (EMS) in 1992-93, which has many common features with the current situation. At that time investors were skeptical about the credibility of the EMS and put it to the test by speculating against European currencies (*sic*). The pound sterling, the lira, the peseta, etc., were attacked in turn, and governments had to make concessions by devaluing their currency. At first this crisis puzzled economists, as they were unable to explain the link between the speculative attacks and fundamentals: firstly, the countries under attack did not all suffer from the same problems, and secondly, while the economic situation had deteriorated gradually, why had investors decided all of a sudden to attack one currency and not another? Finally, why did these attacks succeed? The answer was that the speculation was not determined solely by the economic situation (the “fundamentals”) but was instead self-fulfilling.

The same may well be the case today. If so, then the crisis in Spain, for example, would have its roots in the beliefs of investors: in 2011, as Spain had been designated the weakest link in the euro zone, investors sold their Spanish securities and pushed up borrowing rates. Interest payments ate into the government accounts, and the debt soared. Spain’s public deficit will be higher in 2012 than in 2011 despite its considerable austerity efforts. The crisis is self-fulfilling in that it validates investors’ beliefs *a posteriori*.

How could this be proved? How can we test for the presence of a self-fulfilling dynamic in the European crisis? Our proposal is as follows: market beliefs must be a critical variable if, given the same economic situation, investors nevertheless require different interest rates: when the market is optimistic, the difference in interest rates between Germany and Spain is less than when the market is pessimistic.

Our estimates confirm this hypothesis for a panel consisting of Greece, Ireland, Italy, Spain and Portugal: without any significant change in economic conditions, interest rate spreads rose suddenly following a change in the beliefs of the market.

The next question is to understand where these market beliefs are formed. We tested several hypotheses. Ultimately it is the market for credit default swaps (CDS) that plays the role of the catalyst of market sentiments. CDS are insurance products that were originally designed by banks to ensure against the possibility of a borrower's default. An investor who holds bonds may guard against the non-reimbursement of their security at maturity by buying a CDS: the investor then pays a regular premium to the seller, who agrees to repurchase these bonds if the borrower goes bankrupt. But this insurance instrument quickly became an instrument for speculation: the vast majority of operators who buy CDS are not actually owners of an underlying bond (underlying in financial jargon). In reality, they use CDS to bet on the default of the borrower. It is as if the inhabitants of a street all insured the same house, but did not live in it, and are hoping that it catches fire.

However, our results indicate that it is precisely in this market that investors' beliefs vis-à-vis the debt of a sovereign country are formed. In an environment marked by uncertainty and incomplete information, the CDS market transmits a signal that leads investors to believe that other investors "know something". Given equivalent economic situations, our estimates indicate that investors require higher interest rates when CDS spreads increase.

To summarize, some European countries are subject to self-fulfilling speculative dynamics. A small insurance market is playing a destabilizing role, because investors believe in the information it provides. This is troubling for two reasons. On the one hand, as we have said, this instrument, the CDS, has become a pure instrument of speculation. On the other hand, it is a market that is unregulated, opaque and concentrated – in other words, all the ingredients for abusive behaviour … 90% of the transactions are conducted between the world's 15 largest banks (JP Morgan, Goldman Sachs, Deutsche Bank, etc.). Furthermore, these transactions are OTC, that is to say, not on an organized market, *i.e.* in conditions where it is difficult to monitor what's going on.

Two avenues of reform were adopted in Europe this year: on the one hand, a prohibition against buying a CDS if you do not own the underlying bond – the law will enter into force in November 2012 throughout the European Union. Second is a requirement to go through an organized market in order to ensure the transparency of transactions. Unfortunately, neither of these reforms is satisfactory. Why? The answer in the next post…

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# How France can improve its trade balance*

By Eric Heyer

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

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

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

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

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

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

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

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

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

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

# Who will pay the bill in Sicily?

by Augusto Hasman and Maurizio Iacopetta

Rumors of a Sicily's possible default are in the air again. The employees of the Sicilian parliament did not receive their checks at the end of September.  Another possible default of Sicily made already the international headlines in July (see the New York Times 22/07/12) due to the contagion effects it could have had on other regions.  But in that occasion, the central Italian government prevented Sicily's default by providing an immediate injection of liquidity in the order of 400 million euros.

Other Italian regions are in trouble*.* In recent months the provision of basic health care services has deteriorated; regions are renegotiating contracts with their creditors to obtain deadline extensions. The figures reported by Pierre de Gasquet in *Les Echos* of 02/10/2012, give a good idea of the deterioration of the Italian regional public finance over the last decade.

It will take a good deal of imagination for regional governments to come out of the impending budget crisis, not only in Italy but also in other  European countries that have difficulties in managing their public debts, such as Spain, Ireland and Greece.

In recent weeks we learned that some local politicians are endowed with a good deal of creativeness, but they hardly use it to find a solution to the budget crises.  The governor of the region Lazio –where Rome is located – resigned a few days ago in the midst of a political scandal due to revelations that members of the regional parliament funneled electoral funds to pay extravagant personal expenses, including car upgrades and luxury vacations.

Why don't regional governments issue their own money to finance public expenditures? It may seem absurd that now that European countries have finally accepted a common currency, regional and possibly local governments might be tempted to create some sort of fiat money. But historically it would not be the first time that local monies emerge when the central government has its hands tight.

Argentina in the early 1990s (convertibility law n° 23.928, 27/03/1991) pegged the currency on a one-to-one basis with the U.S. dollar (See Anne-Laure Delatte's article on this blog for a parallel between the Argentinean events and hypothetical scenarios for Greece.). For most of the decade, things seemed to be working well; the economy was growing at the impressive annual rate of almost 5.7%, notwithstanding (or perhaps thanks to) the fact that Argentina, in practice, gave up the monetary policy instrument. But by 1998, the load of public debt started to become unbearable.  Financing it by printing money was out of question. The IMF was called for help to prevent the panic of Argentinean savers.  It granted a loan of 40 thousands million dollars but it also asked the government to impose a severe austerity plan, which had, among many effects, that of depriving provinces under financial difficulties from the prospect of being rescued by the central government.

It was at this point, in 2001, that a number of provinces began to print their own money in order to pay wages and current expenses. (Krugman's open editorial of ten years ago at the New York Times – Crying with Argentina, 01.01. 2002 – gives a fresh reading on the unfolding of the events). Fifteen out of twenty-two provinces ended up using newly issued interest-bearing notes, which earned the name of 'quasi-money'. At the beginning, thanks to an agreement between provinces and large stores, quasi-money had a high level of acceptability. Indeed, competition led more and more stores to accept the quasi-money. Local trade seemed to resuscitate. In August 2002, 5 thousands million pesos of quasi-money circulated side-by-side with 12 thousands million of (real) Argentinean pesos.

Interesting, although the case of Argentina seems very surprising, the academic literature has always been puzzled of why it does not happen more often. The question is why government non-interest bearing banknotes circulate side-by-side with government bonds that promise an interest. In principle the phenomenon defies an elementary no-arbitrage principle.

One of the first to pose the puzzle was Hicks in 1935 in a famous article by the title of 'A suggestion for simplifying the theory of money'. An answer to Hicks' puzzle was offered by Bryant and Wallace (1980). Their argument is based on observation that private banks are not allowed to slice large denomination government bonds in small denomination banknotes. If banks could issue their own small denomination notes that are fully backed by large denomination government bonds, then, competition among banks would presumably drive the return on private banknotes in line with the return on bonds. If interest rates on bonds are positive, the argument goes, the demand for non-interest bearing money should then fall to zero. For Bryant and Wallace only the legal restriction on intermediation would prevent this from happening.

But Makinen and Woodward (1986) report that, during the period from 1915 to 1927, French government treasury bonds circulated at a relatively small denomination of 100 Francs (roughly 50-60 euros of today). The bonds were issued with terms of 1 month, 3 months, 6 months, and 1 year. These bonds were continuously available to all banks (including branches of the Bank of France), post o□ces, and numerous local o□ces of the Finance Ministry. This historical episode casts some doubts on the legal hypothesis, for the Bank of France kept issuing Francs.

Why then in Argentina bonds emerged as money – albeit for a limited period? It seems to us that the key was the promise offered by the issuer to accept the regional bonds in settling a debt – typically a tax obligation. The rules on what the regions can and cannot do in Europe are different from country to country. In Italy for instance regions, provinces, and municipalities have been authorized to issue bonds by the law of ‘rationalization of public finance’, introduced in the first half of the 1990s (art. 32 of the law of 8.6.1990 n.142, for municipalities and provinces, and art.35, law 23.12.1994 n. 724). The law set several conditions for an administration to qualify to issue bonds. First, bonds can be issued only to finance investment projects. The law explicitly forbids the issue of bonds to finance current expenditures. Second, the issuer has to demonstrate a good history of balanced budgets. Third, the maturity of the bonds cannot be shorter than five years. Fourth, the bonds cannot go in direct competition with the central government bonds, namely cannot be offered a real return above the one offered by the central government for bonds with similar maturities. Fifth, the central government is not allowed to back-up bonds of the regions who, in turn, cannot take responsibility for the bonds issued by provinces or municipalities

Is it desirable to relax these conditions? Perhaps it is useful to see the end of the story in Argentina –not particularly that of a Hollywood movie. The acceptability of quasi-money outside the region that issued it was very low. More importantly, the central government did not allow tax payers to use quasi-money for their federal taxes. Consequently, in a few months the de-facto exchange rate between the quasi-money and the national currency dropped from 1 to around 0.7 – it was somewhat higher for Buenos Aires quasi-money, for this was accepted in many other provinces.

At the beginning of 2002, a new government, presided by Eduardo Duhalde, decided to abandon the convertibility law.

As a result, the exchange rate of the pesos vis-à-vis the U.S. dollar dropped from one to four. During that year, the GDP declined 10.9%.

Having gained the power of printing money again, the central government allowed quasi-monies holders to convert them into the devalued national peso. The short run benefits evaporated soon. The recession along with the depreciation slashed the purchasing power of the working class. At the end of the crisis, the national product was about a quarter lower than its 1998 level, and the rate of unemployment shot up to 24%. It appears that issuing of local money delayed the collapse of the financial system, but it is unclear whether the temporary breath gained by local administrators that issued bonds made the subsequent recession less severe. The case of Argentina suggests, nevertheless, that a major relaxation of the current constraints of regional and municipal entities is not going to help solve how to guarantee the provision of health care service in the long run. Nonetheless, the current policy of cutting basic public services indiscriminately is the least imaginative of the solutions.  Alesina and Giavazzi in an open editorial published on Corriere della Sera on Sept 27, suggested that hospitals could charge health care users directly instead of being reimbursed by the regional authorities. By doing so, they argued, not only the quality of the service would improve, but regions would need fewer resources. Although this is food for thought, in the U.S. such a system generated a colossal profit making machine that contributed to the explosion of the health care costs. Similarly, Fitoussi and Saraceno (2008) argue that the spectacular gain in income of the last three decades in China did not go hand-in-hand with similar gains in life expectancy and quality of health care, because the government opted for a health care system based on out-of-pocket expenses.

The Argentinean experience tells us that local administrators in distressed regions of Europe are going to lobby the government to give more freedom in managing their budget intertemporally – something that is already happening in Spain, and is summarized in the London School of Economics blog by K. Basta . They are also probably going to make more intensive use of 'creative accounting', so as to prolong their serving time in office. But this will not be the solution. A major reassessment of the national government's priorities in combination with a sensible monetary policy at the European level is the only way out. We badly need to free up resources to revitalize the public educational system and to maintain the overall good standard of public health care services.

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