

# Fiscal reform: Now or never\*

By Nicolas Delalande (*Centre d'histoire at Sciences Po*)

While the question of taxation was one of the major economic issues of the presidential election, it must not be forgotten that there often exists a gap between the political and media attention received by a set of campaign promises (what political scientists would call the “politics”) and their practical implications in terms of public policy (the “policies”). It is also worth asking whether any such tax reform will actually take place.

For over a year, commentators and politicians have repeatedly argued that taxation would be a key question in the presidential election. Many saw it as one of the only real issues distinguishing the outgoing majority, which with the TEPA law of August 2007 had bet on a strategy of “fiscal shock” to unleash growth (50% cap on taxes, reduction of inheritance taxes, exemption of overtime, etc.), from the Left opposition, which has been quick to denounce the injustice and inefficacy of measures that undermine progressive taxation without obtaining the expected economic benefits, while deepening the deficit. The promise of reform, or even a tax “revolution”, was high on the political agenda, particularly for the Left. However, intense conflicts and debates over taxes do not guarantee that the election of Francois Hollande will be followed by a genuine transformation of the French tax system. There may very well be a gap between the political and media attention received by campaign promises (the “politics”) and their practical implications for public policy (the “policies”). However much tax reform may be touted during the campaign, it may well be distinctly less popular when it comes time for implementation, when political will runs up against varied forms of sometimes unanticipated resistance.

There has, nevertheless, been a felt need almost everywhere in

Europe to increase the taxation of the wealthy, not so much to solve the problem of government deficits as to restore a semblance of fairness and shared effort in a time of economic crisis. A number of countries have embarked on this path (the top marginal rate of income tax is 57% in Sweden, 50% in Britain, and 45% in Germany), even though some have already sounded the retreat (David Cameron's Conservative government has proposed cutting the top marginal rate back to 45% in 2013). Even billionaires like Warren Buffett in the United States have called for raising taxes on better-off strata to put an end to the most blatant inequalities. This kind of reform actually consists of backing off the policies of the last fifteen to twenty years by reversing the trend to erode the progressivity of the tax system: strictly speaking, this is less a matter of reform than of cancelling previous reforms. Increasing tax revenue no longer results as before from creating new tax measures but from removing the tax reductions and exemptions enacted in recent years. Hence the debate, both in the US and Europe, over the real nature of the "tax increases": the Republicans accuse the Democrats of increasing the tax burden, while the latter claim to be merely reversing exemptions that they consider unwarranted and inefficient. Reform thus amounts to nothing more than the restoration of the situation *ex ante*. In France, for example, the Socialists have pledged to cancel what remains of the tax package of 2007 (after having removed the tax cap in 2011), to significantly reduce tax loopholes and to establish a new income tax bracket: the reference point for these proposals is in fact the actual system as it existed only five to ten years ago, with the exception of the promise added during the campaign to create an exceptional 75% bracket on incomes of over 1 million euros.

A more ambitious structural reform, for example along the lines proposed in the recent [book](#) by Camille Landais, Thomas Piketty and Emmanuel Saez, would involve an entirely different scale. Opening the "black box" of the redistribution machine

actually implies a much wider debate on the missions of the tax system, its administrative organization and its relationship to social and family policy. This is where the “costs” of policy reform, such as the eventual cancellation – or modulation – of France’s “family quotient” tax-splitting system, may be felt most directly. In any case, the erosion of the belief that the only reforms that could possibly be any good involve reducing the tax burden means that the current environment has never been more favourable for initiating this debate. The political, social and financial implications of this new configuration will certainly be complex and demanding in terms of democracy, but, in light of the numerous critics of the failings of the existing system, there is little doubt that 2012 offers a unique opportunity for undertaking ambitious reform. Tax reform implies the need for an effective political coalition to overcome the various social, institutional and technical obstacles that are likely to arise and to be able to take advantage of the favourable circumstances in which ideologies and beliefs that were thought to be firmly established are now on shaky ground. From a historical standpoint, it should not seem absurd that the current economic crisis, which is often compared to the 1930s, calls for and indeed even requires a renegotiation of the fiscal pact on a scale as significant as that experienced by Europe and America in the first third of the 20<sup>th</sup> century. The process of reform will, however, inevitably be more complex than before: the systems for collection and redistribution, now more sophisticated than ever, are based on an array of measures that have arisen in different periods and in unique political, economic and social contexts.

*\* This text is taken from the article [“The political economy of tax reform: a historical analysis”](#), which was published in a special Tax Reform issue of the OFCE Revue and is available on [the OFCE web site](#).*

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# Underlying deflation

[Christophe Blot](#), Marion Cochard, Bruno Ducoudré and [Eric Heyer](#)

A look at the latest statistics on price trends indicates that the risk of deflation seems to have given way to renewed inflation in the major developed countries. So do we really need to fear the return of inflation, or are these economies still structurally deflationary?

First, note that the nature and scale of the economic crisis we have been living through since 2008 are reminiscent of what led to past periods of deflation (the crisis of 1929, the Japanese crisis of the 1990s, etc.). The recessionary pattern that began in 2008 has followed the same path: the shock to activity led to a slowdown in inflation – and sometimes lower prices or wages – in most of the developed countries. However, a fall in prices is not necessarily synonymous with deflation: this has to be long term and, above all, it must be anchored in expectations and a vicious cycle of debt deflation. But this deflationary scenario did not materialize. Far from sitting by idly, at the end of 2008 governments and central banks took fiscal and monetary measures to stabilize activity and limit the rise in unemployment. Moreover, independently of the response by economic policy, price trends were strongly influenced by changes in commodity prices. While the collapse in oil prices in the second half of 2008 accelerated the deflationary process, the rise in prices since 2009 has fuelled more general price rises and held off the risk of deflation. Moreover, business has partially cushioned the impact of the crisis by accepting cuts in margins, which has helped to mitigate rising unemployment, a key factor in the deflationary process.

In a study by the OFCE published in its journal of forecasts ([Prévisions de la Revue de l'OFCE](#)), we start from a wage-price model to develop a method for assessing the way that oil price dynamics and labour market adjustments affect changes in inflation. We show that if oil prices had continued their upward trend after they peaked in the summer of 2008, and if the adjustment on the labour market had been, in all countries, the same as in the US, then the year-on-year change in inflation in second quarter 2011 would have been lower, by 0.7 points in France to 3.4 points in the UK (Table 1). This confirms that these economies are still structurally deflationary.

Despite the central banks' repeated efforts at quantitative easing, they need not fear the return of inflation. The macroeconomic environment is still characterized by a risk of deflation, and therefore by the need for an accommodative monetary policy.

## Impact of shocks on consumer prices

Year-on-year change

	Impact on the inflation rate...	2010				2011	
		Q1	Q2	Q3	T4	Q1	Q2
Germany	... of the speed of productivity adjustment	0.3	0.5	0.6	0.8	0.8	0.8
	... of the change in oil prices	0.0	0.2	0.2	0.3	0.4	0.4
	Total impact	0.3	0.7	0.8	1.0	1.2	1.3
France	... of the speed of productivity adjustment	0.0	0.0	0.0	0.1	0.1	0.1
	... of the change in oil prices	0.2	0.4	0.2	0.3	0.5	0.6
	Total impact	0.2	0.4	0.2	0.4	0.6	0.7
Italy	... of the speed of productivity adjustment	0.3	0.3	0.3	0.3	0.2	0.1
	... of the change in oil prices	0.6	0.8	0.6	0.5	0.6	0.6
	Total impact	0.8	1.2	1.0	0.8	0.8	0.8
Spain	... of the speed of productivity adjustment	0.0	-0.1	-0.2	-0.2	-0.3	-0.4
	... of the change in oil prices	0.0	0.3	0.3	0.3	0.4	0.5
	Total impact	0.0	0.2	0.1	0.0	0.1	0.1
UK	... of the speed of productivity adjustment	0.7	1.3	1.8	2.2	2.8	3.1
	... of the change in oil prices	0.1	0.1	-0.1	-0.1	0.1	0.3
	Total impact	0.8	1.4	1.7	2.2	2.9	3.4
USA	... of the speed of productivity adjustment	0.0	0.0	0.0	0.0	0.0	0.0
	... of the change in oil prices	0.5	0.4	0.1	0.0	0.2	0.4
	Total impact	0.5	0.4	0.1	0.0	0.2	0.4
Japan	... of the speed of productivity adjustment	0.6	0.8	0.9	1.0	1.1	1.2
	... of the change in oil prices	0.0	0.2	0.2	0.2	0.3	0.4
	Total impact	0.6	1.0	1.1	1.2	1.3	1.6

Source : National data, OFCE calculations.

# Less austerity = more growth and less unemployment

[Eric Heyer](#) and [Xavier Timbeau](#)

The European Commission has just released its [spring forecast](#), which anticipates a recession in 2012 for the euro zone ("mild" in the words of the Commission, but still -0.3%), which is in line with [the OFCE's economic analysis of March 2012](#).

The brutal fiscal austerity measures launched in 2010, which were intensified in 2011 and tightened even further in 2012 virtually throughout the euro zone (with the notable exception of Germany, Table 1 and 1a), are hitting activity in the zone hard. In 2012, the negative impact on the euro zone resulting from the combination of raising taxes and reducing the share of GDP that goes to expenditure will represent more than 1.5 GDP points. In a deteriorating fiscal situation (many euro zone countries had deficits of over 4% in 2011) and in order to continue to borrow at a reasonable cost, a strategy of forced deficit reduction has become the norm.

**Table 1. The euro zone in 4 macroeconomic aggregates from 2009 to 2012**

	2009	2010	2011	2012
GDP growth (%/yr)	-4,4	1,8	1,5	-0,4
Public deficit (% GDP)	-5,5	-5,5	-3,6	-2,9
Jobless rate (% active pop)	9,6	10,1	10,2	10,9
Fiscal impulse (% GDP)	1,7	-0,3	-1,1	-1,5

Sources : National accounts, OFCE calculations and forecasts.

This strategy is based on declarations that the 3% ceiling will be reached by 2013 or 2014, with balanced budgets to follow by 2016 or 2017 in most countries. However, these goals seem to be overly ambitious, as no country is going to meet its targets for 2013. The reason is that the economic slowdown is undermining the intake of the tax revenue needed to balance budgets. An overly optimistic view of the impact of fiscal restraint on activity (the so-called fiscal multiplier) has been leading to unrealistic goals, which means that GDP growth forecasts must ultimately be systematically revised downward. The European Commission is thus revising its spring forecast for the euro zone in 2012 downward by 0.7 point compared to its autumn 2011 forecast. Yet there is now a broad consensus on the fact that fiscal multipliers are high in the short term, and even more so that full employment is still out of reach (here too, [many authors](#) agree with the [analyses made by the OFCE](#)). By underestimating the difficulty of reaching

inaccessible targets, the euro zone members are locked in a spiral where jitters in the financial markets are driving ever greater austerity.

Unemployment is still rising in the euro zone and has hardly stopped increasing since 2009. The cumulative impact on economic activity is now undermining the legitimacy of the European project itself, and the drastic remedy is threatening the euro zone with collapse.

What would happen if the euro zone were to change course in 2012?

Assume that the negative fiscal impulse in the euro zone is on the order of -0.5 percent of GDP (instead of the expected total of -1.8 GDP points). This reduced fiscal effort could be repeated until the public deficit or debt reaches a fixed target. Because the effort would be more measured than in current plans, the burden of the adjustment would be spread out more fairly over the taxpayers in each country, while avoiding the burden of drastic cuts in public budgets.

Table 2 summarizes the results of this simulation. Less austerity leads to more growth in all the countries (Table 2a), and all the more so as the fiscal consolidation announced for 2012 intensifies. Our simulation also takes into account the impact of the activity in one country on other countries through trade. Thus, Germany, which has an unchanged fiscal impulse in our scenario, would experience an 0.8 point increase in growth in 2012.

**Table 2. Fiscal impulse of -0.5 GDP point in the euro zone in 2012**

	GDP (%/yr)		Public deficit (% GDP)		Jobless rate (% active pop.)	
	2011	2012	2011	2012	2011	2012
2012, under current plans	1,5	-0,4	-3,6	-2,9	10,2	10,9
2012, if 0.5% GDP impulse		1,7		-3,1		9,7

Note: The impulse is the change in the structural deficit. The structural deficit is the public deficit excluding the impact of the economic cycle. A negative impulse reflects a restrictive fiscal policy. Here the public («administrations publiques», or "APU") deficit includes the central state, regional government and social security agencies.

Sources: National accounts, OFCE calculations and forecasts.



In the “less austerity” scenario, unemployment would decline instead of continuing to increase. In all the countries except Greece, the public deficit would be lower in 2012 than in 2011. Admittedly, this reduction would be less than in the initial scenario in certain countries, in particular those that have announced strong negative impulses (Spain, Italy, Ireland, Portugal and ... Greece), which are the ones most mistrusted by the financial markets. In contrast, in some countries, such as Germany and the Netherlands, the government deficit would shrink more than in the initial scenario, with the indirect positive effect of stronger growth outweighing the direct effect of less fiscal consolidation. For the euro zone as a whole, the public deficit would be 3.1 percentage points of GDP, against 2.9 points in the initial scenario. It is a small difference compared to more favorable growth (2.1%), along with lower unemployment (-1.2 points, Table 2) instead of an increase as in the initial scenario.

The key to the “less austerity” scenario is to enable the countries in greatest difficulty, those most obliged to implement the austerity measures that are plunging their economies into the vicious spiral, to reduce their deficits more slowly. The euro zone is split into two camps. On the one hand, there are those who are demanding strong, even brutal austerity to give credibility to the sustainability of public finances, and which have ignored or deliberately underestimated the consequences for growth; on the other are those who, like us, are recommending less austerity to sustain more growth and a return to full employment. The first have failed: the sustainability of public finances has not been secured, and recession and the default of one or more countries are threatening. The second strategy is the only way to restore social and economic – and even fiscal – stability, as it combines a sustainable public purse with a better balance between fiscal restraint and employment and growth, as we proposed in a [letter to the new President of the French Republic](#).

**Table 1a. Details on the 4 macroeconomic aggregates for the euro zone from 2009 to 2012**

	GDP growth (%/yr)				Public deficit (% GDP)				Jobless rate (% active pop.)				Fiscal impulse (% GDP)			
	2009	2010	2011	2012	2009	2010	2011	2012	2009	2010	2011	2012	2009	2010	2011	2012
DEU	-5,1	3,6	3,1	0,3	-3,2	-4,3	-1,0	-1,1	7,8	7,1	6,0	5,5	0,7	1,2	-0,9	-0,3
FRA	-2,6	1,4	1,7	0,2	-7,5	-7,1	-5,2	-4,4	9,2	9,4	9,3	9,8	2,5	-0,7	-1,7	-1,7
ITA	-5,5	1,8	0,5	-1,7	-5,4	-4,6	-3,8	-2,8	7,8	8,4	8,4	9,4	0,8	-0,4	-1,0	-2,9
ESP	-3,7	-0,1	0,7	-1,1	-11,2	-9,3	-8,5	-6,5	18,0	20,1	21,7	23,5	4,1	-1,9	-1,2	-3,4
NLD	-3,5	1,6	1,3	-1,1	-5,6	-5,1	-5,0	-4,5	3,7	4,5	4,5	5,4	3,8	-1,5	-0,2	-1,9
BEL	-2,7	2,3	1,9	0,1	-5,8	-4,1	-4,0	-3,4	7,9	8,3	7,2	7,6	1,8	-0,3	-0,1	-1,4
PRT	-2,9	1,4	-1,5	-2,9	-10,1	-9,8	-4,0	-4,5	10,7	12,1	12,9	13,4	4,9	-0,6	-5,5	-3,0
IRL	-7,0	-0,4	0,7	-0,3	-14,4	-32,0	-10,1	-8,7	11,9	13,7	14,5	14,9	3,7	-4,1	-2,5	-3,0
GRC	-2,3	-4,4	-6,2	-5,3	-15,8	-10,6	-9,3	-7,3	9,5	12,5	17,2	19,5	3,4	-7,9	-5,6	-5,3
FIN	-8,4	3,7	2,8	0,7	-2,5	-2,5	-1,2	-0,9	8,8	8,4	7,8	7,5	0,4	-1,5	-1,1	-1,1
AUT	-3,6	2,5	3,0	0,4	-4,1	-4,4	-3,4	-3,0	4,8	4,4	4,2	4,5	0,4	0,6	-0,5	-1,2

Note: DEU Germany; FRA France; ITA Italy; ESP Spain; NLD Netherlands; BEL Belgium; PRT Portugal; IRL Ireland; GRC Greece; FIN Finland; AUT Austria.

Sources: National accounts, OFCE calculations and forecasts.

**Table 2b. Fiscal impulse of -0.5 GDP point in the euro zone countries in 2012**

	DEU	FRA	ITA	ESP	NLD	BEL	PRT	IRL	GRC	FIN	AUT
GDP growth rate (%/yr)	1,1	2,2	1,4	2,6	2,1	1,8	0,7	2,8	0,2	1,9	1,8
Difference with Table 1a	0,8	2,0	3,1	3,7	3,2	1,7	3,6	3,1	5,5	1,2	1,4
Of which: - direct impact	0,0	1,2	2,4	2,9	2,5	0,9	2,5	2,5	4,8	0,6	0,7
- impact via trade	0,8	0,8	0,7	0,8	0,7	0,8	1,1	0,6	0,7	0,6	0,7
Public deficit (% GDP)	-0,7	-4,6	-3,7	-7,5	-4,3	-3,4	-5,2	-9,7	-9,4	-0,9	-3,0
Difference with Table 1a	0,4	-0,2	-0,9	-1,0	0,2	0,0	-0,7	-1,0	-2,1	0,0	0,0
Jobless rate (% active pop.)	5,1	8,8	7,9	21,6	3,8	6,7	11,6	13,3	16,8	6,9	3,8
Difference with Table 1a	-0,4	-1,0	-1,5	-1,9	-1,6	-0,9	-1,8	-1,5	-2,7	-0,6	-0,7

Sources: National accounts, OFCE calculations and forecasts.

# A letter to President François Hollande

by Jérôme Creel, Xavier Timbeau and Philippe Weil [\[1\]](#)

Dear Mr. President,

France and the European Union are at a crucial economic juncture. Unemployment is high, the output loss to the financial crisis since 2008 has not been recovered and you have promised, in this dismal context, to eliminate French public deficits by 2017.

Your predecessor had committed to achieving the same objective a tad faster, by 2016, and a distinctive feature of your campaign has been your insistence that the major burden of the coming fiscal retrenchment be borne by the richest of taxpayers. These differences matter politically (you did win this election) but they are secondary from a macroeconomic viewpoint unless the long-run future of France and Europe depends on short-run macroeconomic outcomes.

In the *standard macroeconomic framework*, which has guided policy in “normal” and happier times, fiscal multipliers are positive in the short run but are zero in the long run where productivity and innovation are assumed to reign supreme. In such a world, giving your government an extra year to reduce public deficits spreads the pain over time but makes no difference in the long run. When all is said and done, austerity is the only way to reduce the debt to GDP ratio durably – and it hurts badly:

- The fantasy that short-run multipliers might be negative has been dispelled: a fiscal contraction depresses economic activity unless you are a small open economy acting alone under flexible exchange rates and your own national central bank runs an accommodative monetary policy – hardly a description of today’s France. Since France 2012 is not Sweden 1992, the prospect of a rosier fiscal future is not enough to outweigh the immediate recessionary effects of a fiscal contraction.
- To add insult to injury, if the financial crisis has lowered economic activity permanently (as previous banking or financial crises did, according to the IMF), public finances are now in structural deficit. To insure

long-term debt sustainability, there is no way to escape fiscal restriction.

- On top of this, the consensus now recognizes that short-run fiscal multipliers are low in expansions and high in recessions. As a result, accumulating public debt in good times and refraining from running deficits in order to control debt in bad times is very costly: it amounts to squandering precious fiscal ammunition when there is no enemy and to scrimping on it in the heat of combat.

It increasingly looks like, that we are living, since the financial crisis, in a *“new normal” macroeconomic environment* in which fiscal multipliers are still positive in the short run but non-zero in the long run because of **two conflicting effects**:

- A primal fear of French and European policy makers – fed by the outstanding historical work of Carmen Reinhart and Kenneth Rogoff and the difficulties encountered by Italy, Spain or Greece to roll over their public debt – is that bad things might happen when the debt to GDP ratio steps over 90%. For instance, the sudden realization by investors that, past that level, there is no easy way to bring debt back to “normal” levels without inflation or outright default might lead to a rapid rise in sovereign interest rates. These high rates precipitate an increase in the debt to GDP ratio by raising the cost of servicing the debt and impose intensified deficit reduction efforts that further shrink GDP. Thus, crossing the 90% threshold might lead to a one-way descent into the abyss. This implies that fiscal contraction, although recessionary in the short run, is beneficial in the long run. Fiscal pain now is thus an evil necessary for long-run prosperity and debt sustainability. According to this narrative, we may survive – but only if we stop dancing right away.
- An opposite danger is that fiscal contraction now – in a

context of public finances damaged (except for Greece) not by fiscal laxity but by the slowdown in economic activity engendered by the financial crisis since 2008 – might cause a social, political and economic breakdown or durably destroy productive capacity. Fiscal contraction is thus recessionary both in the short run and in the long run. Short-run fiscal expansion is then a necessary condition for long-run prosperity and debt sustainability. In this narrative, we may survive – but only if we keep dancing!

The advisability of your proposal to reduce the public deficits to zero by 2017 depends, Mr. President, on which of these two dangers is the most intense or the most difficult to thwart. Should you be more concerned that loose fiscal policy may hurt long-run growth by increasing the cost of debt service, or should you fear instead first and foremost that strict fiscal policy may harm output durably by leading to social unrest or by reducing productive capacity?

To answer these portentous questions, whose answer is not a matter of ideology or of economic paradigm, we urge you to look at the evidence:

- The sovereign rating of countries with large deficits and debts, like the US and the UK, has been downgraded without any adverse effect on interest rate. This suggests that markets understand, seemingly better than policymakers, that the key problem with EU public finances nowadays is not deficits and debt per se but the governance of the euro zone and its fiscal and monetary policy mix. With a lender of last resort – the euro zone has none –, managing a national debt crisis would be easy and straightforward. The counter-argument that it would lead the ECB to monetize public debts, in sharp contrast with the statutes of this institution and its duty to reach price stability, is invalid: the ex-ante ability to monetize debt would reduce risk premia

by eliminating self-fulfilling runs on national debts.

- Ugo Panizza and Andrea Presbitero have shown that there is no convincing historical evidence that debt reduction leads to higher economic growth. Hence the statement that public debt reduction is a prerequisite to economic growth is at worse an assumption, at best a correlation, but in any case not a causal relation supported by data.
- Twenty years of Japanese stagnation remind us that deflation is a deadly and durable trap. Under-activity pushes prices down slowly but surely. Paul Krugman and Richard Koo have shown how real expected interest rates feed a spiralling of deleveraging when deflation locks into prices expectation. If deleveraging extends to the banking sector, it adds a credit squeeze to the contraction.
- One of the pernicious drawbacks of fiscal austerity is the destruction of human capital by long unemployment spells. Young cohorts entering now on the job market will undergo a problematic start and may never recover. The longer unemployment remains over its natural rate, the larger the frustration stemming from a bleak future will grow.
- Beyond human capital, firms are the place where all sorts of capital are accumulated, ranging from social capital to immaterial assets such as R&D. Philippe Aghion and others have argued that this channel links short-term macroeconomic volatility to long-term growth potential. Moreover, in a competitive world, underinvestment in private R&D impairs competitiveness. Hence, austerity, by making output more volatile, has a negative long-term impact.
- What is true for private immaterial assets is even truer for public assets, that is to say assets that generate flows of public goods that individual incentives fail to produce. Typically, so-called golden rules neglect such assets which are by their very nature hard to measure. As a result, the pursuit of quick deficit reduction is

usually carried out at the expense of investment in assets which have a high social profitability and are essential to ensure a smooth transition to a low carbon economy.

Drawing on these facts, please let us suggest you a four-pronged strategy:

1. You should argue that fiscal austerity is bad for both short-term *and* long-term growth and remind Mrs. Merkel that, as a result, it should be handled with the utmost care.
2. Slowing down the pace at which austerity is imposed on EU countries is vital – both to reduce unemployment in the short-run and to maintain the long-run prosperity without which the reduction of debt-to-GDP ratios will be impossible.
3. You should acknowledge that the fears of your predecessor were well-founded: in the absence of a lender of last resort or without debt mutualization, slowing down austerity does expose sovereign debt to the risk of rising interest rates by provoking the self-fulfilling anxiety of creditors. But the experience of the US shows that the best way to deal with this danger is to have a full-fledged central bank that can act as a lender of last resort. The Maastricht Treaty should be amended fast in that dimension. Endowing the ECB with growth as a second mandate is not essential.
4. Mrs. Merkel is right that allowing the ECB to bail out States is a sure recipe for moral hazard. You should therefore agree, as a complement of the modification of ECB statutes, with her insistence that a Fiscal Compact governs Europe but you should strive for a Smart Fiscal Compact. This Smart Fiscal Compact should aim at enforcing the sustainability of public finances in a world where the long run is not given but depends on the short-run fiscal stance. It should draw its strength

from legitimate European political institutions endowed with the power to control and enforce the commitment of each country to fiscal discipline. This task will require pragmatism and evidence-based economic policy – rather than budgetary numerology and simple-minded rules.

Failing to reduce deficits in Europe may end in a debacle. However, reducing them cold turkey is a sure recipe for disaster. Believing that old tricks like deregulating job markets will bring back economic growth lost in the recession is delusional, as the ILO warned in its last report. The possibility of brutal switches in economic or social trends rules out half-measures. The creeping build-up of long-term disequilibria requires prompt and decisive action in the short run. What is true for France is even truer for our main neighbors: the whole EU needs room for maneuver, and it needs it fast for the sake of its future.

Yours faithfully.

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**Let's negotiate a global  
carbon price signal –**



# quickly!

By Stéphane Dion [\[1\]](#) and [Éloi Laurent](#)

Two decades after the Rio Conference, and just as a new climate conference is opening in Bonn on Monday 14 May 2012, we must admit to collective failure in combating human-induced climate change. We cannot escape serious climate disruption if we continue down this same path. We must change direction, and we must do it quickly.

The International Energy Agency forecasts warming of over 3.5°C by the end of the 21st century if all countries respect their commitments, and by more than 6°C if they content themselves with their present policies. At that level of warming, climate science warns us that our planet will become much less hospitable for humans and all other forms of life.

At the Durban Conference in December 2011, the countries expressed their grave concern about the gap between their commitments and achieving the objective of a 2°C limit on increased global warming (relative to the pre-industrial era). They promised to re-double their efforts to bridge this gap. But they failed to make any commitment to achieve more stringent targets. We are thus facing an increasingly untenable gap between the urgent need for action and the inertia of international negotiations.

The developed countries are refusing to strengthen their climate policies so long as the other major emitters don't do the same. But the emerging economies, particularly China and India, with annual GDP growth rates of 8 to 10%, will not accept in the foreseeable future targets for the reduction of the volume of their greenhouse gas (GHG) emissions. On the other hand, these countries might be more open to the idea of setting a price per ton of CO<sub>2</sub> that was standardized at the global level, from which they would derive revenue, and which

their economic competitors would also be required to levy.

We believe that the best instrument for the international coordination needed to combat climate change is a global carbon price signal. This is why we are proposing that the forthcoming negotiations focus on this crucial goal.

Here is what we are proposing (for more detail, see, in French, <http://www.ofce.sciences-po.fr/pdf/dtravail/WP2012-15.pdf> and, in English): every country would make a commitment to introduce, in their respective jurisdictions, a carbon price aligned with a scientifically validated international standard, in order for the world to achieve or at least come as close as possible to the objective of keeping global warming below 2°C. Each country would decide whether to extract this levy through taxation or through a system of ceilings and trading in emissions permits (a “carbon market”).

Governments would be free to invest, as they see fit, revenues from the carbon emission levy and from the corresponding elimination of fossil fuel subsidies. They could, for example, invest in research and development in clean energy and public transportation, etc. They could also choose to address social inequalities with respect to access to energy.

Developed countries would be required to set aside part of their revenues to help developing countries introduce policies to mitigate emissions, to adapt facilities and to create carbon sinks (by means of reforestation, for example). The contributions of each country would be based on what their respective GHG emissions represent relative to the total emissions of all the developed countries.

Under this international agreement, countries would have the right to levy border taxes on products from countries that have not established a carbon price in accordance with the international standard. The message would be clear to all

large emitters: if you do not levy a carbon tax on your products before you export them, the other countries will do so in your place, and it is they who will collect the revenues. Each country will understand that it is in its own commercial interests to comply with the international agreement, to tax its own emissions and to use the corresponding revenues as it sees fit.

In this way, the world would have available an instrument that is vital to its sustainable development. At last, carbon emitters would be required to pay the environmental price for their actions. Consumers and manufacturers would have an incentive to choose lower-carbon-content goods and services and to invest in new emission-reducing forms of technology.

We need to negotiate a global carbon price signal, and quickly. What better place to do this than at Rio, where the problem of climate change was first recognized by the international community 20 years ago?

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[\[1\]](#) Stéphane Dion is a Member of the House of Commons of Canada; as Canada's then Minister of the Environment, he chaired the 11th Conference of the Parties to the United Nations Framework Convention on Climate Change, held in Montréal in 2005 (COP 11).

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## **Italy: Mario Monti's challenge**

By [Céline Antonin](#)

From his arrival in power on 12 November 2011, Mario Monti has

explicitly set out his aims, which are structured around three points: fiscal discipline, growth and equity. Will he meet the challenge?

Mario Monti succeeded Silvio Berlusconi at a time when investors' lack of confidence in Italy was growing continuously, as was seen in the widening gap with German bond rates and the sharp increase in CDS prices.

### ***Ici graph***

To meet his first objective of fiscal discipline, in December 2011 one of the government's first measures was to adopt an austerity plan, which came to 63 billion euros over three years. This plan, the third in a single year, has the evocative name of *Salva Italia* (Save Italy) and aims to achieve a near balance of the public books by 2013 (see [Italy: Mario Monti's wager](#) in French).

The second objective, to restore growth and enhance the country's competitiveness, is addressed in the *Cresci Italia* plan ("Grow Italy") adopted in stormy conditions by the Council of Ministers on 20 January 2012. This plan calls for further reforms, including to simplify administrative procedures (tendering procedures, business creation, digital switchover, etc.) and to liberalize the regulated professions, energy, transportation, and insurance, and in particular to enhance labor market flexibility. The ease with which the austerity measures contained in this second plan were adopted was matched by their poor reception, in particular with regard to discussion of the amendments to Article 18 of the Labour Code, which provides protection against dismissal for employees and workers in firms with more than fifteen employees.

Finally, with respect to equity, progress is still slow, especially in the fight against tax evasion and against the underground economy.

Italians know that these measures will be painful: the financial daily *Il Sole 24 Ore* announced that the annual increase in taxes for an average family living in Lombardy will come to 1,500 euros per year, and almost 2,000 euros for a family from Lazio. Yet up to now the people of Italy have displayed great awareness of the national interest, accepting the cure of fiscal consolidation in a spirit of resignation. As for the financial markets, they initially relaxed the pressure on the country, with the gap in long-term government rates with Germany falling from 530 to 280 basis points from early January to mid-March 2012. Mario Monti's actions are not the only explanation: the ECB's purchase of bonds in late 2011 and its two 3-year refinancing operations (LTRO) of the banking system for a total of 1,000 billion euros, which greatly benefited Italy's banks, definitely helped to ease the pressure on rates. Moreover, the success of the plan for the exchange of Greek debt with private creditors also contributed to easing rates.

The situation is still fragile and volatile: the weakness Spain showed regarding fiscal discipline was enough to trigger a renewed loss of confidence in Italy, as the interest rate differential with Germany on long-term bonds began to rise again, reaching 400 basis points in early May 2012, as did CDS premiums (graph).

So what are the prospects for the next two years? After a recession that began in 2011, with two quarters of negative growth, Italy is expected to experience a difficult year in 2012, with GDP falling sharply by 1.7% as a result of the three austerity plans approved in 2011. Their impact will continue to be felt in 2013, with a further contraction in GDP of -0.9% [\[1\]](#). In the absence of additional austerity measures, this will reduce the country's deficit, but less than expected, due to the [multiplier effect](#): the deficit will fall to 2.8% of GDP in 2012, and to 1.7% in 2013, i.e. a pace of deficit reduction that falls short of its commitment to

balance the public finances by 2013.

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[\[1\]](#) The IMF forecast is more pessimistic for 2012, with growth of -1.9%, and more optimistic for 2013, at -0.3 %.

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# Competitiveness and industrial demand: The difficulties facing the French-German couple

[Jean-Luc Gaffard](#)

The obsession with competitiveness has returned to centre stage with the election campaign. This reflects the reality that French companies are indeed suffering a loss of competitiveness, which is behind the deterioration in foreign trade for almost a decade. This loss is clear vis-à-vis the emerging markets and explains the trend towards relocating abroad. It is also clear vis-à-vis firms from other developed countries, mainly in the euro zone and in particular German companies. This latter situation is especially serious, as it challenges the coherence of European construction ([cf. OFCE, note 19: Competitiveness and industrial development: a European challenge in French](#)).

The gap in competitiveness that has emerged with Germany is clearly based on non-price competition. One of the reasons for

this is Germany's superior business model, which is characterized by the maintenance of a network of local businesses of all sizes that focus on their core business and on the international fragmentation of production. This model is especially suitable for business development that is targeted at global markets, and it largely protects the countries hosting these companies from the risk of deindustrialization.

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

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

Two developments have particularly hurt France's industry. Its network of industrial SMEs has fallen apart. They were hit less by barriers to entry than by barriers to growth. All too often SME managers have been inclined or encouraged to sell the enterprises to large corporations rather than to ensure their growth. This is due both to the lack of genuine partnerships with these corporations and to the difficulties experienced in obtaining permanent financing from the banks and markets. For their part, the large industrial firms, both those operating on a multitude of local markets and those in the international markets, have chosen to focus on acquisitions and on the geographical decentralization of both their operations and their equipment and services suppliers. This strategy has been designed to meet geographical shifts in demand and to deal with the demand for immediate profitability

set by volatile shareholders, but this has come in part at the expense of the development of local production networks. This process involved a vast movement of mergers and acquisitions that primarily drew on financial skills. The financial institutions were, in turn, converted to the universal banking model, abandoning some of their traditional role of being lending banks and investment banks. These concomitant developments have proved disastrous for overall competitiveness, particularly as hourly labour costs in industry were rising simultaneously.

There are two requirements for restoring the competitiveness of French companies and thereby encouraging the country's re-industrialization. The first is to allow immediate control of labour costs and the restoration of profit margins; this could be helped in particular by tax measures that would adjust the financing of a portion of social protection. The second requirement is to promote the reorganization of industry through the creation of a network of stable relationships between all those involved in the industrial process, especially by the use of aid that is conditioned on cooperation between large and small firms in "competitiveness clusters".

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

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# Plea for a growth pact: the sound and fury hiding a persistent disagreement

By [Jean-Luc Gaffard](#) and [Francesco Saraceno](#)

The emphasis on the need to complement fiscal restraint by measures to boost growth, which is rising in part due to the electoral debate in France, is good news, not least because it represents a belated recognition that austerity is imposing an excessively high price on the countries of southern Europe.

Nevertheless, there is nothing new about invoking growth, and this may remain without consequence. In 1997, as a result of a French government intervention, the Stability Pact became the Stability and Growth Pact, but this had no significant impact on the nature of strategy, which remained fully oriented towards the implementation of strict monetary and fiscal rules and a constant search for more flexible markets.

Last week, [Mario Draghi](#), along with [Manuel Barroso and Mario Monti](#), were worried not only about the recession taking place in Spain, Portugal, the Netherlands and Great Britain but also about the need to respond formally to a request that may come from a new French government. They too are arguing for a negotiated Growth Pact, while taking care to note that it must consist of a common commitment to carry out structural reforms wherever they have not yet been made. This position echoes the February [letter](#) of the eleven Prime Ministers to the European authorities. In other words, nothing is to change in the doctrine that determines the choice of Europe's economic policy: growth can be achieved only through structural reform, in particular of the labour markets.

There are two grounds for criticizing this position. [It is far from sure](#) that structural reform is effective, unless, that

is, it is wielded in a non-cooperative spirit to improve the competitiveness of the country that undertakes the reform at the expense of its trading partners, as Germany was able to do with the Hartz reforms. Secondly, widespread reform, including where this is justified in terms of long-term growth, would initially have a recessionary impact on demand [\[1\]](#), and hence on activity. Reform cannot therefore deal with what is actually the immediate top-priority requirement, namely stemming the spreading recession.

The real challenge facing Europeans is to reconcile the short term and the long term. The solution proposed so far, general fiscal austerity aimed at [restoring the confidence of private actors](#), which would be complemented by structural reforms intended to increase the potential growth rate, just doesn't work. This can be seen by developments in Greece, as well as in Portugal and Ireland, which are model students of Europe's bailout plans, and also in Britain, Italy and Spain. The fiscal multipliers remain firmly Keynesian (see [Christina Romer](#), and [Creel, Heyer and Plane](#)), and any "non-Keynesian" effects on expectations are limited or nonexistent.

Growth can neither be decreed nor established instantly, unlike the deflationary austerity spiral in which more and more European countries are currently trapped.

Growth is likely to materialize only if fiscal consolidation is neither immediate nor drastic – in fact, only if the consolidation required of countries in difficulty is spread over time (beyond the year 2013, which in any case will be impossible to achieve) and if the countries that are able to carry out a more expansionary fiscal policy actually do this in such a way that at the European level the overall impact is neutral or, even better, expansionary. This strategy would not necessarily be punished by the markets, which have shown recently that they are sensitive to the requirement for growth. Otherwise, steps should be taken by the ECB to deal with the constraints imposed by the markets. This short-term

support must be accompanied by substantial medium-term investment made through European industrial programs financed by the issuance of Eurobonds – which would mean, finally, a European budget on a scale large enough to handle the tasks facing the Union. This method of coordinating short- and medium-term choices would be an important step towards the establishment of the kind of federal structure that alone will allow the resolution of the “European question”.

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[\[1\]](#) R.M. Solow, Introduction to Solow, R.M. Ed. (2004), *Structural Reforms and Macroeconomic Policy*, London: Macmillan).

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## The middle class: baseless fears or genuine hardship?

By Louis Chauvel

The term “middle class” is one of those social science concepts that provoke controversy due to its complex definition and dynamics and the political debate it generates. The fact that it is surrounded by sharp controversy should not therefore come as a big surprise. [In a note by the OFCE](#) – where a multifaceted definition of the middle class is proposed [1] – we review several dimensions of the social malaise afflicting this social group, which is often

considered to be relatively privileged, in an effort to understand the actual situation.

Two theses are considered here:

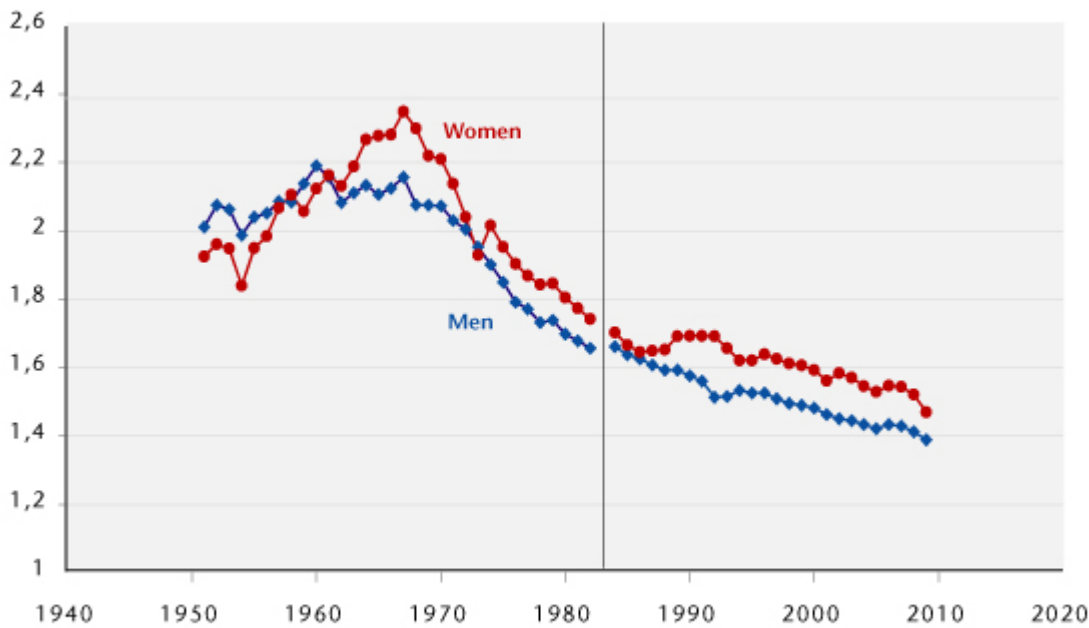
- on the one hand, the thesis of the middle class maintaining its former status, the strengthening of the protection its members enjoy and confirmation of their economic ascent [2] – a thesis that makes the “fear of decline” that haunts them a paradox;

- on the other hand, the thesis of an objective increase in social problems that were previously limited to people in lower strata (employees and workers, two social groups whose hourly wages are similar), with the upwards diffusion of the problems through capillary action now less blocked [3].

Proponents of the optimistic thesis, that of maintenance, argue that “contrary to popular belief”, the fall in status of the middle class is a “fiction”, as this social group “simultaneously embodies a ‘France holding its own’ and a ‘France that’s rising’” (Goux and Maurin). In this view, fear of decline is a psychological reaction of the middle class with no real cause.

In the Note, which upholds a different view, we review several aspects of this analysis to understand the objective basis for the malaise of the middle class. We show that the increasing difficulties faced by lower strata – for example, the risk of unemployment – are seeping into the intermediate middle classes, who can no longer be said to be protected. This is an element of the “theory of the lump of sugar at the bottom of the cup of coffee”: while the upper and middle parts of society still seem intact, erosion is continuing through the capillary-like action of the immersed part and, if nothing is done, it threatens inevitable deterioration.

Ratio between the net annual full-time salary of the intermediate professions and that of manual workers (men and women, separately)



Note: An in-depth examination shows that over the last 50 years workers and employees have experienced similar changes in wages.

Source: DADS data, private and semi-public sector.

The relative standard of living of the intermediate middle class peaked in what the French call the “Trente glorieuses”, the three decades of post-war prosperity: since the end of this golden age, stagnant wages and incomes, the reduction of wage differentials with the lower classes holding jobs (see chart), the unprecedented risk of unemployment, the numerical expansion of diplomas to numbers that go well beyond the space available in the intermediary professions, and the consequent devaluation of education, etc., were a number of the problematic issues analyzed in this paper that highlight the existence of a very real malaise. It is thus possible to show that, in terms of diplomas, the intermediate middle class population increasingly consists of a share of potential managers (based on their level of education) who have not actually managed to enter the upper middle class, due to a lack of sufficient places, and on the other hand survivors of the intensified competition, a reflection of the growing number of people with the same level of education who have fallen into the lower classes.

In this note, we therefore consider the cause of the

destabilization of the project of “middle class civilization” (Alexandre Koyré) that had emerged in the context of the growth and modernity that marked the 1960s to 1980. The corresponding social dynamics were not based simply on the numerical expansion of the intermediate middle class, but also on a coherent social and political project that has now become unstable. What are the ways to reconnect with this dynamic? How would it be possible to escape the vicious circle whereby the middle classes disintegrate and we develop policies targeted at those most in need without seeing that they feed the fall of groups that were previously better situated but that haven’t been supported? The answer lies in productive investment in sectors with long-term promise. Without coming to terms with the real causes of the malaise of the intermediate middle class and dealing with the root problems, we may be preparing ourselves for a difficult decade.

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[1] The middle class is defined in their plurality as falling into the upper middle classes, comparable to the “executives and intellectual professions” who make up about 10% of households, and the intermediate middle classes, which corresponds to the 20% located immediately below, and thus close to the intermediary professions as defined by the INSEE.

[2] D. Goux and E. Maurin, 2012, *Les nouvelles classes moyennes*, Seuil, Paris. Most of these ideas were already presented in S. Bosc, 2008, *Sociologie des classes moyennes*, La Découverte.

[3] L. Chauvel, 2006, *Les classes moyennes à la dérive*, Seuil, Paris.

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# The financial markets: Sword of Damocles of the presidential election

By [Céline Antonin](#)

Although some of the candidates may deny it, the financial risk linked to the fiscal crisis in the euro zone is the guest of honour at the presidential campaign. As proof that this is a sensitive issue, the launch in mid-April of a new financial product on French debt crystallized concerns. It must be said that this took place in a very particular context: the Greek default showed that the bankruptcy of a euro zone country had become possible. Despite the budgetary firewalls in place since May 2010 (including the European Financial Stability Fund), some of France's neighbours are facing a lack of confidence from the financial markets, which is undermining their ability to meet their commitments and ensure the fiscal sustainability of their government debt, the most worrying example to date being Spain. What tools are available to speculators to attack a country like France, and what should be feared in the aftermath of the presidential election?

**The tool used most frequently for speculation on a country's public debt is the Credit Default Swap, or CDS.** This contract provides insurance against a credit event, and in particular against a State's default (see the "Technical functioning of CDS" annex for more detail). Only institutional investors, mainly banks, insurance companies and hedge funds, have direct access to the CDS market on sovereign States [\[1\]](#).

Credit default swaps are used not only for coverage, but also

as an excellent means of speculation. One criticism made of the CDS is that the buyer of the protection has no obligation to hold any credit exposure to the reference entity, i.e. one can buy CDS without holding the underlying asset ("naked" purchase/sale). In June 2011, the CDS market represented an outstanding notional amount of 32,400 billion dollars. Given the magnitude of this figure, the European Union finally adopted a Regulation establishing a framework for short-selling: it prohibits in particular the naked CDS on the sovereign debt of European States, but this will take effect only on 1 November 2012.

### **The FOAT: new instrument for speculation on French debt?**

This new financial instrument, introduced by Eurex on April 16 [2], is a futures contract, that is to say an agreement between two parties to buy or sell a specific asset at a future date at a price fixed in advance. The specific asset in this case is the French Treasury OAT bond, with a long residual maturity (between 8.5 and 10.5 years) and a coupon of 6%, and it has a face value of 100,000 euros. Should we worry about the launch of this new contract on the eve of the presidential election? Not when you consider that the launch of the FOAT addresses the gap in yields between German and French bonds that has arisen since the recent deterioration of France's sovereign rating: previously, as German and French bond yields were closely correlated, the FOAT on German bonds allowed coverage of both German and French bond risks. After the gap in yields between the two countries widened, Eurex decided to create a specific futures contract for French bonds. Italy witnessed this same phenomenon: in September 2009, Eurex also launched three futures contracts on Italian government bonds [3]. In addition, Eurex is a private market under German law, and is much more transparent than the OTC market on which CDS are traded. Note that the FOAT launch was not very successful: on the day it was launched, only 2,581 futures contracts were traded on French bonds, against



1,242,000 on German bonds and 13,671 on Italian bonds [\[4\]](#).

Even if, as with the CDS, the primary function of the FOAT is to hedge against risk, it can also become an instrument for speculation, including via short selling. While speculation on French debt was previously limited to large investors, with an average notional amount of 15 billion euros per CDS [\[5\]](#), the notional amount of the new FOAT contract is 100,000 euros, which will attract more investors into the market for French debt. If speculators bet on a decline in the sustainability of France's public finances, then the price of futures contracts on the OAT bonds will fall, which will amplify market movements and result in higher interest rates on OAT contracts.

### **The not so rosy future?**

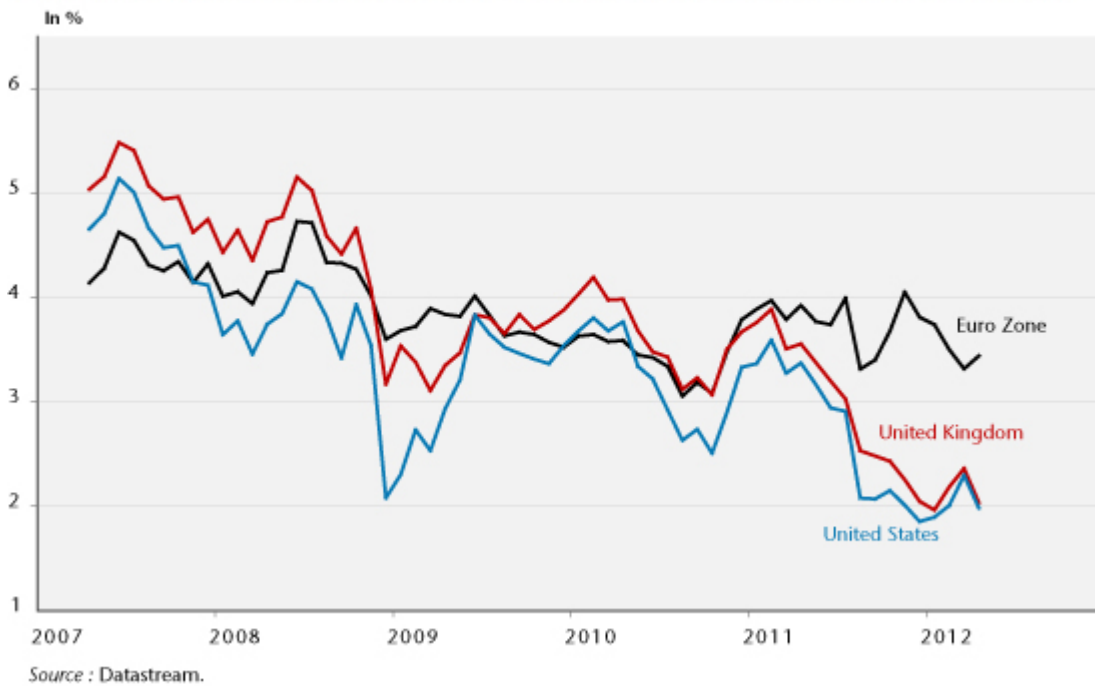
It is difficult to predict how the financial markets will behave in the wake of the French presidential election. Studying what has happened in other euro zone countries is not very informative, due to each one's specific situation. The country most "comparable" to France would undoubtedly be Italy. However, the appointment of Mario Monti in November 2011 took place in an unusual context, where the formation of a technocratic government was specifically intended to restore market confidence through a strenuous effort to reduce the deficit, with Italy also benefitting from the ECB's accommodative policy.

The [French budgetary configuration is different](#), as the financial imperative appears only in the background. The candidates of the two major parties both advocate the need to restore a balanced budget. Their timetables are different (2016 for Nicolas Sarkozy's UMP, 2017 for François Hollande's PS), as are the means for achieving this: for Sarkozy, the focus will be more on restraint in public spending (0.4% growth per year between 2013 and 2016, against 1.1% for the PS), while Hollande emphasizes growth in revenue, with an

increase in the tax burden of 1.8% between 2012 and 2017 (against 1% for the UMP).

But this is not the heart of the matter. What is striking, beyond the need to reduce public deficits in the euro zone countries, is the fact that our destinies are inextricably linked. As is shown by the graph on changes in bond yields in the euro zone (Figure 2), when the euro zone is weakened, all the countries suffer an impact on their risk premium relative to the United States and the United Kingdom, although to varying degrees. It is therefore unrealistic to think about France's budget strategy and growth strategy outside of a European framework. What will prevent the financial markets from speculating on a country's debt is building a Europe that is fiscally strong, has strict rules, and is supported by active monetary policy. This construction is taking place, but it is far from complete: the EFSF does not have sufficient firepower to help countries in difficulty; the growth strategy at the European level agreed at the summit of 2 March 2012 needs to be more comprehensive; and the ECB needs to pursue an active policy, like the Fed, which specifically requires a revision of its statutes. As was pointed out by Standard and Poor's when it announced the downgrade of the French sovereign rating last December, [what will be watched closely by the financial markets is the fiscal consistency of the euro zone](#). On 6 May 2012, what attitude will the next President then take vis-à-vis the construction of the budget and how able will he be to assert his position in the euro zone – this will determine the future attitude of the financial markets, not only vis-à-vis France, but also vis-à-vis every euro zone country.

Figure 1. Average yields on 10-year bonds in the euro zone, the United States and the United Kingdom



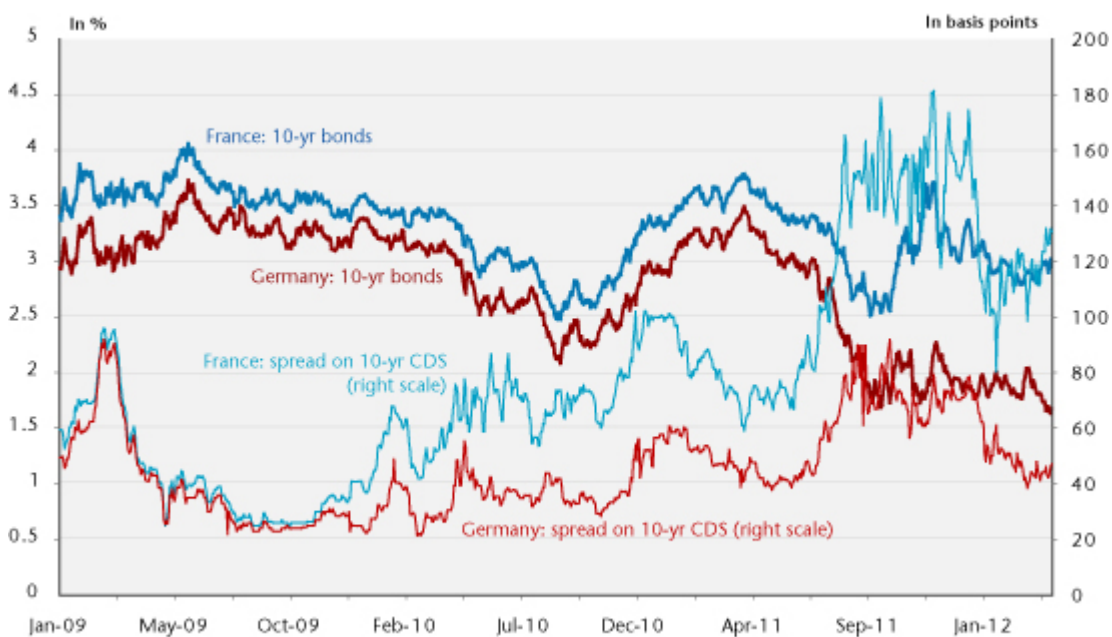
### **Annex: Technical functioning of Credit Default Swaps**

The contract buyer acquires the right to sell a benchmark bond at its face value (called the “principal”) in case of a credit event. The buyer of the CDS pays the seller the agreed amounts at regular intervals, until maturity of the CDS or the occurrence of the credit event. The swap is then unwound, either by delivery of the underlying instrument, or in cash. If the contract terms provide for physical settlement, the buyer of the CDS delivers the bonds to the seller in exchange for their nominal value. If the CDS is settled in cash, the CDS seller pays the buyer the difference between the nominal amount of the buyer’s bonds and the listed value of the bonds after the credit event (recovery value), in the knowledge that in this case the buyer of the CDS retains its defaulted bonds. In most cases, the recovery value is determined by a formal auction process organized by the ISDA ([International Swaps and Derivatives Association](#)). The annual premium that the bank will pay to the insurance company for the right to coverage is called the CDS spread and constitutes the value listed on the market: the higher the risk of default, the more the CDS spread increases (Figure 1). In reality, as the banks are both the buyers and sellers of protection, the spread is usually

presented as a range: a bank can offer a range from 90 to 100 basis points on the risk of a French default. It is thus ready to buy protection against the risk of default by paying 90 basis points on the principal but it demands 100 to provide that protection.

To illustrate this, consider the following example. On 7 May 2012, a bank (buyer) signs a CDS on a principal of 10 million euros for five years with an insurance company (seller). The bank agrees to pay 90 basis points (spread) to protect against a default by the French State. If France does not default, the bank will receive nothing at maturity, but will pay 90,000 euros annually every 7 May for the years 2012-2017. Suppose that the credit event occurs on 1 October 2015. If the contract specifies delivery of the underlying asset, the buyer has the right to deliver its French bonds with a par value of 10 million euros and in exchange will receive 10 million euros in cash. If a cash settlement is expected, and if the French bonds are now listed only at 40 euros, then the insurance company will pay the bank 10 million minus 4 million = 6 million euros.

Annex Figure. France/Germany: premiums on 10-year CDS and 10-year bond yields



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[\[1\]](#) Individuals can play on the markets for corporate CDS via trackers (collective investment in transferable securities that replicates the performance of a market index).

[\[2\]](#) The Eurex was created in 1997 by the merger of the German futures market, Deutsche Termin-Börse (DTB), and the futures market in Zurich, the Swiss Options and Financial Futures Exchange (SOFEX), to compete with the LIFFE. It belongs to Deutsche Börse and dominates the market for long-term financial futures.

[\[3\]](#) In September 2009 for bonds with long residual maturities (8.5 to 11 years), October 2010 for bonds with short residual maturities (2 to 3.25 years) and July 2011 for bonds with average residual maturities (4.5 to 6 years).

[\[4\]](#) Note that this comparison is biased due to the fact that there are 4 types of futures contracts on German debt, 3 on Italian debt and only 1 on French debt.

[\[5\]](#) Weekly data provided by the [DTCC](#) for the week of 9 to 13 April 2012 on CDS on French sovereign debt: the outstanding notional amount came to 1,435 billion dollars, with 6822 contracts traded.