

Doesn't real estate capital really contribute to inequality?

By [Guillaume Allègre](#) and [Xavier Timbeau](#)

[In a response to *Capital in the twenty-first century*, Odran Bonnet, Pierre-Henri Bono, Guillaume Chapelle and Etienne Wasmer \(2014\)](#) attempt to show that the book's conclusions regarding an explosion in wealth inequality are “not plausible”. The authors point out an inconsistency in Thomas Piketty's thesis: the model of capital accumulation is implicitly a model of the accumulation of productive capital, which is inconsistent with the decision to include real estate capital at its market value in measuring capital. If valued correctly, the ratio of capital to income would have remained stable in France, Britain, the United States and Canada, which contradicts the thesis of Piketty's work.

In [OFCE Briefing Note, no.9/2015 \(“Does housing wealth contribute to wealth inequality? A tale of two New York”\)](#), we respond that the authors minimize the contribution of housing to inequality. In particular, we do not believe that trends in real estate prices have “second order effects (actual distributional effects) that are attenuated”. As is often the case, the disagreement is due in part to a lack of consensus about what kind of inequality actually matters: inequality in wealth? Income? Consumption? The potentially divergent dynamics of these inequalities? The disagreement is also due to the type of model used. The authors use a dynastic model in which property is passed from parents to children and grandchildren. In this model, changes in real estate prices do not have any real effect. This model is not relevant to accounting for inequalities generated by property in a society where people are mobile and have different life projects from

their parents.

The housing bubble could fuel the development of inequality. Home ownership in the world's metropolises is more and more becoming a closed club for the wealthy, which partitions young people between those with social, educational or financial capital, who can acquire property, and those who can only rent or move to less prosperous areas, with the consequence of further reducing their access to different types of capital. Would it not be better to build enough for everyone to find housing at a price that is in line with the amenities offered? Isn't it apparent that this latter situation is more egalitarian than the former?

For more on this, see: [Allègre, G. and X. Timbeau, 2014 : "Welcome to Nouillorc : Le capital-logement ne contribue-t-il vraiment pas aux inégalités?", Note de l'OFCE, no. 42 of 25 June 2014.](#)

Unemployment insurance for the euro zone?

By [Xavier Timbeau](#)

In the latest publication of France's Treasury Department, [Lettre Trésor-Eco, no. 132, June 2014](#) (Ministère des Finances et des Comptes publics and Ministère de l'Économie du Redressement productif et du Numérique), Thomas Lellouch and Arthur Sode develop the operating methods and the merits of a common unemployment insurance for the euro zone. They specify the main steps of how it would be applied, which would ensure

neutrality between the Member States. They argue for harmonized employment and labour market policies, leading in the long term to a single contribution rate in the euro zone:

- “Harmonization at the euro zone level of an unemployment insurance component would provide the euro zone a new solidarity instrument capable of giving a social Europe real substance while ensuring greater stability of the zone as a whole...

- This common base could compensate e.g. those who are unemployed less than one year (the most cyclical component) at 50% of their past salary, with financing determined on a harmonized base (e.g. payroll). It would be supplemented by national compensation in accordance with the preferences of each state, thus ensuring the continuation of the current level of compensation...

- Modulating the contribution rate of each member according to its unemployment level, with regular updates based on past trends, would ensure *ex ante* budget neutrality between the Member States...

- In the longer term, and after the unemployment rates of the various Member States converge, a system marking greater solidarity between the Member States could be considered, with financing through a single contribution rate ...”.

New solidarity, but posing three problems ...

Unemployment insurance functions as an important automatic stabilizer. Having a common system for the euro zone members would have made possible significant transfers during the crisis we have just been through. Based on the scheme proposed by the authors (pooling the most cyclical component), Spain could have benefited from almost 35 billion euros by end 2012, mainly from Germany and France. This would not be sufficient to cancel Spain's public deficit, but it would have kept down its level.

A system like this could play a major role in avoiding the sovereign debt crises that dry up a State's credit. It would introduce solidarity and neutral transfers during cycles, but would be responsive to the state of the cycle.

However, this proposal raises three problems: the first is that unemployment insurance systems are the fruit of a national social compromise that has won general acceptance and is consistent with the rest of the country's labour market policies, whether these are active policies or not. A European unemployment insurance component built on top of national systems could lead to confusion and to questions about the national balance. This could disrupt the social dialogue, since the social partners would have a potential resource for which they are not responsible, in addition to the issue of whether the European authorities or partner countries might also wish to have a say. Furthermore, unemployment insurance is often a sensitive subject, as was seen by the issue of entertainers and artists (*intermittents*) in France in early summer 2014.

This could be solved by limiting the sharing to macroeconomic transfers, independent of national arrangements. But, and this is the second problem, to ensure that transfers between states do not become permanent, the transfers need to be balanced over the business cycle. This requires a procedure for identification of the cycle that the stakeholders agree on. The recent experiences of the crisis and the calculation of structural deficits show that this is far from the case today. Another option would be to "replenish" the system prior to using it by accumulating contributions over a number of years before a major downturn. It would suffice to limit use to what has been accumulated to resolve discrepancies. But then the system would be bereft of value in the face of a systemic crisis. The day the buffer collapses, the Kings would be as naked as before. At best the crisis is delayed, at worst it is aggravated.

A final option would be to give up balancing the transfers *a priori* (or by the mechanics of the way it operates), leaving it to polarize gradually one way or another and to ensure an asymptotic convergence. But in this case the system could lead to undesired structural transfers that could very well call it into question.

Spain for instance has high unemployment, well above its structural rate; entering into a transfer system based on the differences between current unemployment and structural unemployment could be done only on an equilibrium basis, or would run the risk of a long-lasting initial transfer.

This then raises the third issue, governance. It is difficult to design such a system without implying, at least potentially, significant transfers between States. How could such transfers be justified without a legitimate common representation? Furthermore, what could be done to avoid these transfers becoming an instrument for control of macroeconomic policy as a whole? The establishment of a banking union is a reminder of how key this problem is. Likewise, Spain's refusal to submit to the conditions set for a conventional assistance program (EU / IMF) clearly indicates that in the absence of legitimate and sincere solidarity, the beneficiaries of transfers will be as suspicious as the payers.

What options for the European Central Bank?

By [Paul Hubert](#)

All eyes are now on the ECB, whose recent statements indicate that it is concerned about the risk of deflation in the euro

zone. The further downturn in inflation in May to 0.5% year on year is a reminder that this risk [is increasing](#). This could lead the ECB to take action at the monthly meeting of the Board of Governors being held today, or in the months to come. This post provides a brief summary of the possible options available to the ECB.

1. To lower the key interest rate (main refinancing operations rate, the MRO rate), which is currently 0.25%. The consensus in the financial markets is for a reduction of around 10 to 15 percentage points, which would further cut financing costs for banks that are still dependent on ECB liquidity. However, this would have a marginal impact on the rates of refinancing operations (MRO and long-term refinancing operations, or LTRO), which would not have much influence on financing conditions and thus not much benefit for Spanish and Italian banks (the main users of this option).

2. To lower the deposit facility rate from zero to a negative rate (again by 10 to 15 percentage points). This option has been largely anticipated by the financial markets. A negative interest rate on deposits should also be accompanied by a change in the policy on the ECB's excess reserves by capping the amount of commercial banks' excess reserves on the ECB's balance sheet or by applying the same negative rate to excess reserves. Otherwise the banks would simply transfer their funds from deposit accounts to excess reserves. A combination of these two policies should lead to a lower Euro OverNight Index Average (EONIA) rate of between zero and 0.05%. The incentive for banks to keep their cash at the ECB would thus be reduced, thereby stimulating the distribution of credit to the non-financial sector.

3. An extension of the policy of providing liquidity in unlimited amounts at a fixed rate (fixed-rate full allotment) from mid-2015 to late 2015 or even mid-2016 is considered by most to be an easy and quick option that would provide additional assurance on the markets before the LTRO deadlines

in early 2015. This kind of measure would ensure the liquidity of the banking system but its impact on activity and inflation could be limited, in so far as the banks would prefer to place their cash with the central bank.

4. An ECB announcement of the end of sterilization through the Securities Markets Programme (SMP), a programme for purchasing the sovereign bonds of euro zone countries in difficulty. The markets seem divided on this issue. The ECB has not managed to attract sufficient demand to completely sterilize this operation in the last eight weeks. This would add 164.5 bn euros (the SMP target amount) of liquidity to the system and take the EONIA rate to zero or even into negative territory, and could reduce the volatility that has appeared in recent months. This measure would therefore also cut the interbank refinancing rate, which would more or less amount to the first option.

5. A conditional and targeted LTRO programme could see the light of day. This would consist of copying the Funding for Lending Scheme (FLS) set up by the Bank of England, in which cheap financing is arranged for banks in exchange for granting new loans to the real economy. However, it would take time to implement this, and even more before there is any real impact on the economy. It would nevertheless probably be the most effective way to stimulate activity, because it would go beyond interbank operations in influencing refinancing conditions.

In any event, the economic situation in the euro zone for both the business outlook as well as for the situation on the labour market calls for a strong response from the ECB so as to ensure that the euro zone does not incur deflation. The effect of the signal may be just as important as the measure actually implemented by the ECB. By demonstrating in today's meeting that it is active, the ECB would show its determination to fight against the risk of deflation, which could at least change agents' expectations. While any action

by the ECB would be welcome, it is still the case that the current economic situation is also the result of the restrictive fiscal policies that have hit activity (see [here](#)).

Rock around the Clock: an explanation of flash crashes

Sandrine Jacob Leal,[\[1\]](#) Mauro Napoletano,[\[2\]](#) Andrea Roventini,[\[3\]](#) Giorgio Fagiolo[\[4\]](#)

On May 6 2010, contemporaneously with the unprecedented price decrease of the E-Mini S&P500[\[5\]](#), many US equity indices, including the Dow Jones Industrial Average, nosedived by more than 5% in few minutes, before recovering much of the loss. During this “flash crash”, most asset prices lost any informational role, as over 20,000 trades across more than 300 securities were executed at prices more than 60% away from their values just moments before. Many were executed at prices of a \$0.01 or less, or as high as \$100,000, before prices of those securities returned to their “pre-crash” levels ([CFTC and SEC, 2010](#)). Such a huge mispricing was associated with a sudden evaporation of market liquidity, swelled volatility and a prolonged crisis in [market confidence](#) (average daily volumes were down for several months after the crash). Furthermore, extreme asset misalignments could also be a source of [systemic crises](#) in light of mark-to-market financial accounting practices, according to which banks’ and other financial institutions’ assets are evaluated at current market prices.

The flash crash of May, 6 2010 widely reported in the [press](#) was not an isolated incident. Similar episodes have been observed since then [in many financial markets](#). Moreover,

because of their disruptive consequences on the orderly functioning of markets, flash crashes attracted the attention of regulators, politicians and academic researchers. In the last four years, many conjectures have been advanced to clarify the origins of the phenomenon and to propose regulatory measures able to prevent its emergence and/or to mitigate its effects. Most theories focused on the role of high-frequency trading (HFT). Indeed, as suggested by a [SEC report](#), high-frequency (HF) traders may have had a fundamental role in fueling the crash by increasingly selling their positions. However, [no convincing explanation has emerged yet](#) and the debate on the benefits and costs of HFT, and its role in flash-crash events, is still unsettled. Some studies suggest that HFT can negatively affect market efficiency, exacerbating market volatility, reducing market liquidity and possibly [fueling flash crashes](#). Others suggest that high-frequency traders are [“modern” market makers](#), who provide an almost continuous flow of liquidity, thus reducing transaction costs and fostering price discovery and market efficiency.

The lack of a consensus on the net benefits of HFT is not surprising, as the ultra-fast algorithms adopted by high-frequency traders represent a genuine financial innovation, whose social impacts are difficult to assess given [the legion of associated –often unintended– externalities](#) and the underlying complexity of financial markets. In such a context, [agent-based models](#) (ABMs) may represent a powerful tool to study the impact of financial innovations such as HFT on market dynamics. Indeed, ABMs allow the researcher to build artificial markets where price fluctuations can emerge from direct interactions occurring among heterogeneous traders, endowed with a repertoire of different trading strategies, ranging from simple to very sophisticated ones (as those employed by HF traders).

Following this intuition, in a [OFCE Working Paper n°2014-03](#), we develop an ABM of a limit-order book (LOB) market, wherein

heterogeneous HF traders interact with low-frequency (LF) ones. Our main goal is to study whether HFT is responsible for the emergence of flash crashes and more generally for periods of higher volatility in financial markets. Furthermore, we want to shed some light on which salient features of HFT are relevant in the generation of flash crashes and in the process of price-recovery after a crash.

The model portrays a market wherein LF agents trade a stock, switching between fundamentalist and chartist strategies according to their profitability. HF agents differ from LF ones not only in terms of speed, but also in terms of activation and trading rules. First, contrary to LF strategies, which are based on *chronological* time, the algorithmic trading required by HFT naturally leads HF agents to adopt trading rules which rest [on event time](#). As a consequence, LF agents, who trade at exogenous and constant frequency, co-evolve with HF agents, whose participation in the market is endogenously triggered by price fluctuations. Second, HF agents adopt *directional* strategies that exploit the price and volume information released in the LOB by LF traders. Finally, HF traders keep their positions open for very short periods of time and they typically display high order cancellation rates. To study the model, we run extensive numerical simulations. Our results show that flash crashes together with high price volatility occur *only* when HF agents are present in the market. Why do flash crashes occur in our model in presence of HF traders? We clearly show that the emergence of flash crashes is not only related to the faster trading speed of HF agents, but more important to the use of specific trading strategies which enable them both to siphon liquidity off the market, leading to high bid-ask spreads[\[6\]](#), and to synchronize on the sell-side of the LOB, when the market crucially needs liquidity.

Finally, we explore the effects of HF agents' order cancellation rate on market dynamics. [Order cancellation](#) has

received much attention in recent public debates, because HF traders can use it strategically to move prices in the desired directions by filling the LOB with fake orders within few microseconds only to cancel them just as quickly. We find that high rates of order cancellations have an ambiguous effect on price fluctuations. Indeed, a larger rate of order cancellations leads to higher volatility and more frequent flash crashes, but also to faster price recoveries, which in turn reduce the duration of flash crashes. We therefore suggest that order-cancellation strategies extensively employed by HF traders cast more complex effects than thought so far, and that [regulatory policies](#) aimed to curb these practices should take

[1] CEREFIGE – ICN Business School (Nancy-Metz) France, and GREDEG. Address: ICN Business School (Nancy-Metz) 13, rue Michel Ney, 54000 Nancy (France). Tel:+33 383173776. Fax:+33 383173080. E-mail address: sandrine.jacob-leal@icn-groupe.fr

[2] OFCE, Skema Business School, Sophia-Antipolis (France), and Scuola Superiore Sant’Anna, Pisa (Italy). E-mail address: mauro.napoletano@sciencespo.fr

[3] Università di Verona (Italy); Scuola Superiore Sant’Anna, Pisa (Italy), and OFCE, Sophia-Antipolis (France). E-mail address: andrea.roventini@univr.it

[4] Scuola Superiore Sant’Anna, Pisa (Italy). E-mail address: giorgio.fagiolo@sssup.it

[5] A [futures contract](#) on the S&P 500 index.

[6] The difference between the highest price a buyer is willing to pay for an asset and the lowest price a seller is willing to sell this same asset.

How many euros per job created?

By Guillaume Allègre, [@g_allegre](#)

The Responsibility Pact, the CICE competitiveness tax break, reductions on social security charges ... is it possible to reduce the evaluation of such measures to the cost in euros of each job created? While such an assessment is obviously important, the final figure is often subject to misinterpretation or misuse in the public debate, sometimes in perfectly good faith. For some commentators, a very high cost per job created, generally higher than the average real cost of a public (or private) job, represents a waste of public money that would be better used elsewhere, for nurseries, education or the national police.

This kind of logic is based on a misinterpretation of the billions involved. To understand this, let's do the following thought experiment: take two tax measures, *A* and *B*, which are intended to reduce the cost of labour in order to generate jobs. Measure *A* creates 200,000 jobs and costs the State and government *ex post* (that is to say, after taking into account the jobs created and interaction with the social security and tax systems) 20 billion and 1 euros. The cost per job created is thus 100,000 euros, which seems excessive. Measure *B* creates 180,000 jobs and has an *ex post* cost of 20 billion euros, 111,111 euros per job, which is even worse. At first glance, there's no point in implementing either Measure *A* or *B*: the cost per job created is far too great. Now, suppose it is also possible to enact Measure $-A$ or $-B$ which, conversely to *A* and *B*, push up the cost of labour (through higher payroll taxes) with symmetrical effects on employment. Suppose also

that the impact on employment and the cost are additive when two measures are implemented at the same time. It now seems clear that we should implement [A-B][\[1\]](#): reducing the cost of labour by A and increasing it by -B would create 20,000 jobs for a cost of 1 euro, or 0.00005 euros per job created! The ratio of the cost of a job created between Measure A and Measure [A-B] is 2 billion to 1 ($= 100,000/0.00005$)! Someone not paying attention might then say: Measure A must certainly not be implemented.

	Number of jobs created	Ex post cost of the measure	Cost per job created
A	200 000	20 000 000 001	100 000
B	180 000	20 000 000 000	111 111
[A-B]	20 000	1	0,00005

Since Ricardo, economists have known that it is often the relative advantages that count and not the absolute advantages: alone, A is not of much interest, but combined with -B it is very powerful, just as in poker a 2 of Hearts in a hand does not have the same value when it is with Jacks as when it is with the 2s of Spades, Clubs and Diamonds. Economic policy measures cannot be evaluated in isolation: they must be evaluated in their interaction with all the instruments that have already been implemented or are simply there.

In addition to the failure to take into account macroeconomic dynamics and the financing, another limitation of reasoning in terms of cost per job created is that it does not always consider the questions: who pays the bill, and who gets what? Expenditures by the State (for childcare, education or the national police) are not equivalent to tax expenditures: if they are funded, the former reduce the disposable income of households, while the latter do not (they are a transfer between households, between businesses or between households and businesses). As a consequence, it is misleading to compare the two types of expenditure only in terms of jobs created. In effect, the jobs created are simply an indirect consequence of a tax expenditure (the direct effect is the transfer from the

State to households and businesses); if the measure is funded, as in $[A-B]$, the jobs created are a second-order effect related to the different behavioural responses to A and $-B$. In contrast, a structural increase in government spending (and therefore in the tax burden) has the first-order effect of increasing the consumption of public goods and reducing the consumption of private goods. If you reason only in terms of jobs, there is a risk of ending up with full employment but in a completely socialized economy. To evaluate this type of transfer, parameters other than job creation also need to be considered. In particular it is necessary to take into account well-being (what is the utility of nurseries or spending on education and national police versus private spending?) and incentive effects (what is the effect of higher social contributions on economic incentives to meet consumer needs?). It is also necessary to think in terms of the tax burden. $[A-B]$ can create jobs only by organizing transfers within households and / or businesses. The relevant questions are therefore: who are the *ex post* winners and losers (taking into account the jobs created and changes in prices and wages)? Do these transfers reduce or increase inequality? Do they violate horizontal equity (equal taxation on equal abilities to pay)? Are they likely to affect long-term growth (via the structure of employment, capital-labour substitution, etc.)?

And what if the ECB respected its mandate!

By [Christophe Blot](#)

Article 127 of the Treaty on the Functioning of the European Union (TFEU), *i.e.* former Article 105 of the Maastricht Treaty, states clearly that “the primary objective of the European System of Central Banks ... shall be to maintain price stability”. However, no precise quantification of this goal is given in the Treaty. The European Central Bank has interpreted this by stating that it would target inflation that is below, but close to, 2% over the medium term. Furthermore, Article 127 of the TFEU adds that, “without prejudice to the objective of price stability , the [European System of Central Banks] shall support the general economic policies in the Union, as laid down in Article 3 ...”, which includes in particular the sustainable development of Europe based on balanced economic growth and price stability, full employment and social progress. It is therefore clear that the goal of growth and employment is not abandoned but subordinated to the goal of price stability. Starting from this review of the definition of the ECB’s objectives, what conclusion can we draw on the orientation of monetary policy in the euro zone?

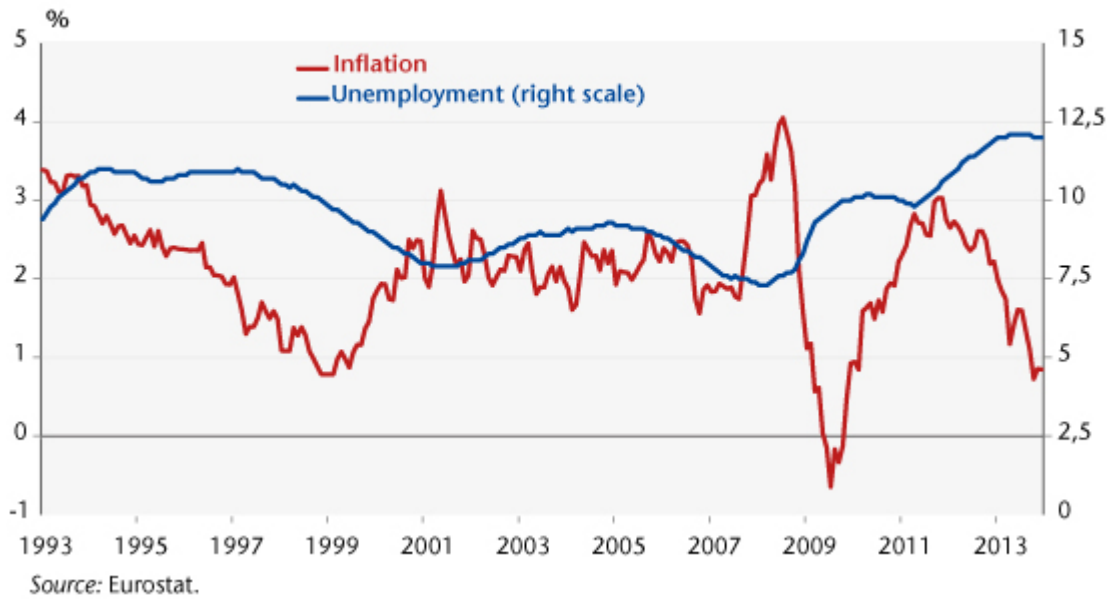
Since the end of 2013, a few signs of economic recovery have appeared in the euro zone. Initial estimates of growth in the fourth quarter of 2013 have confirmed that the recession is ending, with GDP up 0.3%. Nevertheless, the economy is still in poor health. As proof, simply recall that 12% of the labour force is currently unemployed, which is the highest level since 1993 (see chart). Growth is expected to accelerate in 2014 and 2015. According to the ECB forecasts announced in March 2014, growth will hit 1.2% in 2014 and 1.5% in 2015, a pace that is still insufficient to lead to a rapid or significant reduction in the unemployment rate. In addition, since the end of 2013 inflation has dropped below the threshold of 1% and is coming dangerously close to a point where deflation is a risk. Furthermore, still according to the ECB forecasts, inflation should not exceed 1.0% in 2014, before pushing up to 1.3% in 2015 and 1.5% in 2016. It is in any case far from the mid-term target of 2%. The objective of

price stability as defined by the ECB will therefore not be met. At his press conference in March, Mario Draghi announced that the maintenance of the ECB key interest rate [\[1\]](#) at 0.25% and the absence of additional (so-called unconventional) measures could stimulate the euro zone. The status quo was justified by the absence of signs of a more rapid fall in inflation. By taking this stand, the ECB President is indicating that he is satisfied with a situation where inflation remains permanently below the 2% level and where the euro zone is marked by persistent mass unemployment. Are we therefore supposed to reinterpret the definition of price stability invoked by the ECB and accept that the term *below* is more important in the eyes of the members of the ECB Governing Council than the term *close to 2%*? The answer to this question is obviously not neutral, since it would reflect a certain asymmetry in the central bank's reaction to inflation, with the ECB reacting more quickly when inflation exceeds 2% than when it falls below 2%, including over the forecast horizon of its own team. But however its main objective is interpreted, the fact remains that the risk to price stability is not currently a barrier to the implementation of a more expansionary monetary policy. In these conditions, the ECB has all the room it needs to be actively concerned about its other objectives, including first of all growth and unemployment.

So what tools does the ECB have available, knowing that with the benchmark rate at 0.25% it has only very limited manoeuvring room for a downward adjustment? The ECB must therefore use other levers. Communication by the central banks has played an increasing role in the implementation of monetary policy, as this can be used to influence agents' expectations and hence the impact of decisions on inflation and growth. In this respect, the central bank has recently (July 2013) engaged in what is called forward guidance by stating that the key rate will be maintained at a low level for an extended period [\[2\]](#). The ECB could go further by conditioning a hike in the key interest rate on a target

unemployment rate, as both the Bank of England and the Federal Reserve have done; this would give added substance to its objectives on employment and growth. In addition, unconventional measures could be used to strengthen the expansionary character of monetary policy. This mainly means measures that alter the size or composition of the central bank's balance sheet, which would supplement the role of the reduction in short-term rates in influencing financing conditions. A recent report by France's Council of Economic Analysis (see [here](#)) points in this direction, and in particular proposes that the ECB should purchase securitized small and medium enterprises' (SME) loans in order to reduce the cost of business financing. The Outright monetary transactions (OMT) programme [3] could have been activated to support the reduction in long-term sovereign rates. The announcement of this measure did indeed contribute to lowering long-term sovereign rates in Spain and Italy, in particular because it sent a signal that the risk of collapse of the euro zone was being averted. Up to now, the ECB has not intervened in the markets to buy government securities. Yet given its unlimited capacity for intervention, doing this would help to reduce long-term rates. Note, however, that the OMT programme is currently being challenged by Germany's Constitutional Court in Karlsruhe, which has questioned the programme's constitutionality, with the case being referred to the European Court of Justice. A rejection or restriction of the ECB's actions in this matter would be unfortunate. The ECB's scope for intervention does of course need to be clarified. But it is also essential to retain the objectives of price stability and growth. The judges in Germany and at the European Court of Justice would be well advised to keep this in mind.

Figure. Unemployment rate and inflation rate in the euro zone



Revising the budget in Croatia: yes, but ... for whom and why?

By [Sandrine Levasseur](#)

Under the [excessive deficit procedure that Croatia has been subject to since 28 January 2014](#), the country's government has been obliged to revise its projected budget for the forthcoming three years, which is the timeframe that has been set for putting its finances into "good order", with "good order" being understood to mean a public deficit that does not exceed 3% of GDP. This new budget is being fixed in adverse economic conditions, as the government's forecast of GDP growth for 2014 has been revised downward from 1.3% to a tiny 0.2%.

Paradoxically, the new budget could help prolong the recession

in the country rather than help it recover, at least in 2014. This paradox is especially worth noting since this is also the opinion of those for whom the Croatian government is making this adjustment: first of all, the [rating agencies](#), and second, the international institutions (or at least [the IMF](#), as the European Commission has to keep quiet on the matter). In fact, a simple glance at the revised budget is enough to see that the fiscal adjustment being proposed by the Croatian government will not have an expansionary impact on GDP. For example, the budget provides for a hike in tax revenues, in particular through an increase in the rate of health insurance contributions from 13% to 15%. But this will also result in undermining the [international competitiveness of the country's businesses](#), which have already been hit hard.

The wages and bonuses of civil servants will fall (by about 6%) so as to give the public finances some breathing room. But these cuts in civil servant salaries will not help perk up domestic demand, which has been anaemic due to the [adjustments consumers and businesses have made in their balance sheets](#). To take the latest example, to help bail out the state finances the profits of state enterprises will not be reinvested in the economy. However, the country is thereby depriving itself of a source of growth since, because of their weight in the economy, these enterprises account for a large [share of productive investment](#).

There is no doubt that Croatia's public finances need to be cleaned up. However, the horizon for the fiscal consolidation decided on by the Croatian government seems to us extremely "short-termist", as it doesn't call into question the existing model of growth or seek sources of sustainable growth. A few weeks ago, in an [OFCE note](#) we discussed the impact alternative fiscal adjustments would have on growth and the public finances. In the specific [case of Croatia](#), the government cannot avoid the need to consider doing the following: restructuring the productive apparatus (including through

privatization and concessions); improving the system of tax collection; and, more broadly, implementing an anti-corruption policy to improve the country's "business climate". In the meantime, in large part due to the fiscal decisions being taken, 2014 is likely to wind up as the sixth year in a row Croatia has been in recession. The IMF forecasts, which anticipate that the recessionary impact of the fiscal consolidation will be greater than that projected by the Croatian government, [is expecting GDP to fall by about 0.5% to 1%](#) in 2014. In total, the decline in GDP since 2009 will therefore come to between 11.6% and 12.5%. It's not exactly the stuff of dreams....

Central banks and public debt: dangerous liaisons?

By [Christophe Blot](#)

Since 2008, monetary policy has been in the forefront of efforts to preserve financial stability and stem the economic crisis. Though the Great Recession was not avoided, the lessons of the crisis of the 1930s were learned. The central banks quickly cut short-term interest rates and have kept them at a level close to zero, while developing new monetary policy instruments. These so-called unconventional measures led to an increase in the size of balance sheets, which exceed 20% of GDP in the United States, the United Kingdom and the euro zone and 45% in Japan. Among the range of measures employed was the central banks' purchase of public debt. The goal was to lower long-term interest rates, either by signalling that monetary

policy will remain expansionary for an extended period, or by modifying the composition of the asset portfolios held by private agents. However, the Federal Reserve recently announced that it would gradually reduce its interventions ([see here](#)), which could cause a rapid rise in interest rates like that seen in May 2013 (Figure 1) upon the previous announcement of this type. In a context of high public debt, interest rate dynamics are crucial. The central banks need to take into account the enhanced interaction between monetary and fiscal policy by coordinating their decisions with those taken by governments.

In normal times [\[1\]](#), monetary and fiscal policy pursue common goals, foremost among them macroeconomic stability. There are therefore interactions between the decisions taken by the two authorities. A tightening of monetary policy via an increase in interest rates could for instance counteract a fiscal expansion, and vice versa. It is thus necessary to coordinate economic policy in order to ensure the best macroeconomic balance. The implementation of unconventional monetary policy measures enhances these interactions. The adoption of unconventional measures has led central banks to buy government debt, to such an extent that, with the exception of the ECB, these banks hold a significant portion of the outstanding debt (Figure 2). In doing this, their operations are interfering with the management of debt, which is usually vested in the Treasury. The link between monetary policy and debt management is not new, though it receded as central banks became independent institutions with a primary objective of price stability, which they seek to achieve exclusively by changing the key interest rate. Goodhart [\[2\]](#) (2010) clarifies that this role was historically devolved on them. Nevertheless, the objectives of the central bank and of the agency responsible for issuing public debt may be contradictory (Blommestein and Turner [\[3\]](#), 2012), as the Treasury seeks to minimize the cost of debt service, regardless of the macroeconomic impact of its decisions. Two

additional interactions can emerge. On the one hand, the government may partially counteract the central bank's actions on long-term rates by seeking to profit from their decline through additional issues on the maturities targeted by monetary transactions. The excess demand is then partially absorbed by an additional supply for a given maturity. This is what has happened in the United States, as the average maturity of the debt rose from 48.5 months in October 2008 to 64 months in May 2012. Recent work by Chadha, Turner and Zampolli [\[4\]](#) (2013) suggests that this policy of managing the maturity of the public debt supply has a significant impact on interest rates. The [minutes](#) of the US Treasury meeting on 2 November 2010 illustrate the potential conflict between objectives: "It was pointed out by members of the Committee that the Fed and the Treasury are independent institutions, with two different mandates that might sometimes appear to be in conflict. Members agreed that Treasury should adhere to its mandate of assuring the lowest cost of borrowing A couple [of] members noted that the Fed was essentially a 'large investor' in Treasuries and that the Fed's behavior was probably transitory. As a result, Treasury should not modify its regular and predictable issuance paradigm to accommodate a single large investor."

On the other hand, the reduction in the portfolio of government securities held by the central bank should lead to higher long-term rates. This is in any case what is suggested by some of the recent literature on the impact of unconventional monetary policies. The dynamics of bond yields observed in May 2013 (Figure 1), the first time that the markets anticipated [\[5\]](#) a steady decline in purchases by the Federal Reserve, shows that the increase may be rapid and cause high volatility on the financial markets. The explanation for this increase may be related to the end of or the unwinding of arbitrage operations carried out by investors who took advantage of low long-term interest rates in the industrialized countries in order to take on debt and

seek more profitable investments in other markets, in particular the emerging markets. The consequences of such a scenario must be taken into account by the central banks. If the conduct of monetary policy involves making fewer central bank interventions, then the impact on debt service of this pull-back needs to be factored in. Despite the process of public debt reduction, government financing needs will stay high, and additional refinancing costs due to higher interest rates could lead States to strengthen fiscal consolidation, which would have adverse effects on economic activity. Conversely, the maintenance of low interest rates could greatly contribute to facilitating fiscal adjustment by allowing low-cost refinancing and by giving a stimulus to the economy, thereby reducing the recessionary impact of the fiscal adjustment.

Due to the nature of these interactions, to a macroeconomic context marked by a high level of public debt, and to the risk of financial instability, it is essential to coordinate monetary and fiscal policy. This necessity is illustrated perfectly in the case of the United States in an observation by James Tobin quoted by Turner[\[6\]](#) (2011): “The Federal Reserve cannot make rational decisions of monetary policy without knowing what kind of debt the Treasury intends to issue. The Treasury cannot rationally determine the maturity structure of the interest-bearing debt without knowing how much debt the Federal Reserve intends to monetize.”

In Europe’s case, this seems to be a second-order question, since the ECB has a small portfolio of assets (Figure 2). While taking note that this portfolio is concentrated on bonds issued by certain countries (Italian, Spanish, Portuguese, Greek and Irish), whose public debt represents 42% of euro zone debt, the outstanding debt held by the ECB comes to 5% when considering only the countries in crisis. It’s regrettable that the ECB has not taken a more active monetary policy, which would have made it possible to effect a major

uniform reduction in interest rates in all the euro zone countries, which would have helped to reduce the need for fiscal consolidation and mitigate its negative effects.

Figure 1. Interest rates on long-term public debt

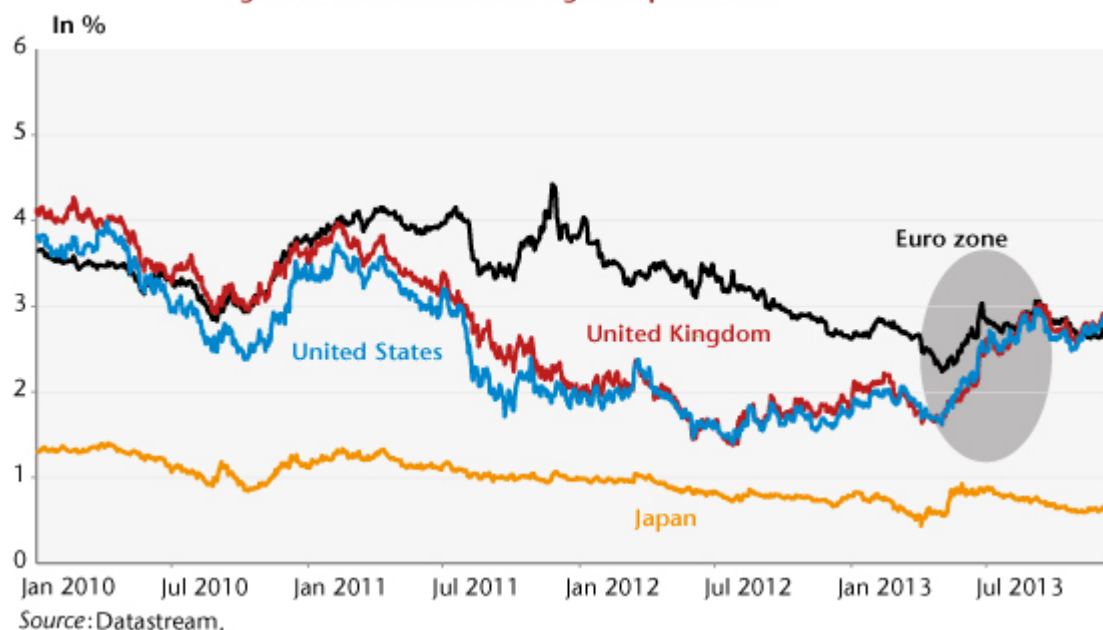
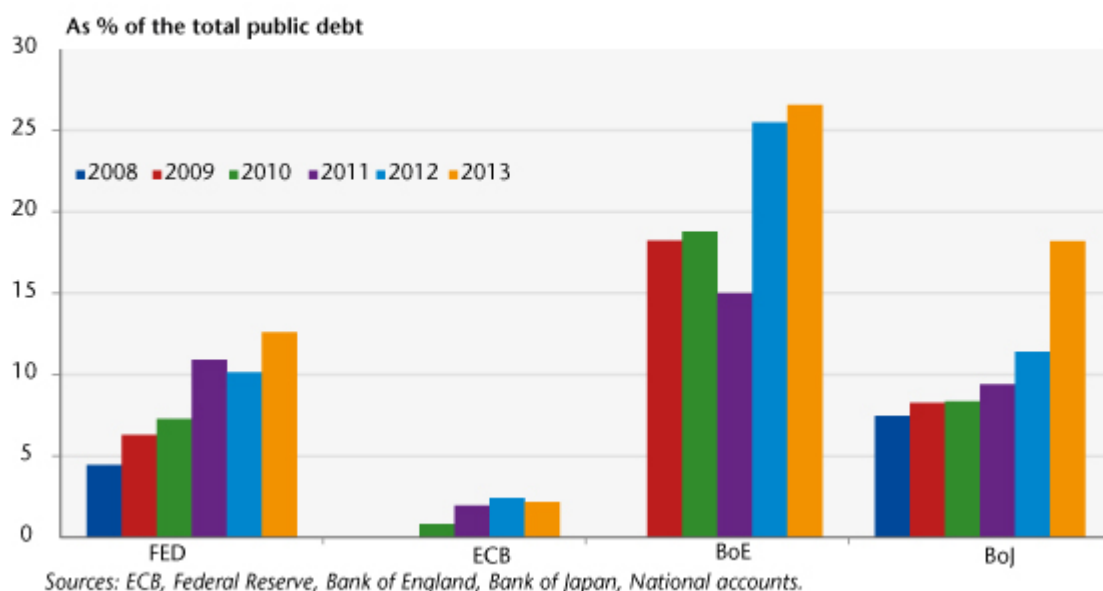


Figure 2. National public debt held by the central banks



[1] Here the expression “in normal times” refers to the fact that the conduct of monetary policy is usually characterized by decisions taken by the central banks on the key interest rate, which is a short-term rate. During the crisis, the central banks set this key rate at a very low level, near to the zero lower bound, and so turned to new measures to strengthen the expansionary character of monetary policy.

[2] See “[The changing role of central banks](#)”, *BIS Working Paper* no. 326, November.

[3] See “[Interactions between sovereign debt management and monetary policy under fiscal dominance and financial instability](#)”, *OECD Working Paper* no. 3.

[4] See “[The interest rate effects of government debt maturity](#)”, *BIS Working Paper* no. 415, June.

[5] These expectations were initially fuelled by the improving jobs situation in the United States and then by Ben Bernanke’s statement confirming a possible pull-back by the Federal Reserve. These elements are described in more detail by the BIS in its [Quarterly Review](#), September 2013.

[6] See “[Fiscal dominance and the long-term interest rate](#)”, 2011, *Financial markets group special paper series* 199, May.

Croatia under the Excessive

Deficit Procedure: which measures should be implemented?

By [Sandrine Levasseur](#)

How to put public finances on a good track when (almost) all measures regarding spending cuts and tax increases have been already exhausted? Croatia's government has been seeking to solve this tricky problem since mid-November when [an excessive deficit procedure \(EDP\) was launched](#) against the country. Let us explain what an EDP means: the public deficit of Croatia currently exceeds 3% of GDP; the breach is neither exceptional nor temporary; consequently, the government of Croatia has to curb its public deficit in a lasting way.

On 28 January 2014, the EU Council will propose (1) the time limits within which Croatia must reduce its deficit below 3% of GDP and (2) the average annual amounts of deficit reduction during the period. Yet, (3) the EU council will invite *formally* the government of Croatia to propose concrete measures towards reducing the deficit-to-GDP ratio below 3%.

The problem facing the government of Croatia is not straightforward since the proposed measures should not further depress the economy. Currently, only modest signs of recovery are in sight in Croatia, and its unemployment rate stands at a high level (16.5%). The country is among the poorest EU members: its GDP per capita is 62% of that of the EU-28.

Briefing Paper n° 6 aims at proposing a list of measures that an EU country under EDP such as Croatia could envisage. For each measure, we present the main arguments "in favor of" it and "against" it in general terms. Then, we discuss the relevance of every measure for Croatia. Note that our list of measures is suitable for both advanced and less advanced EU

countries. More generally, our list could be used for any country facing public finance problems and looking for solutions.

Three measures (out of seven) seem to us particularly relevant in the case of Croatia:

- the use of service concession contracts;
- the privatization of some state-owned enterprises;
- the improvement of tax collection and compliance.

The first two measures are related to the need to restructure state-owned enterprises that are inefficient due to poor management. In particular, state-owned enterprises which are neither natural monopolies nor of strategic importance (*i.e.* in the tourism and agriculture sectors) should be privatized. Privatization of other state-owned enterprises should be envisaged more carefully, but not excluded. Croatia is the first country to join the EU with such a high share of state-owned enterprises (25%), and the slow pace of privatization has hindered growth. More privatizations will result in (long-run) gains even if causing (short-run) pains, in particular layoffs among the workforce. Service concession contracts are another way of restructuring the state-owned sectors. The impact on public finances is different, though. Services concession contracts provide a regular source of revenues for the government (through receipts of concession fees) and/or of savings (through lower payments of government subsidies). By contrast, immediate and potentially large amounts of cash can be obtained from the proceeds of privatization.

Recommending a restructuring of state-owned enterprises in Croatia is not a novelty. The [International Monetary Fund](#), the [World Bank](#) and the European Commission have repeatedly stated that the pace of privatization or service concessions should be accelerated to raise the efficiency of the economy. Currently, the government of Croatia is actively engaged in

accelerating such a process, in particular for service concessions. A few recent concessions include [Zagreb's airport](#) and [Rijeka's port](#), while [motorways](#) and [Brijuni's island](#) have also been proposed to bidders.

Croatia's citizens do not always support the restructuring process. To obtain greater public acceptance of privatization and service concessions, communication should be improved and intensified. In particular, the budgetary authorities should explain *what* they are doing, *why* they are doing it, and what the long-run benefits of their actions will be. Otherwise, the restructuring of state-owned enterprises will be perceived as a gift to the private sector. Last but not least, the process of privatization and service concessions should be more controlled to prevent misguided choices, abuse or conflicts of interest. That also means fighting corruption.

The improvement of tax collection is the third measure that we advocate to curb Croatia's public deficit. According to the [Institute of Public Finance](#), the cumulated uncollected tax revenues in Croatia would amount to HRK 40bn, which represents more than twice the projected public deficit for 2014 (HRK 19.3bn). Should the government be capable of collecting at least a portion, it would give a little breathing room to the public finances. In Croatia, increasing the tax collection means several interrelated things: fighting the grey economy (since unreported incomes are untaxed incomes) and prosecuting tax fraud (otherwise, rules and procedures are useless). Again, tighter control means fighting corruption.

By contrast, other measures such as wage cuts in the public sector or low corporate tax rates do not appear suitable to put the public finances of Croatia on track.

Further details can be found at <http://www.ofce.sciences-po.fr/pdf/briefings/2014/briefing6.pdf>.

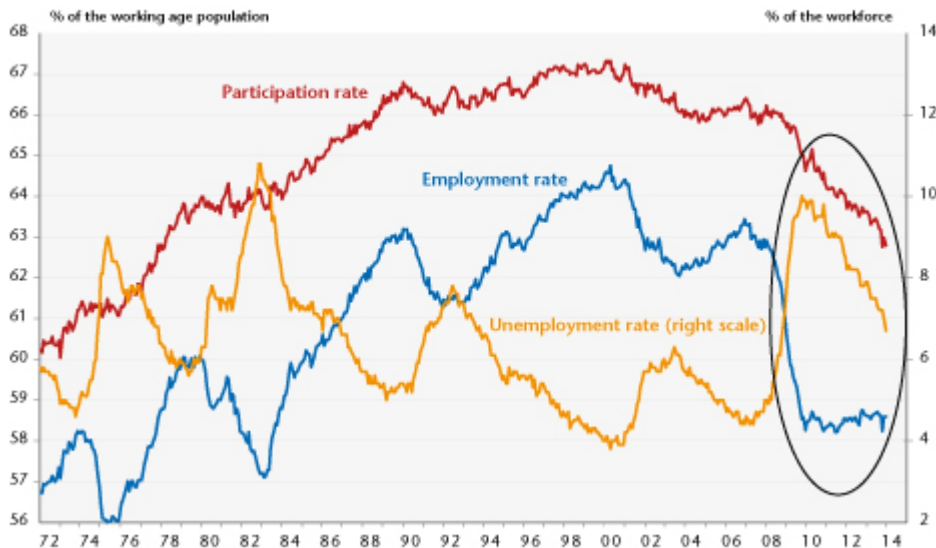
What's masked by the fall in US unemployment rates

By Christine Riffart

Despite the further decline in the US unemployment rate in December, data from the Bureau of Labor Statistics released last week confirms paradoxically that the American labour market is in poor health. The US unemployment rate fell by 0.3 percentage point from November (-1.2 points from December 2012) to end the year at 6.7%. The rate has fallen 3.3 percentage points from a record high in October 2009, and is coming closer and closer to the [non-accelerating inflation rate of unemployment](#) (NAIRU), which since 2010 has been set by the OECD at 6.1%. However, these results do not at all reflect a rebound in employment, but instead mask a further deterioration in the economic situation.

While the unemployment rate is the standard indicator for summarizing how tight a labour market is, this can also be considered using two other indicators, *i.e.* the employment rate and the labour force participation rate – in the US case, these give a different view of the state of the labour market (see chart).

US labour market



Source : Bureau of Labor Statistics.

After falling nearly 5 percentage points in 2008 and 2009, the employment rate has been constant for 4 years, at the level of the early 1980s (58.6%, following a peak of 63.4% at end 2006). Since then, the decline in the unemployment rate has reflected the decline in the participation rate, a trend that is confirmed by the figures for December. Over the period 2010-2013, the participation rate lost a little more than 2 percentage points, to wind up at end December at its lowest level since 1978 (62.8%, following a peak of 66.4% at end 2006).

This poor performance is due to insufficient job creation, which has a threefold impact. Despite positive GDP growth – which contrasts with the recession in the euro zone – demand is far from sufficient to reassure business and revitalize the labour market. After four years of recovery, at end 2013 employment has still not returned to its pre-crisis level. Net creation of salaried jobs in the private sector has not even been sufficient to absorb the demographic increase in the working age population. As a result, the employment rate is not improving from where it bottomed out.

Moreover, the difficulty in finding employment is encouraging the exit or delaying the entry or return of people who are old

enough to participate in the labour market. This effect, familiar to economists, is called *effet de flexion* (“bending effect”) in French: young people are encouraged to study longer, women stay at home after raising their children, and unemployed people become discouraged and stop looking for work. Despite the resumption of economic growth and job creation, this effect continued to be felt in full in 2013. While the reduction in the participation rate slowed in 2011 and 2012 – the growth of the labour force was once more positive but remained lower than that of the working-age population – it accelerated in 2013 with the decline in the labour force. During the second half of 2013, 885,000 people were in effect diverted away from the labour market, due in particular to the more difficult economic and social conditions.

Companies seem reluctant to rehire in the particularly difficult economic context. The fiscal shock in early 2013 depressed activity: GDP growth fell from 2.8% in 2012 to an expected level of about 1.8% in 2013. There will be additional fiscal adjustments in 2014. Beyond drastic cuts (related to sequestration [\[1\]](#)) in state spending, some exceptional measures that have been in force since 2008-2009 for the poorest households and the long-term unemployed (3.9 million out of the 10.4 million unemployed) are coming to an end and have not been renewed. According to estimates by the [Centre on Budget and Policy Priorities \(CBPP\)](#), 1.3 million unemployed who have exhausted their entitlement to basic benefits (26 weeks) and who have enjoyed an exceptional extension will find themselves without support as of 1 January 2014 due to the non-renewal of the measure, and nearly 5 million unemployed will be affected by the end of the year.

There is a risk of growing numbers of people falling into poverty in this situation. According to the Census Bureau, since 2010 the poverty rate has been about 15%. However, again according to the [CBPP](#), unemployment benefits would have

prevented 1.7 million people from falling below the poverty line. The greater difficulties facing the long-term unemployed and the withdrawal of part of the population from the labour market are the direct result of a morose labour market, which is not indicative of a continuous decline in the unemployment rate.

[1] See [America's fiscal headache](#) written 9 December 2013.