BANQUE DE FRANCE
EUROSYSTÈME

Research Newsletter

EDITED BY THE DIRECTORATE GENERALE ECONOMICS AND INTERNATIONAL RELATIONS OF THE BANQUE DE FRANCE

1st half 2012

Coming up

Macroeconomic and Financial Vulnerability Indicators in Advanced Economies • Strasbourg, 13-14 September 2012

18th International Panel Data Conference • Paris, July 5-6, 2012

Past events

Conferences and symposiums

Firms' financing and default risk during and after the crisis • Paris , February 9-10, 2012

"The Euro Area Sovereign debt crisis" • Paris, December 19, 2011

"Fiscal and Monetary Policy in the Aftermath of the Financial Crisis" • Paris, December 8-9, 2011

"Forecasting the Business Cycle" • Conference Banque de France and International Institute of Forecasters • Paris, December 1-2, 2011

Seminars of the Fondation Banque de France

Cédric Tille (Graduate Institute, Genève), "Self fulfilling risk panics", July 1, 2011.

Francesco Lippi (University of Sassari), "The Optimum Quantity of Money with Borrowing Constraints", August 25, 2011.

Céline Rochon (University of Oxford), "From search to match: when loan contracts are too long", August 31, 2011.

Enrique Mendoza (University of Maryland), "Financial innovation, the discovery of risk and the U, 2011.S credit crisis", September 9, 2011.

Fabio Canova (University of Pompeu Fabra), "Club Med? Cyclical Fluctuations in the Mediterranean Basin", September 6, 2011.

Estrella Gomez Herrera (University of Granada), "Is there a "euro effect" on trade? New evidence using gravity equations with panel cointegration techniques", September 15, 2011.

Thomas Eife (University of Heidelberg) "Optimal price setting during a currency changeover: Theory and evidence from French restaurants", September 22, 2011.

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Structural heterogeneity in the euro area

Pierre Jaillet, Director General for Economics and International Relations

As pointed out by Jean Pisani-Ferry, originally, the European Monetary Union did not meet the characteristics of an optimal currency area. This is probably why the questions of homogeneity and convergence have always been a central concern in the euro area construction process: whether to join the euro area (Maastricht criteria) or to prevent the imbalances towards which one or the other Member State could drift. After a 12 year experience record and as a result of the crisis, the Heads of State and Government have assessed the limitations of this "surveillance" framework and have made significant improvements (strengthening of the Stability and Growth Pact; better monitoring of external imbalances, in particular, under the "Euro-Plus Pact").

However, the crisis has also brought to light the risks associated with the persistence of structural heterogeneities within Economic and Monetary Union. Admittedly, the "Europe 2020" strategy, which follows on from the Lisbon strategy, defines a series of common structural reform objectives: convergence of employment rates of the 20-64 year age group to levels above 75%, increase in the share of R&D in GDP (to 3%), reduction in the school drop-out rate, the poverty rate and greenhouse gas emissions. However, these objectives – provided they are met – will bear fruit only in the long run. Now the real catching-up process has virtually come to a halt in a certain number of countries (notably in the smaller Southern economies), with a marked polarisation of manufacturing activities, in particular, towards the economies that were better endowed from the outset. The consequences are now well-known: lasting trade imbalances, inefficient labor markets, heterogeneous reactions to shocks, less effective economic policy instruments due to shrinking tax bases, weakened local financial institutions and, in the absence of a "buffer" federal budget, obligation to set up community safety nets (EFSF, ESM). It is crucial for the smooth functioning of the EU that the structural catching-up process be resumed in order to help euro area economies organized around "clusters" to start converging again.

A prerequisite is to take the measure of the problem: by mobilizing a very wide range of structural indicators publicly available on each euro area country at the aggregate level (education, R&D spending, patents, employment rates, market regulations, administrative burden, underground economy, etc.), it is possible by constructing an appropriate set of metrics to measure the structural heterogeneity of the euro area and its development since the mid-1990s. Four countries in the 12-country euro area display relatively unfavorable structural factors: Spain, Greece, Italy and Portugal. For example, Spain, Greece and Italy have very low employment rates. In Spain, the school drop-out rate is still high and lifelong training is hardly developed. Until recently, Italy had a patchy system of unemployment benefits and a much higher level of protection of permanent jobs than its European partners.

According to this quantitative analysis conducted by the Microeconomic and Structural Analysis Directorate, the euro area is structured around two groups – the group formed by these four countries and the other countries. This bipolarization has increased since the 1990s, because the distance between the groups has kept on growing while the groups themselves have remained fairly homogeneous.

This empirical analysis shows that the single currency is not enough to spontaneously and endogenously induce a structural convergence of economies. After the diagnosis comes the prescription: the "Europe 2020" strategy defines a common framework. Several countries, like Spain, Italy or Portugal more recently, have implemented ambitious structural reform programs that target the labor market, as well as the civil service, pension systems and the goods and services markets, and aim at achieving a balanced convergence between flexibility and protection (of companies, workers etc.) on the different segments of economic activity. The financial crisis has also highlighted the need to set up, in the framework of a completely open financial market, harmonized procedures for macro-prudential regulation, alongside the monitoring of systemic risks. All these factors should contribute to improving the homogeneity of transmission channels and hence the visibility and effectiveness of the single monetary policy.

Andrew Siegel (Washington University), "Reflections on Conditioning Information in Portfolios", October 12, 2011.

Mark Spiegel (FRB San Francisco) "Currency Composition of International Bonds: The EMU Effect", October 24, 2011.

Ethan Cohen-Cole (University of Maryland) and Yves Zenou (University of Stockholm) "Systemic Risk and Network Formation in the Interbank Market", October 25, 2011.

Jesper Lindé (FRB) "Fiscal Consolidations in Currency Unions: Spending Cuts vs, 2011. Tax Hikes", October 27, 2011.

Lorenzo Ciari (Institut Européen de Florence) "Issues on competition policy", December 6, 2011.

Iftekhar Hasan (Fordham University et Banque de Finlande) "Bank supervision and information content: Global evidence", December 9, 2011.

Three questions to… Jean Pisani-Ferry

Director of Bruegel and professor at Université Paris-Dauphine

Has the structural heterogeneity of euro area countries been reduced since 1999?
The issue of structural heterogeneity across Eurozone countries was investigated extensively in the run-up to the monetary unification and economic research largely agreed that the EMU risked being quite far from the ideal of an Optimal Currency Area. Comparison with the US showed that heterogeneity across the euro area was higher – especially for European peripheral countries – and adjustment mechanisms such as labor mobility, automatic budgetary transfers and financial diversification less powerful. Moreover, the risk that one-size-fits-all monetary policy could result in serious credit bubbles was also foretold.

At the time, however, the tendency was to interpret this literature in a rather complacent way. It was hoped that the introduction of the single currency would eventually be sufficient to turn the Eurozone endogenously into an optimal currency area. The trade-creation effects of the single currency was expected to reduce business cycle asymmetry and it was thought that a solid anchoring of inflation expectations would have enabled the common monetary policy to deal appropriately with different countries. It was also assumed that the forsaking of exchange-rate flexibility would endogenously foster price flexibility.

Ex-post, this reading has turned out to be overly optimistic. Nominal convergence has been accompanied by a process of demand-side divergence. Inflation differentials have proven to be persistent and have translated into wide competitiveness gaps within the Eurozone. The trade-creation effect has been very limited. Manufacturing activity has predominantly concentrated in core countries. External positions have been steadily diverging.

Is this heterogeneity at the root of the summer 2011 crisis?
The crisis had its immediate cause in the Greek fiscal crisis, but heterogeneity within the Eurozone has certainly contributed to the build-up of unsustainable real exchange-rate misalignments and current-account imbalances. As the crisis developed, it became increasingly apparent that the private credit developments of the last decade, price divergence and the resulting asymmetries in the relative shares of the non-traded and the trade-goods sectors contributed to doubts about the wisdom of investing in Southern Europe. Moreover, financial integration has proved to be more destabilizing that previously thought. Financial integration was considered a major success of the euro but countries like Greece, Portugal and Spain that were relying heavily on foreign banks' intermediation for the financing of their large external deficits proved to be very vulnerable to the reversal of capital inflows. Financial markets' doubts about solvency have immediately translated into sizable capital outflows, making the situation of national banking systems even more precarious and casting further doubts on the situations of sovereigns.

How can economic policy deal with this heterogeneity?

The current strategy puts an almost exclusive emphasis on fiscal adjustment. Certainly, public finances have to be made sustainable to restore market confidence and it is true also that fiscal adjustment in the South contributes to correcting real exchange-rate misalignments. However adjustment is a process that is bound to affect the euro area as a whole. There has been a confusing debate between the sharing of the burden between the North and the South, to which the ECB policy framework ultimately provides the answer. Price stability should be maintained for the Eurozone as a whole, with inflation being lower in deficit countries and higher in surplus countries. Monetary policy in this way will contribute to the rebalancing – provided equilibrating price developments are not counteracted by fiscal, wage or macroprudential policies in the North.

Publications in the 2nd half of 2011

"Forecasting the business cycle -Summary of the 8th International Institute of Forecasters workshop hosted by the Banque de France on 1-2 December 2011 in Paris", L. Ferrara, Banque de France *Quarterly Selection of Articles* No. 24 Winter 2011-2012.

"Fiscal and monetary policy in the aftermath of the financial crisis Summary of the BDF/EABCN/EJ/PSE conference on 8-9 December 2011", M. Bussière and P. Towbin, Banque de France *Quarterly Selection of Articles* No. 24 Winter 2011-2012.

"Particle filters for continuous likelihood evaluation and maximization", S. Malik and M. Pitt, *Journal of Econometrics*, December, 165, pp. 190-209.

"Bubbles and self-fulfilling crises", X. Ragot, E. Challe, *B.E. Journal of Macroeconomics*, 11(1), 2011.

« Les commissions de surendettement des ménages : de l'objectif de négociation à la prévention de la rechute », H. Fraisse and A. Muller, *Économie et Statistique*, No. 443, pp. 3-27, novembre 2011.

"Exchange Rate Volatility across Financial Crises", V. Coudert, C. Couharde and V. Mignon, *Journal of Banking and Finance*, November 2011, v. 35(11), pp. 3010-18.

« Nouveaux défis pour la dette publique dans les pays avancés », C. Bouthevillain, G. Dufrénot and P. Jaillet, *Revue Économique*, November, 62(6), pp. 965-69.

« L'impact des fondamentaux macroéconomiques sur les spreads souverains de la zone euro est-il influencé par les réformes financières ? », O. Damette, G. Dufrénot and P. Frouté, *Revue Économique*, November, 62(6), pp. 1135-45.

"Can fiscal policy stimulus boost economic recovery?", L. Agnello and R .Sousa, *Revue Économique*, November, 62(6), pp. 1045-66

"Surplus Consumption Ratio and Expected Stock Returns", I. Ghattassi, *Annales d'Économie et de Statistiques*, October, 103/104 (2), pp. 241-268.

« La BCE : Quels scénarios de sortie de crise ? », C. Bordes and L. Clerc, *Revue d'Économie Financière*, October, 103, pp. 117-44.

"Lumpy price adjustments: A microeconometric analysis", P. Sevestre, E. Dhyne, C. Fuss and H. Pesaran, *Journal of Business and Economic Statistics*, October, 29(4), pp. 529-540.

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Fiscal and Monetary Policy in the Aftermath of the Financial Crisis

8-9 December 2011, Paris

The recent financial crisis has led fiscal and monetary authorities throughout the world to take unprecedented measures. The aim of the conference was to bring together prominent academics and policy makers to present recent analytical work and exchange views on these complex issues. The conference was organized in association with the Paris School of Economics (PSE) – as part of the partnership agreement that links the Banque de France and PSE–, the euro Area Business Cycle Network (EABCN) and The Economic Journal. It was hosted by the Paris School of Economics at the Maison des Sciences Économiques on December 8-9 in Paris.

Public debt levels and budget deficits have increased dramatically since the start of the financial crisis, raising questions about their sustainability and appropriate consolidations strategies. A natural consequence of debt levels that are perceived as unsustainable are corrective fiscal measures. A first set of papers investigated the effects of fiscal consolidation strategies on economic growth. Topics included a comparison of alternative consolidation strategies based on spending cuts or tax increases, refinements in the statistical estimation of the tax multiplier, and research on the interaction between spending multipliers and sovereign risk.

The second part of the conference was devoted to gain a better understanding of the interaction between financial markets and sovereign risk. The years prior to the crisis were characterized by a substantial increase in household leverage and private credit in several advanced economies. Against this background, the research presented investigated the effects of household leverage on the transmission of government spending shocks in a New-Keynesian model with unemployment.

The third part of the conference centered on the role of expectations in the conduct of fiscal and monetary policy. Research presented emphasized that the optimal conduct of monetary policy crucially depends on whether expectations are anchored or not, investigated the effect of the maturity of government debt on the optimal rate of inflation, and considered the implications of uncertainty about the timing and the composition of fiscal consolidation packages.

A last set of papers was motivated by the rapid increase in asset prices prior to the crisis and the question whether central banks should "lean against the wind" to prevent excesses. One paper questioned the conventional wisdom that tightening monetary policy can fight asset price bubbles. Other research made a case for using both ex ante macroprudential policies and ex post stimulative policies when dealing with financial imperfections that derive from excessive leverage.

The conference concluded with a policy panel to which Pierre Jaillet, Daniel Cohen, Albert Marcet, and Frank Smets participated. Participants discussed the implications of the global financial crisis and the turbulences in the Euro area for current and future fiscal and monetary policy. Topics included the underlying reasons behind sovereign stress in the euro area, the interaction of monetary and macroprudential policy, and the difficulties inherent in fiscal sustainability assessments. While no definite answer can be drawn from the debates, the conference gave researchers in the field the opportunity to present some of their key findings and to discuss them with practitioners. Overall, the discussion witnessed the rapid progress that the field has achieved since the crisis.

« *Coordination internationale et sortie de crise : Quel rôle pour le G20 ?* », B. Cabrillac and P. Jaillet, *Revue d'Économie Financière*, October, 103, pp. 237-55.

« *Quelques éléments empiriques sur la crise financière récente* », V. Coudert and V. Mignon, *Revue d'Économie Financière*, October, 103, pp. 21-40.

"Trend Agnostic One-Step Estimation of DSGE Models", F. Ferroni, *B.E. Journal of Macroeconomics: Advances in Macroeconomics*.

"Companies after the crisis – Banque de France seminar, 28 June 2011", Banque de France *Quarterly Selection of Articles*, No. 23, Autumn 2011.

"Fiscal and monetary policy challenges in the short and long run – Summary of the Banque de France-Bundesbank conference held on 19 and 20 May 2011 in Hamburg", L. Clerc, H. Kempf and X. Ragot, Banque de France *Quarterly Selection of Articles*, No. 23, Autumn 2011.

"After the collapse, the reshaping of international trade – Summary of the Banque de France/PSE/CEPII conference of 25 and 26 May 2011", P. Bourgeon, J.-C. Bricongne and G. Gaulier, Banque de France *Quarterly Selection of Articles*, No. 23, Autumn 2011.

"Does Euro or Dollar Pegging Impact the Real Exchange Rate? The Case of Oil and Commodity Currencies", V. Coudert and C. Couharde and V. Mignon, *World Economy*, September 2011, v. 34(9), pp. 1557-92.

"Externality in labor supply and government spending", J. Matheron, J.-G. Sahuc and P. Fève, *Economics Letters*, September 2011, v. 112(3), pp. 273-76.

"Booms and Busts in Housing Markets: Determinants and Implications", L. Agnello and L. Schuknecht, *Journal of Housing Economics*, September 2011, v. 20(3), pp. 171-90.

« *Les comportements d'emprunt des régions françaises : Quel degré d'hétérogénéité ?* », G. Dufrénot, P. Frouté and C. Schalck, *Revue Économique*, September, 62(5), pp. 919-40.

"Gold and financial assets: Are there any safe havens in bear markets?", V. Coudert and H. Raymond-Feingold, *Economics Bulletin*, Vol. 31(2), pp. 1613-22.

"Would the Bundesbank Have Prevented the Great Inflation in the United States?", L. Benati, *Journal of Economic Dynamics and Control*, July 2011, v. 35(7), pp. 1106-25.

"Public housing and regional segregation of immigrants in France, 1968-1999", G. Verdugo, *Population*, 2011, Vol. 66(1), pp. 169-93.

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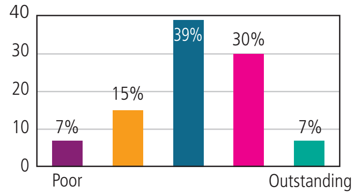
The Banque de France's survey of academic economists: Feedback summary

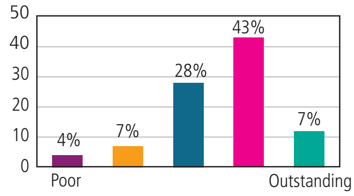
Last November, a survey was conducted to obtain an overview of academic economists' opinion about the overall contribution of the Banque de France to research (67 responses). Ten questions were asked about the Bank, its Foundation for research and its joint ventures with the academic community. Those concerning the DGEI more specifically are summarized below.

Question 1 • Has the Bank staff carved out a reputation for itself as a producer of high-quality research in comparison with the ECB, the Federal Reserve and other central banks?



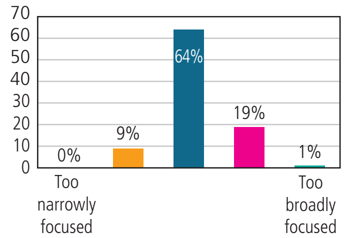
The modal response (39 percent) is that the quality of research is satisfactory. A total of 22 percent of respondents consider that research is underperforming, against 37 percent weighing on the side of high achievement.

Question 2 • How do you evaluate the DGEI for promoting research in the international academic community (job market recruitment, conferences, seminars, etc.)?



The overall view of the DGEI's support for research in the academic community is favorable: 55 percent of respondents consider that its performance is excellent or even outstanding, and 28 percent that it is reasonable.

Question 3 • Does the staff's contribution appear adequately focused for a central bank?



The majority of respondents consider that the scope of DGEI research corresponds to what is expected from a central bank. The excess percentage of those suggesting a narrower rather than broader focus is small.

Do you have comments or suggestions that might enable the DGEI to improve its research contribution?

The main outcome of the survey is that the DGEI's reputation is largely based on its support for the academic community rather than its track record of publications, although the focus of research is itself considered appropriate. A few suggestions are made to bridge this gap, such as the guidance from an internationally appointed steering committee or the need to have DGEI research assessed by the wider community. The DGEI has been advised to "take risks" by anticipating relevant forward-looking topics and forewarned against the risk of focusing on directed research, which could hinder its visibility in journal publications. Developing contacts with new or former visiting scholars, hiring on the junior academic job market, or entering into one-off part-time contracts with seasoned researchers are suggested as important steps – which is precisely what the DGEI has been doing over the past few years. One respondent concluded that it may be too early to see the benefits of the DGEI's change of attitude towards research: its reputation has been steadily improving, but an assessment will take more time.

"What prospects for a European Debt Agency?", L. Daniel and P. Diev, *Revue Économique*, Vol. 62(6), pp. 1147-62.

« Plus grandes, plus fortes, plus loin… Les performances des firmes exportatrices françaises », M. Crozet, I. Méjean and S. Zignago, *Revue Économique*, 62(4), pp. 717-36.

« Évaluation de la politique monétaire dans un modèle DSGE pour la zone euro », S. Adjemian and A. Devulder, *Revue Française d'Économie*, July, 26(1), pp. 201-245.

"The Economics of Badmouthing: Libel Law & the Underworld of the Financial Press in France Before World War I", V. Bignon and M. Flandreau, *The Journal of Economic History*, 71(3), pp. 616-653.

"Are the effects of fiscal changes different in times of crises and non crisis? The French case", C. Bouthevillain and G. Dufrénot, *Revue d'Économie Politique*, 121(3), pp. 341-407.

« Crise et croissance : une stratégie pour la France », P. Aghion, G. Cette, É. Cohen and M. Lemoine, *Rapport du Conseil d'analyse économique*.

« Comment relever la croissance potentielle après la crise ? Forces et faiblesses des évaluations de la croissance potentielle », M. Chetouane and M. Lemoine, complément au *Rapport du Conseil d'analyse économique « Crise et croissance : une stratégie pour la France »*.

« Une analyse fine de la concurrence internationale entre la France et l'Allemagne », J.-C. Bricongne, L. Fontagné and G. Gaulier, complément au *Rapport du Conseil d'analyse économique « Crise et croissance : une stratégie pour la France »*.

Convergence of euro area inflation rates

Inflation rates and their convergence within the Euro area have been a major concern since well before the advent of the single currency. The recent financial crisis and its strong impact on several Euro area countries with higher inflation rates have strengthened this interest, especially in the light of the European Central Bank's (ECB) objective of price stability.

Assessing whether Euro area inflation rates satisfy such a convergence since the introduction of the single currency is challenging, due to the limited amount of available data and the poor performance of standard time series techniques typically used to test convergence.

Claude Lopez and David Papell address this issue in two steps. First, they use a new testing procedure with improved performance in relatively small samples and show compelling evidence of group-wise convergence among the 12 initial Euro area countries. Second, they show that these countries meet the ECB's objective on price stability, both as a group and individually. The result holds even when a minority of countries, namely Greece, Ireland and Spain, report consistently higher inflation rates for most of the Euro period. The resulting loss in price competitiveness contributed to the trade imbalances and current account deficits that partly explain the build-up of bubbles and these countries' disadvantage in the run-up to the 2008 crisis. Interestingly, the crisis acted as an inflation "realignment" device for Spain and Ireland, but not for Greece.

Claude Lopez and David Papell*, "Convergence of euro area inflation rates", *Journal of International Money and Finance, forthcoming.

Claude Lopez is a senior economist in the International Macroeconomic Division (SEMSI). Prior to joining Banque de France, she was a tenured professor in Economics at the University of Cincinnati (USA). Her research on finite sample convergence issues has been published in journals such as the Journal of Money, Credit and Banking, the Journal of International Money and Finance and Econometrics Reviews, among others.

Are reserve requirements effective for financial stability?

Emerging market central banks face a well-known dilemma when dealing with credit booms driven by capital inflows: higher interest rates to halt the credit boom might just attract more capital and appreciate the currency. A number of countries, including Brazil, China, and Turkey, therefore use reserve requirements as an additional policy instrument.

Christian Glocker and Pascal Towbin build a small open economy model with sticky prices, financial frictions and a banking sector that is subject to legal reserve requirements. If monetary authorities target interest rates or exchange rates, they accommodate reserve requirement changes automatically through an endogenous expansion of the monetary base. Reserve requirements act mainly as a tax on deposits and widen the spread between lending and deposit rates. An increase in reserve requirements generates an exchange rate depreciation and tougher credit conditions at the same time, and has ambiguous effects on output and inflation.

Overall, the results indicate that reserve requirements can support the price stability objective only if financial frictions are important. They can lead to substantial improvements if the central bank has a financial stability objective in conjunction with foreign currency debt. In subsequent empirical work, the authors find supportive evidence of the main predictions of the model in Brazilian data.

Christian Glocker, Pascal Towbin*, "Reserve requirements for price and financial stability: When are they effective?", *International Journal of Central Banking, March 2012. …/…

Banque de France Working Papers

358 Market access in global and regional trade, José de Sousa, Thierry Mayer and Soledad Zignago.

357 Capital controls and spillover effects: evidence from Latin-American countries, Frederic Lambert, Julio Ramos-Tallada and Cyril Rebillard.

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355 Firm-Network Characteristics and Economic Robustness to Natural Disasters, Fanny Henriet, Stéphane Hallegatte, and Lionel Tabourier.

354 Fiscal Policy Discretion, Private Spending, and Crisis Episodes, Luca Agnello, Davide Furceri and Ricardo Sousa.

353 Price Stickiness and Sectoral Inflation Persistence: Additional Evidence, Hervé Le Bihan and Julien Matheron.

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351 Interpreting the Hours-Technology time-varying relationship, Cristiano Cantore, Filippo Ferroni and Miguel León-Ledesma.

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349 Risk aversion and Uncertainty in European Sovereign Bond Markets, Valère Fourel and Julien Idier.

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345 Debt enforcement and the return on money, Mariana Rojas-Breu.

344 Wealth Effects on Consumption Plans: French Households in the Crisis, Luc Arrondel, Frédérique Savignac and Kevin Tracol.

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Pascal Towbin is an economist at the International Macroeconomics Division (SEMSI) since 2010. He holds a Ph. D. from the Graduate Institute of International and Development Studies, Geneva. His research interests lie in international macroeconomics, in particular capital flows, exchange rate regimes and financial integration.

Speculative bubbles, size of the financial sector and skilled labor

The crisis has led economists to reflect on the place of the financial sector vis-à-vis the services that it provides to the economy. Four major stylized facts have been observed over the past twenty years in the United States and, to a lesser extent, in other OECD countries: the pronounced growth of the sector, the surge in compensation, the widening of wage inequalities, and the emergence of a string of financial bubbles.

To link these developments together, Pierre Cahuc (CREST) and Edouard Challe build an overlapping generations model in which agents choose to work in the "classic" productive sector or in the financial sector. The financial sector performs the intermediation required between household savings and corporate investment, but enjoys a power of rent-extraction. In this context, a rational financial bubble increases both the return on assets and the rent extracted by the financial sector.

In a free entry equilibrium, skilled workers are attracted to this lucrative sector, causing a scarcity of skilled labor in the rest of the economy and mechanically raising the skills premium. At the same time, the lack of skilled labor in the productive sector lowers productivity, and therefore the real wage, of unskilled labor. In short, the financial bubble increases the size of the financial sector, compensation in finance and wage inequalities throughout the entire economy.

P. Cahuc, E. Challe,* "Produce or speculate? Asset bubbles, occupational choice and efficiency", *International Economic Review, forthcoming.

Edouard Challe is a research fellow at the CNRS, a lecturer at the Ecole Polytechnique, a research associate at the CREST and a consultant to the Banque de France. He previously taught at the University of Cambridge and the University Paris-Dauphine. His research focuses on asset bubbles and asset price volatility on the one hand, and precautionary savings and liquidity hoarding behaviour on the other. His research has appeared in journals such as the Journal of Economic Theory, Economic Theory, the Economic Journal and the Journal of Economic Dynamics and Control.

The determinants of intrafirm trade: Evidence from French firms

Companies constantly have to choose between operating internally («intra-firm trade») or in the market. A key issue is the hold-up problem. When production requires specific investments by the parties involved in the contracts (employee training, special equipment, etc.), each one is captive of its exclusive relation to the other when unforeseen circumstances arise. According to the theory of incomplete contracts, it is the control rights that determine, ex post, the allocation of rents and, ex ante, the boundaries of companies.

In a publication co-authored with Gregory Corcos (HEC Norway), Giordano Mion (LES) and Thierry Verdier (PSE), Delphine Irac corroborates using French data the main predictions .../...

343 Capital Utilisation and Retirement, Antoine Bonleu, Gilbert Cette et Guillaume Horny.

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339 The impact of unconventional monetary policy on the market for collateral: The case of the French bond market, Sanvi Avouyi-Dovi and Julien Idier.

338 Median-Unbiased Estimation in DF-GLS Regressions and the PPP Puzzle, Claude Lopez, Christian J. Murray and David H. Papell.

337 Short Note on the Unemployment Rate of the French Overseas regions, Jean François Hoarau, Claude Lopez and Michel Paul.

336 How have global shocks impacted the real effective exchange rates of individual euro area countries since the euro's creation?, Matthieu Bussière, Alexander Chudik and Arnaud Mehl.

335 Immigration and the Occupational Choice of Natives: a Factor Proportions Approach, Javier Ortega and Grégory Verdugo.

334 Unit Roots, Level Shifts and Trend Breaks in Per Capita Output: A Robust Evaluation, Mohitosh Kejriwal and Claude Lopez.

333 Macroeconomic consequences of global endogenous migration: A general equilibrium analysis, Vladimir Borgy, Xavier Chojnicki, Gilles Le Garrec and Cyrille Schwellnus.

332 The Stability of Macroeconomic Systems with Bayesian Learners, James B. Bullard and Jacek Suda.

331 Impact of the crisis on potential growth: An approach based on unobserved component models, Matthieu Lemoine, Marie-Elisabeth de la Serve and Mabrouk Chetouane (in French).

concerning the boundaries of international firms: (i) capital intensive and high-skilled labor intensive firms, as well as the most productive firms, conduct more intra-firm trade, (ii) intra-firm imports are more likely to come from capital abundant countries, (iii) the most productive firms import more internally from countries with good contract enforcement structures.

Thus, a high-tech company, in the pharmaceutical industry for example, will prefer to set up a subsidiary in a partner country with high-quality legal institutions rather than do business with firms in this country. The quality of the institutional framework not only facilitates trade between companies, in particular by lowering transaction costs associated with litigation, but, more importantly, it secures property rights which are particularly important for high-tech companies. It is this second effect that dominates.

Delphine Irac, Gregory Corcos, Giodano Mion & Thierry Verdier,* "The determinants of intrafirm trade: Evidence from French firms", *The Review of Economics and Statistics, forthcoming.

Delphine Irac holds a PhD from Columbia University. She is currently Head of the Structural Policy Analysis Division and a lecturer at the Paris School of Economics.

What explains the dynamics of US inflation, Good Luck or Good Policy ?

The level of US inflation and of nominal interest rates shows an inverted U-shaped pattern, rising at the end of the 1970s and falling at the beginning of the 1980s. The volatility of inflation dramatically declined since the mid 1980s. A popular explanation points at the change in monetary policy from passive to active since the beginning of 1980s ('good policy' hypothesis). A low inflation regime ensued, and the larger predictability of monetary policy made the macroeconomic environment less volatile. The alternative view suggests that the reduction in the volatility of inflation was mainly caused by the decline in the intensity of the shocks hitting the US economy ('good luck' hypothesis).

Fabio Canova and Filippo Ferroni ascertain which of the two explanations is more plausible by estimating a DSGE model over rolling samples of fixed length. They find that the fall in inflation volatility can be attributed in part to monetary policy but, in agreement with the good luck hypothesis, they also detect variations in the estimate of the variance of the shocks. Interestingly, the private sector played a specific role as well. The real balances trade-off and the investment adjustment cost have increased in the later samples and contributed to explaining why inflation volatility has subsided.

Fabio Canova and Filippo Ferroni,* "The dynamics of US inflation: Can monetary policy explain the changes?", *Journal of Econometrics, 167, (2012) 47–60.

Filippo Ferroni is an Economist in the Directorate of Business Conditions and Macroeconomic Forecasting of Banque de France. He received his Ph.D. in Economics at Universitat Pompeu Fabra in 2009 and he has publications in Journal of Econometrics, Quantitative Economics, The B.E. Journal of Macroeconomics. His main fields of expertise are macroeconometrics, quantitative macroeconomics and applied times series.

Exchange rate flexibility across financial crises

Many emerging countries have loosened the link of their currencies to the US dollar since Lehman Brothers' bankruptcy in 2008, mainly under the fire of violent market pressures. Investors bearing heavy losses on advanced stock markets may have engaged in selling off assets across the board, including in emerging …/…

Acknowledgement of discussants

The following discussants contributed insightful remarks and suggestions to the DGEI's weekly seminars in the second semester of 2011. They are warmly thanked for their support.

Jacopo Cimadomo (European Central Bank), Hans Dewachter (Banque nationale de Belgique), Romain Duval (OECD), Jonathan Eaton (Pennsylvania State University), Patrick Fève (Toulouse School of Economics), René Garcia (EDHEC), Domenico Giannone (Université libre de Bruxelles), Koen Jochmans (Sciences-Po), Christian Julliard (London School of Economics), Jean Mercenier (Paris 2), Joël Peress (INSEAD), Barbara Rossi (Duke University), Cyrille Schwellnus (OECD)

countries. Carry-trades have also been suddenly unwound, as risk-aversion surged. Incidentally, the rationale to pegging to the dollar was undermined by neighboring countries giving up their peg.

In a paper joint with Cécile Couharde (Paris Ouest) and Valérie Mignon (Paris Ouest), Virginie Coudert tests whether exchange rate policies in emerging countries are contingent on financial strains in advanced markets. They measure exchange rate policies by the degree of currency volatility, and assess global financial stress by the volatility on both world stock markets and commodity markets. They confirm that exchange rate volatility tends to increase more than proportionally with the indicator of global financial strains and find evidence of non-linearities in the contagion effects from one emerging currency to its neighbors. According to these results, financial turmoil in advanced markets spills over into a loosening of exchange rate policies in emerging countries. This effect is amplified once the volatility on global financial markets has exceeded a certain threshold.

V. Coudert, C. Couharde, V. Mignon,* "Exchange rate volatility across financial crises", *Journal of Banking and Finance, forthcoming.

Virginie Coudert works as a Scientific Advisor for the Directorate of Financial Stability. She is also a Visiting Professor at the University of Paris Ouest Nanterre la Défense and a research associate at the CEPII. She has written articles on various topics in monetary economics, international finance and exchange rates, in journals such as the Journal of Banking and Finance, the Review of International Economics, the World Economy.

Multi-country models

The study of international trade, exchange rates and capital flows requires modeling simultaneously several countries or regions. These models can also be used to analyze global imbalances. In order to achieve a sufficient degree of realism, they are necessarily large-scale models and often built by entire teams over several years. The DGEI uses two: the EAGLE model, constructed by the European System of Central Banks (ESCB), and the GIMF model developed by the IMF.

The ESCB has built the EAGLE model, used by the SEPS, to study the transmission channels of shocks occurring in a member country of a monetary union and the role of structural features specific to a particular country. It is thus possible, for example, to analyse the consequences of the heterogeneity between euro area countries for the formulation of common policies. The model includes two regions inside the monetary area and two regions outside it.

The GIMF model is used by the SEMSI. In its basic version, it contains five regions: the United States, the euro area, Japan, emerging Asia and the rest of the world. Because of its representation of households using overlapping generations, it displays non-Ricardian properties that make it particularly suitable for analyzing tax policies and their consequences for other countries. This model has been used extensively by the IMF and some central banks to analyze the fiscal stimulus policies adopted at the beginning of the financial crisis and the absorption of government deficits.

Michel Julliard is coordinator of the DSGE network at the Banque de France and researcher at the CEPREMAP

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If you want to respond to this letter, you can write to the following address:
labolog@banque-france.fr