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Gilbert Cette

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What conditions are required to ensure a lasting reduction in euro area imbalances?

Gilbert Cette, Director, Microeconomic and Structural Analysis Directorate (DEMS)

The recent cyclical improvement in the euro area, combined with the narrowing of peripheral sovereign yield spreads over the Bund, the successful return to the sovereign debt market by one of the peripheral nations, Ireland, and diminishing or extinguished current account deficits, all suggest that the crisis in the euro area is over. However, unemployment is still exceptionally high (12.1% in the euro area as a whole, 26.7% in Spain), debt ratios have climbed to levels never before seen in peacetime and in some quarters low inflation is fuelling fears of a “Japanese-style” deflation scenario.

Analyses carried out at the Banque de France help provide a better understanding of the mechanisms that have led to macroeconomic imbalances and the conditions needed to redress them that would be compatible with a reduction in mass unemployment.

Gaulier and Vicard (2012) have put forward an analysis of the increase in current account imbalances in the euro area. They have found that the dynamics of domestic demand in deficit countries, partly driven by capital flows, created a situation whereby these nations were unable, due to inadequate competitiveness, to offset the ensuing growth in imports through higher exports. When it was created, the single currency was indeed expected to facilitate capital flows (doing away with currency risk). However, it proved difficult to control the risks tied to massive flows. In a number of countries, a property bubble fuelled by capital from the rest of Europe led to strong growth in imports and sent inflation higher than in the rest of the euro area (notably by comparison with Germany, which was experiencing wage moderation). The production capacities required to repay foreign debt were not created as funds were channelled into sectors with least exposure to international competition – sectors where the least-productive firms operate.

The downtrend in private capital flows, while largely offset by public funds, namely liquidity injections from the Eurosystem and the use of the TARGET2 payment system (see Kalantzis and Zignago, forthcoming), played a part in weakening foreign as well as domestic demand due to a preponderance of intra-European trade for most countries. Until now, peripheral nations have, by and large, balanced their current accounts through a drop in domestic demand: imports moved down while at the same time foreign demand from outside of the euro area was trending upwards and demand from euro area countries in surplus was stabilising.

In order to put net international investment positions (assets less liabilities) – aggravated by the accumulation of current account deficits – back on sustainable trajectories, export-driven growth conditions need to be created. This requires a decrease in relative prices in the countries concerned (see Durand and Lopez, 2012, as well as Coudert, Couharde and Mignon, 2013) for an assessment of misalignments in real exchange rates). While there have been substantial adjustments in equilibrium exchange rates for certain countries (Spain and Portugal), this has worked against France and Italy more than Germany, which has expanded its current account surplus (Carton and Herré, 2013).

In the current macroeconomic context, it is important to examine the conditions needed for the success of internal devaluation policies.

The success of internal devaluation strategies is compromised when such strategies are introduced simultaneously by too many member states of a monetary union, especially in the context of a liquidity trap. When key lending rates are close to zero, wage moderation cannot go hand in hand with a cut in nominal interest rates to drive up investment. In fact, disinflation makes for a hike in real interest rates, which can dampen investment, offsetting profitability and the competitiveness gains expected from lower labour costs and increasing the real private and public debt burden. Cuts in investment by businesses that see deleveraging as a priority then makes for a decrease in current account deficits but at a high cost and with no lasting impact.
Using a multi-country macroeconometric model, Berthou and Gaulier (2013) simulated wage moderation by lowering the annual pace of growth in labour costs in deficit countries of the euro area. The simulation showed that an adjustment solely by the deficit countries had a deflationary impact on the euro area as a whole. Symmetrical adjustment (factoring in faster wage growth in Germany) is more effective, does not negatively impact growth and does not hinder deleveraging. Carton and Hervé (2013) also highlighted the difficulty of adjusting real exchange rates in the euro area in a context of low inflation. Simply put, in a period of low average inflation, it is harder to achieve a strong and sustained inflation rate hierarchy between countries. In the euro area, such a hierarchy would help rapidly redress current account imbalances.

Coordination of economic policies is therefore essential. Common policies (first and foremost monetary policy) and those implemented in individual countries need to be compatible with the achievement of adequate levels of demand and inflation for the area as a whole. Domestic demand can be driven by additional investment in undervalued countries. Fiscal devaluation (lowering employers’ social security contributions by shifting the burden to households or cuts in public spending; see Aghion 2012, Cette, Fahri and Cohen 2012), which can help adjust the competitiveness of deficit countries, can be balanced using symmetrical “revaluation” policies in countries displaying a surplus. Wage stimulation in countries in surplus, such as the introduction of a minimum wage in Germany for example, may also have a balancing effect.

Aghion (P.), Cette (G.), Farhi (E.) and Cohen (E.) (2012), "Pour une dévaluation fiscale", Le Monde, 24 October.

Berthou (A.) and Gaulier (G.) (2013), "Wage dynamics and current account rebalancing in the euro area", Banque de France, Quarterly Selection of Articles No. 30.


Coudert (V.), Couharde (C.) and Mignon (V.) (2013), "Les mésalignements de taux de change réels à l’intérieur de la zone euro", Revue de l’OFCE, No. 127.

Durand (C.) and Lopez (C.) (2012), "Equilibrium exchange rate and competitiveness within the euro area", Banque de France, Quarterly Selection of Articles No. 28.

Gaulier (G.) and Vicard (V.) (2012), "Current account imbalances in the euro area: competitiveness or demand shocks?", Banque de France, Quarterly Selection of Articles No. 27.


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Workshop on the economics of cross-border banking

*Banque de France and Paris School of Economics – December 13 and 14, 2013*

The unprecedented freeze in bank funding markets and the subsequent events that unfolded during the 2008-09 financial crisis have motivated a rich research agenda on the behaviour of international banks, the transmission of shocks through global banking flows and the nature of international financial integration. The Banque de France, in cooperation with the Paris School of Economics (PSE), the Federal Reserve Bank of New York and the Centre for Economic Policy Research, organised an international conference on the “Economics of Cross-Border Banking” in Paris.¹

The first session on Friday, December 13, addressed the modeling of international banking integration. José Fillat (FRB Boston) presented a model of entry into the banking sector from the point of view of the host country whereas Friederike Niepmann (FRB New York) suggested a model of heterogeneous banks, which are constrained in their ability to enter foreign markets. Mathias Hoffmann (Universität Zürich) presented a paper on the interaction between financial development and financial integration of banks at the intra-national level.

The second session featured a presentation by Ivan Iaccard (ECB) on the role of capital flows to the adjustment to common shocks as well as a presentation by Jean-Christophe Poutineau (University of Rennes) on the role of the cross-border lending channel for the business cycle of a monetary union. The third session concentrated on empirical studies of international banking: the paper by Eugenio Cerutti (IMF) investigated the factors that led to a retrenchment in cross-border lending during the financial crisis whereas the paper by Neeltje van Horen (DNB) analysed the transmission of shocks by international banks in host countries.

The keynote speech was held by Linda Goldberg (FRB New York) who elaborated on the increasing complexity and size of banks, which have expanded both in scope and scale over the recent years. Particularly noteworthy, she stressed that banking groups are often part of (international) firms, which not only engage in financial services, but actually offer a wide range of services and products. Complexity is important when it comes to issues of resolution mechanisms, interconnectedness and risk exposure as well as the way banking activities are conducted.

On Saturday, December 14, the fourth session of the conference featured presentations on financial crises and banking regulation. Adrian Penalver (PSE) presented a model of banks’ behavior in setting credit standards to analyse whether the observed decline in pre-crisis credit standards can be attributed to low interest rates or to the savings glut hypothesis. Addressing the question of the drivers of financial crises, Mortiz Schularick (Universität Bonn) spoke about the role of private and public debt accumulation as well as their interaction. Vania Stavrakeva (LBS) presented a model of optimal bank regulation when governments are constrained in their ability to bail out banks.

The last session featured presentations by Silvia Gabrieli (Banque de France) and Galina Hale (FRB San Francisco) who both used network analysis to study the interactions and transmission channels between different banks. Whereas the first presentation concentrated on the liquidity allocation among European banks during the Lehman crisis, the second presentation concentrated on the international transmission of shocks through interbank relationships and exposure to crisis countries.

¹ The conference program is available on-line at https://www.banque-france.fr/fileadmin/user_upload/banque_de_france/Economie_et_Statistiques/Programme-2013_11_24.pdf
Are individuals inattentive when they form their macroeconomic expectations?

Several recent theoretical papers show that imperfect information, in the form of inattentiveness on the part of economic agents, is a promising way to account for macroeconomic empirical regularities that are problematic, such as the persistence of inflation. Persistence in price dynamics can thus be explained in relation to the sluggish adjustment of inflation expectations to the shocks underlying inflation, rather than by resorting to the ad-hoc and counterfactual assumption of price indexation.

There are two main approaches in this literature: models where agents adjust their information sets infrequently (“sticky information” models), and models where individuals have continuous access to noisy and idiosyncratic information on the state of the economy (“noisy information” models). Each of these approaches has different implications for the dynamics and heterogeneity of expectations.

In “Inattentive Professional Forecasters”, written jointly with Hervé Le Bihan, we use individual expectations from the ECB Survey of Professional Forecasters (SPF) to design new empirical tests for these models. We show that, despite the fact that new information is released each quarter, professional forecasters do not systematically update their forecasts on a quarterly basis. This is consistent with the sticky information approach. Furthermore, for a given quarter, there is a substantial diversity of opinions about future macroeconomic outcomes among the forecasters who updated their forecasts. In line with the “noisy information” approach, disagreement across forecasters is not merely due to the infrequent updating of information sets.

In light of this qualitative evidence, we develop an expectations model that features both types of imperfect information. We show that the model has difficulty matching quantitatively the empirical properties of both the forecast errors and the disagreement across forecasters as observed in the SPF data. Intuitively, to account for the observed sluggishness in the consensus forecasts is not merely due to the infrequent updating of information sets. We show that, despite the fact that new information is released each quarter, forecasters do not systematically update their forecasts on a quarterly basis. This is consistent with the sticky information approach. Furthermore, for a given quarter, there is a substantial diversity of opinions about future macroeconomic outcomes among the forecasters who updated their forecasts. In line with the “noisy information” approach, disagreement across forecasters is not merely due to the infrequent updating of information sets.

Philippe Andrade is a senior economist in the Monetary Policy division. His work focuses on the formation of expectations and their impact on macroeconomic fluctuations, as well as the dynamics of prices in an international setup. He has published articles in journals such as: The International Journal of Forecasting, the Journal of Econometrics and the Oxford Bulletin of Economics and Statistics.

Civic capital and the size distribution of plants

What determines the size of economic organisations? Economists usually explain differences in firm size by variations in factors such as market size, financial development and tax and labor regulations.

In this article, Matthias Bürker and G. Alfredo Minerva claim that societal values and beliefs, the so-called civic capital, shape the size distribution of plants. Employing Italian census data, the authors show that the stock of provincial civic capital increases both the average and the dispersion of plant size. The reason is that civic capital restrains opportunistic behavior, implying that in provinces where civic virtues are more pronounced agents have a lower propensity to shirk. This favors cooperation in intra-plant transactions and reduces the incidence of principal-agent problems. The empirical findings are consistent with models from organisational economics that predict a negative relationship between the incidence of agency problems and firm size.

Results show that the stock of civic capital, proxied by electoral turnout in referendums, blood donations and volunteering, increases the average size of plants in a given province. Similarly, civic capital raises the standard deviation of the plant size distribution. Analysing specific points of the size distribution reveals that the effect of civic capital is more pronounced for larger plants. The findings are economically important: a standard deviation increase of one in civic capital raises average plant size by 16%. The econometric specification allows for potential dynamics in plant size, addresses problems related to the measurement of civic capital, and includes fixed effects on a highly disaggregated industry and spatial scale as well as an extensive set of provincial controls. Moreover, civic capital is instrumented by historical measures from the 14th and 19th century to demonstrate that results are not driven by reversed causation.


Matthias Bürker is an economist in the Companies Directorate. His research focuses on applied microeconomics, in particular the behavior and organisation of firms as well as the geography of civic capital. He holds a PhD in Economics from the University of Bologna (Italy). His works have been published in the Journal of Economic Geography and Regional Science and Urban Economics.
Do product market regulations hinder growth?

Distortions in competition in the intermediate goods markets may hamper total factor productivity in product markets, even more so when firms are close to their technological frontier. Indeed, anti-competitive regulations enable firms in upstream sectors to extract a share of the innovation rents of firms in downstream sectors, which are therefore less inclined to innovate.

Based on an endogenous growth model, Gilbert Cette and his co-authors show that imperfections in intermediate goods markets can curb incentives to improve productivity in downstream industries. These predictions are confirmed by estimating a model of multifactor productivity growth in which the effects of upstream competition vary with the distance to the productivity frontier. Estimates are realised on a panel of 15 OECD countries and 20 sectors over the period 1985-2007. Competitive pressures are proxied with sectoral product market regulation data. Anti-competitive upstream regulations appear to have curbed multifactor productivity growth (MFP) over the past 15 years, and the effect is stronger for observations that are close to the productivity frontier. Some simulations show that all countries could expect significant MFP growth gains from structural reforms consisting in adopting best regulation practices in sectors that are important providers of intermediate inputs to the economy. However, these MFP growth gains differ across countries. The larger the excess regulatory burden, the higher the intermediate consumption of regulated products, the greater the sectoral composition effect and the smaller the distance to the productivity frontier, the stronger the gains in productivity from aligning regulations in upstream sectors with best international practice.

These MFP gains could significantly improve potential output growth, thereby also facilitating the adjustment of public finances.


Gilbert Cette is Director, Structural and Microeconomic Studies, at the Banque de France and Habilitated Doctor and Associate Professor at the Aix-Marseille School of Economics.

He has published several articles on growth, productivity and the labor market.
"No-arbitrage near-cointegrated VAR(p) term structure models, term premia and GDP growth", Jardet (C.), Monfort (A.) and Pegoraro (F.), Journal of Banking and Finance, February

"Limits of floating exchange rates: The role of foreign currency debt and import structure", Towbin (P.) and Weber (S.), Journal of Development Economics, March

"Default, liquidity, and crisis: An econometric framework", Monfort (A.) and Renee (J.-P.), Journal of Financial Econometrics, Spring

"Bank monitoring incentives and optimal ABS", Pagès (H.), Journal of Financial Intermediation, May

"Foreign entry and spillovers with technological incompatibilities in the supply chain", Carluccio (J.) and Fally (T.), Journal of International Economics, May

"The ‘forward premium puzzle’ and the sovereign default risk”, Couder (V.), Journal of International Money and Finance, February

"Welfare implications of heterogeneous labour markets in a currency union “, Poilly (C.) and Sahuc (J.-G.), Macroeconomic Dynamics, March

"Discretionary government consumption, private domestic demand, and crisis episodes”, Agnello (L.), Fureri (D.) and Sousa (R.), Open Economics Review, February


"Competition, R&D, and the cost of innovation: Evidence for France”, Askenazy (P.), Cahn (C.) and Irac (D.), Oxford Economic Papers, April

"The ECB’s separation principle: Does it ‘rule ok'? From policy rule to stop and go”, Bordes (C.) and Clerc (L.), Oxford Economic Papers, April

"Labor relations quality and productivity: An empirical analysis on French firms”,Cette (G.), Dromel (N.), Lecat (R.) and Paret (A.-C.), Review of Economics and Institutions, Spring

"Costs, demand, and producer price changes”, Loupias (C.) and Sevestre (P.), Review of Economics and Statistics, February

Production factor returns: The role of factor utilisation

In the short run, returns to scale increase when estimated solely on the basis of production factors, and total factor productivity is procyclical. Gilbert Cette, Nicolas Dromel, Remy Lecat and Anne-Charlotte Paret test whether omitting production factor utilisation (labor workweek, capacity utilisation rate, capital workweek) can explain this surprising result.

Measuring short-term returns to scale creates a puzzle, which has given rise to several hypotheses. A classical microeconomic explanation attributes these returns to insufficient competition, which leads firms to restrain their production in order to increase prices. A second explanation is that externalities linked to the production level yield increasing returns. Another hypothesis is that factor services are poorly measured due to the omission of factor utilisation. Indeed, capital stock cannot fully account for capital services if its use varies across the cycle, in terms of rhythm or workweek length. Similarly, without taking into account the length of the labor workweek, the number of employees alone is a poor reflection of labor’s contribution to the production process.

Using firm-level data from the Banque de France’s factor utilisation survey, the authors test this last hypothesis. In this survey, firms specify in a detailed manner the degree of utilisation of their production factors and the obstacles they may face when increasing the capital workweek. Once factor utilisation is taken into account, returns to scale are indeed constant in the short run. Crucially, this result relies on the capital workweek length. Indeed, firms have substantial leeway on this matter as they can change the number of shifts. Hence, it is crucial to take into account factor utilisation when measuring total factor productivity in order to capture technical progress and not cyclical factors.


Remy Lecat is Head of the Microeconomic Analysis Division at the Banque de France. He graduated from Sciences Po, Cambridge University and Paris-X-Nanterre University and holds a PhD from the EHESS-Paris School of Economics. His research focuses on production functions, firm productivity and the housing market. He has published articles in The Review of Economics and Statistics, the Review of Economics and Institutions, Economics Letters and Economie et Statistique.
Risk shifting in an opaque financial system

The ongoing global financial and economic crisis has revived interest in systemic risk in the financial system and its dramatic spillover to the real economy, and has raised the question of whether and how it should be addressed by public policies.

We show how the level of economy-wide risk taking depends on the distribution of equity among intermediaries and the level of interest rates in the economy. Our key assumption is that outside providers of funds cannot tell apart “prudent” and well-diversified banks and “imprudent” ones that are overly exposed to a particular asset, because the balance sheets of individual intermediaries are imperfectly observable or opaque. Opacity implies that intermediaries with low levels of capital may be tempted to hold high-risk portfolios, or even to gamble for resurrection in the face of worsening economic conditions. The limited liability of intermediaries creates incentives for them to increase leverage and hold insufficiently diversified portfolios, which raises their return on equity in the event of success while transferring much of their losses to their creditors in the event of failure. However, this tendency is alleviated by the inside equity stake held by intermediaries’ shareholders, which disciplines risk taking and thereby limits leverage and favors diversification.

This trade-off gives rise to an endogenous sorting of intermediaries along the equity dimension, with well-capitalised intermediaries holding diversified portfolios and maintain a limited level of leverage, and poorly capitalised ones resorting heavily to leverage and investing in correlated assets. One implication of our analysis is that an exogenous increase in the supply of funds to the intermediary sector lowers interest rates and raises the number of imprudent intermediaries. Another one is that easy financing may lead an increasing number of intermediaries to gamble for resurrection following a severe shock to the sector’s capital, again raising economy-wide systemic risk.


Benoît Mojon is Director, Monetary and Financial Studies, at the Banque de France and Associate Professor at Ecole polytechnique. His research covers various topics in applied macroeconomics, including the transmission of monetary policy, the dynamics of inflation, and real and financial cycles. He has made numerous contributions in books and journals such as the Journal of Monetary Economics, the Review of Economics and Statistics, or the European Economic Review.
Pricing default events: Surprise, exogeneity and contagion

Debtor defaults affect the cash flows of various financial instruments such as bonds issued by debtors or credit default swaps (CDS) written on reference entities. Various methods have been proposed in the literature aimed at valuing these financial products in a tractable and maturity-consistent way. Nevertheless, computational simplicity often comes at the cost of strong assumptions. In particular, standard credit-risk models price the default intensities, not the default events themselves: in pricing formulas, the default indicator is replaced by an appropriate prediction and the prediction error, that is the default-event surprise, is neglected.

Christian Gourieroux, Alain Monfort and Jean-Paul Renne develop an approach to get closed-form expressions for the prices of credit derivatives written on multiple names without neglecting the default-event surprises. It is important to keep track of the number of names in the portfolio, as the occurrence of new defaults may have its own impact on the pricing of risk, beyond that captured by risk factors. Hence, an appealing feature of the framework lies in its ability to model the propagation of defaults as the pool size shrinks.

Applying this approach to US bond data shows how it can account for the credit spread puzzle. This puzzle corresponds to the observation of both low bond prices and low default probabilities for issuers. The mechanism implicitly developed by the authors relies on the fact that defaults tend to occur during crisis periods: when buying defaultable bonds, investors act as insurers and ask for a discount in bond prices, on top of the risk premiums already taken into account by standard models.


A seminar on DSGE models

At the start of 2014, we organised an introductory seminar on DSGE models within the framework of the International Banking and Finance Institute (IBFI) training programme. For one week, economists from around 20 central banks attended lectures in the morning and carried out practical exercises in the afternoon. The sessions were run by economists from the Directorate General Economics and International Relations (DGEI): Simona delle Chiaie, Filippo Ferroni, Michel Juillard, Julien Matheron and Daniele Siena.

The lectures focused on: the neoclassical growth model, on which all subsequent studies were based, the New Keynesian developments that introduce nominal and real rigidities into the model, the techniques for solving DSGE models and an introduction to Dynare software, an introduction to Bayesian econometrics, and an in-depth presentation of the Smets-Wouters Model (2007).

A second, more advanced seminar will be offered internally in May-June and within the IBFI framework at end-September. This second seminar will focus on: analyses of optimal policy, Open-Economy DSGE Models; models for emerging economies; the introduction of financial frictions; and the use of DSGE Models for forecasting.

Acknowledgement of discussants

The following discussants contributed insightful remarks and suggestions to DGEI’s weekly seminar in 2013. They are thanked wholeheartedly for their support.

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