

# Friends of acronyms, here comes the OMT

By [Jérôme Creel](#) and [Xavier Timbeau](#)

We had the OMD with its Orchestral Manœuvres in the Dark, and now the OMT with its Orchestral Manœuvres in the [liquidity] Trap, or more precisely, “Outright Monetary Transactions”, which is undoubtedly clearer. The OMT is a potentially effective mechanism that gives the European Central Bank (ECB) the means to intervene massively in the euro zone debt crisis so as to limit the differences between interest rates on euro zone government bonds. The possibility that a country that comes into conflict with its peers might leave the euro zone still exists, but if there is a common desire to preserve the euro then the ECB can intervene and play a role comparable to that of the central banks of other major states. Opening this door towards an escape route from the euro zone’s sovereign debt crisis has given rise to great hope. Nevertheless, certain elements, such as conditionality, could quickly pose problems.

The OMT is simply a programme for the buyback of government bonds by the European Central Bank, like SMP 1.0 (the Securities Markets Programme) which it replaces but limited to States that are subject to a European Financial Stability Fund / European Stability Mechanism (EFSF / ESM) programme and thus benefiting from European conditional aid. For the ECB to intervene, the country concerned must first negotiate a macroeconomic adjustment plan with the European Commission and the European Council, and apply it. The ECB, potentially members of the European Parliament or the IMF can be a party to this (these institutions – the Commission, the ECB and the IMF – form the Troika of men in black, so famous and feared in Greece). Secondly, and more importantly, the country will be under the supervision of the Troika thereafter.

So if Italy and Spain want to benefit from the purchase of their bonds by the ECB, then their governments will have to submit to an EFSF or ESM adjustment programme. This does not necessarily imply that the plan imposed will be more drastic in terms of austerity than what these governments might have already devised or implemented (the doctrinaire approach in the management of public finances is highly contagious in Europe), but it will require the two countries to submit *ex ante* to outside scrutiny of any adjustment plan they develop and *ex post* to control by the Commission and the Council. If the country under surveillance starts *ex post* to veer away from implementing the adjustment plan, then it could, of course, withdraw from the programme, but its sovereign bonds would no longer be covered by OMTs. They would lose the support of their peers and would thus sail into the financial markets in uncharted waters. That would probably be the first step towards a default or an exit from the euro.

Furthermore, the ECB has not committed itself to absorbing all the bonds issued and thus maintains a real threat capacity: if the country were to rebel, it could be obliged to face higher rates. The OMT thus introduces both a carrot (lower rates) and a stick (to let the rates rise, sell the bonds the ECB holds in its portfolio and thereby push rates upward), upon each new issue. The OMT is therefore akin to being put under direct control (conditionality) with progressive sanctions and an ultimate threat (exiting the programme).

The ECB says that its interventions will mainly cover medium-term securities (maturity between 1 and 3 years), without excluding longer-term maturities, and with no quantitative limits. Note that short / medium-term emissions *usually* represent a small proportion of total emissions, which tend to be for 10 years. However, in case of a crisis, intervention on short-term maturities provides a breath of fresh air, especially as maturing 10-year securities can be refinanced by 3-year ones. This gives the Troika additional leverage in

terms of conditionality: the OMT commitment on securities is only for three years and must be renewed after three years. The financial relief for countries subject to the programme may be significant in the short term. For example, in 2012 Spain, which has not yet taken this step, will have issued around 180 billion euros of debt. If the OMT had reduced Spain's sovereign borrowing rates throughout 2012, the gain would have amounted to between 7 and 9 billion for the year (and this could be repeated in 2013 and 2014, at least). This is because, instead of a 10-year rate of 7%, Spain could be benefitting from the 2% rate at which France borrows for 10 years, or instead of its 4.3% rate at 3 years, Spain could have borrowed at 0.3% (France's 3-year sovereign rate). This is the maximum gain that can be expected from this programme, but it is significant: this roughly represents the equivalent of the budgetary impact of the recent VAT hike in Spain (or a little less than one Spanish GDP point). This would not alter Spain's fiscal situation definitively, but it would end the complete nonsense that saw Spaniards paying much more for their debt to compensate their creditors for a default that they have been striving arduously not to trigger.

It can even be hoped (as can be seen in the easing of Spanish sovereign rates by almost one point following the ECB announcement on Thursday, 6 September 2012, or the almost half a point reduction in Italian rates) that the mere existence of this mechanism, even if Spain or Italy do not use it (and thus do not submit to control), will be enough to reassure the markets, to convince them that there will be no default or exit from the euro and therefore no justification for a risk premium.

The ECB announced that it would terminate its preferred creditor status for the securities. This provision, which had been intended to reduce the risk to the ECB, led to downgrading the quality of securities held outside the ECB and thus reducing the impact of ECB interventions on rates. By

acquiring a government bond, the ECB shifted the risk onto the bonds held by the private sector, since in case of a default the Bank was a preferred creditor that took priority over private holders of bonds of the same type.

The ECB explained that its OMT operations will be fully sterilized (the impact on the liquidity in circulation will be neutral), which, if it is taken at its word, implies that other types of operations (purchases of private securities, lending to banks) will be reduced correspondingly. What do we make of this? The example of the SMP 1.0 can be drawn on in this regard. SMP 1.0 was indeed also accompanied by sterilization. This sterilization involved short-term deposits (1 week, on the ECB's liabilities side), allocated in an amount equal to the sums involved in the SMP (209 billion euros to date, on the ECB's assets side). Each week, the ECB therefore collects 209 billion euros in short-term fixed-term deposits. This is therefore a portion of bank deposits that the ECB assigns to the sterilization instrument, without there being sterilization in the strict sense (because this does not prevent an increase in the size of the ECB's balance sheet nor does it reduce the potential liquidity in circulation). The mention of sterilization in the OMT appears to be an effort at presenting this in a way that can convince certain states, such as Germany, that this monetary policy will not be inflationary and therefore not contrary to the mandate imposed on the Bank by the Treaty on the European Union. Currently, and because the crisis remains unresolved, private banks have substantial deposits with the ECB (out of fear of entrusting these deposits to other financial institutions), which gives it considerable flexibility to prevent the announced sterilization from affecting the liquidity in circulation (the ECB has a little more than 300 billion euros in deposits that are not mobilized for sterilization). The ECB can then probably use the current accounts (by blocking them for a week), which poses no difficulty since the ECB lends to the banks on tap through long-term refinancing operations (LTROs).

At worst, the ECB would lose money in the sterilization operation in case of a gap in compensation between the fixed-term deposits and the loans granted to banks. Sterilization could therefore lead to this kind of absurd accounting, but wind up, in a situation of monetary and financial crisis, having no impact on liquidity. On the other hand, if the situation normalizes, the constraint of sterilization would weigh more heavily. We're not there yet, but when we do get there, the ECB needs to limit lending to the economy or to accept an increase in liquidity if the OMT continues to be implemented for some euro zone members.

The deal that is now on the table places the euro zone countries in a formidable dilemma. On the one hand, acceptance of the Treaty on Stability, Coordination and Governance of the euro zone (TSCG) determines eligibility for the EFSF and the ESM [\[1\]](#), and therefore now determines eligibility for the OMT programme. Refusing to sign the fiscal treaty means rejecting in advance the potential intervention of the ECB, and thus accepting that the crisis continues until the breakup of the euro zone or until a catastrophic default on a sovereign debt. On the other hand, signing the treaty means accepting the principle of an indiscriminately restrictive fiscal strategy (the rule on public debt reduction included in the TSCG will be devastating) that will trigger a recession in the euro zone in 2012 and perhaps in 2013.

Signing the treaty also means relieving the pressure of the markets, but only to wind up submitting solely to the Troika and to the baseless belief that the fiscal multipliers are low, that European households are Ricardian and that the sovereign debt is still holding back growth. It is true that lowering sovereign interest rates, particularly those of Italy and Spain, will create some breathing room. But the main gain from lower rates would be to spread the fiscal consolidation over a longer period of time. Interest rates place a value on time, and reducing them means granting more time. The debts

contracted at negative real interest rates are not ordinary debts, and do not represent the same kind of burden as debts issued at prohibitively high rates.

It would be a terrible waste to gain new maneuvering room (the OMT) only to bind one's hands immediately (the TSCG and the Troika's blind fiscal strategy). Only a change in fiscal strategy would make it possible to take advantage of the door opened by the ECB. In short, saving the euro will not help if we do not first save the EU from the disastrous social consequences of fiscal blindness.

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[\[1\]](#) Paragraph 5 of the preamble to the Treaty establishing the European Stability Mechanism states: "This Treaty and the TSCG are complementary in fostering fiscal responsibility and solidarity within the economic and monetary union. It is acknowledged and agreed that the granting of financial assistance in the framework of new programmes under the ESM will be conditional, as of 1 March 2013, on the ratification of the TSCG by the ESM Member concerned and, upon expiration of the transposition period referred to in Article 3(2) TSCG on compliance with the requirements of that article."

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# **A letter to President François Hollande**

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

Dear Mr. President,

France and the European Union are at a crucial economic

junction. Unemployment is high, the output loss to the financial crisis since 2008 has not been recovered and you have promised, in this dismal context, to eliminate French public deficits by 2017.

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

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

- The fantasy that short-run multipliers might be negative has been dispelled: a fiscal contraction depresses economic activity unless you are a small open economy acting alone under flexible exchange rates and your own national central bank runs an accommodative monetary policy – hardly a description of today’s France. Since France 2012 is not Sweden 1992, the prospect of a rosier fiscal future is not enough to outweigh the immediate recessionary effects of a fiscal contraction.
- To add insult to injury, if the financial crisis has lowered economic activity permanently (as previous banking or financial crises did, according to the IMF), public finances are now in structural deficit. To insure long-term debt sustainability, there is no way to escape

fiscal restriction.

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

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

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



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

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

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

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

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

assets which have a high social profitability and are essential to ensure a smooth transition to a low carbon economy.

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

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

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

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

Yours faithfully.

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## **The misfortunes of virtue\***

By [Christophe Blot](#)

\* *This text summarizes the outlook produced by the Department of Analysis and Forecasting for the euro zone economy in 2012-2013, which is available in French on the [OFCE web site](#)*

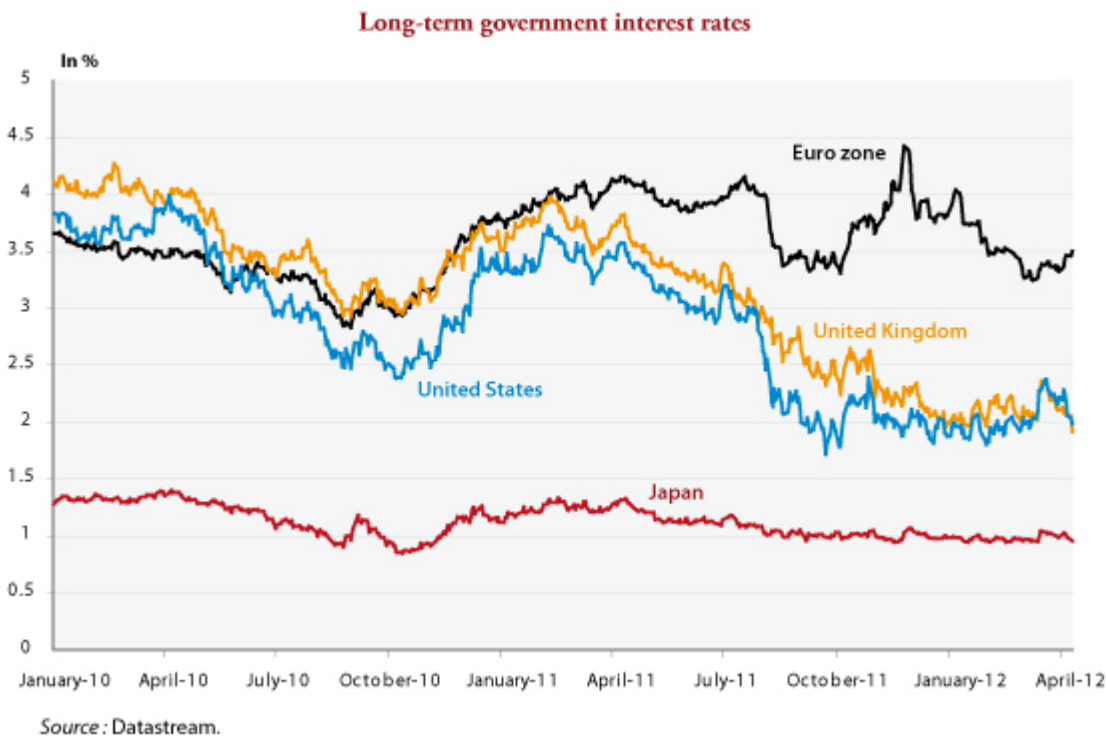
The euro zone is still in crisis: an economic crisis, a social crisis and a fiscal crisis. [The 0.3% decline in GDP in the fourth quarter of 2011](#) is a reminder that the recovery that began after the great drop of 2008-2009 is fragile and that the euro zone has taken the first step into recession, which will be confirmed in early 2012.

The fall in the average long-term government interest rate in the euro zone seen since the beginning of the year has come to a halt. After reaching 3.25% on 9 March, it rose again due to new pressures that emerged on Italian and Spanish rates. Indeed, despite the agreement to avoid a default by Greece, Spain was the source of new worries after the announcement that its budget deficit had reached 8.5% in 2011 – 2.5 points above the original target – and the declaration that it would not meet its commitments for 2012, which has reinforced doubts about the sustainability of its debt. The Spanish situation illustrates the close link between the macroeconomic crisis and the sovereign debt crisis that has hit the entire euro zone. The implementation of fiscal adjustment plans in Europe, whose impact is being amplified by strong economic interdependence, is causing a slowdown or even a recession in various euro zone countries. The impact of synchronized restrictions is still being underestimated, to such an extent that governments are often being assigned targets that are difficult to achieve, except by accepting an even sharper recession. So long as the euro zone continues to be locked in a strategy of synchronized austerity that condemns in advance any resumption of activity or reduction in unemployment, the pressure will not fail to mount once again in 2012. Long-term public interest rates in the euro zone will remain above those of the United States and the United Kingdom (see the figure), even though the average budget deficit was considerably lower in 2011 in the euro zone than in these two countries: 3.6% against 9.7% in the US and 8.3% in the UK.

To pull out of this recessionary spiral, the euro zone

countries need to recognize that austerity is not the only way to reduce budget deficits. Growth and the level of interest rates are two other factors that are equally important for ensuring the sustainability of the public debt. It is therefore urgent to set out a different strategy, one that is less costly in terms of growth and employment, which is the only way to guarantee against the risk that the euro zone could fall apart. First, generalized austerity should be abandoned. The main problem with the euro zone is not debt but growth and unemployment. Solidarity must be strengthened to curb speculation on the debt of the weaker countries. The fiscal policies of the Member states also need to be better coordinated in order to mitigate the indirect effects of cutbacks by some on the growth of others [1]. It is necessary to stagger fiscal consolidation over time whenever the latter is needed to ensure debt sustainability. At the same time, countries with room for fiscal manoeuvre should develop more expansionary fiscal policies. Finally, the activities of the European Central Bank should be strengthened and coordinated with those of the euro zone governments. The ECB alone has the means to anchor short-term and long-term interest rates at a sufficiently low level to make it possible both to support growth and to facilitate the refinancing of budget deficits. In two exceptional refinancing operations, the ECB has provided more than 1,000 billion euros for refinancing the euro zone banks. This infusion of liquidity was essential to meet the banks' difficulties in finding financing on the market. It also demonstrates the capacity for action by the monetary authorities. The portfolio of government debt securities held by the ECB at end March 2012 came to 214 billion euros, or 2.3% of euro zone GDP. In comparison, in the United States and the United Kingdom, the portfolio of government securities held by the central banks represents more than 10% of their GDP. The ECB therefore has significant room for manoeuvre to reduce the risk premium on euro zone interest rates by buying government securities in the secondary markets. Such measures would make it possible to

lower the cost of ensuring the sustainability of the long-term debt.



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[1] See “He who sows austerity reaps recession”, [OFCE note no. 16](#), March 2012.

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# A letter to President François Hollande

by Jérôme Creel, Xavier Timbeau and Philippe Weil [[archivage et redirection](#)]

[[version française](#) ; [english version](#)]

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# Regaining confidence in the euro: Three pressing issues

By [Jérôme Creel](#)

In a communication on European economic governance before the European Parliament's ECON Committee on Monday, 17 October 2011, three pressing issues were identified in order to save the euro and improve its management.

Saving the euro without further delay is the priority. To do this, it is necessary to provide the EFSF with sufficient funds and to require the ECB to continue intervening in the market for government bonds, so as to resolve the difference between the long-term rates of the peripheral countries and those in the countries in the heart of the euro zone (Germany, France, Netherlands), where these rates are falling and thus benefiting these countries, whereas the rise in the periphery is placing a heavy burden on the public finances of Greece, of course, but also of Portugal and Spain.

Second, the new legislation amending the Stability and Growth Pact and setting up a symmetrical device for monitoring macroeconomic imbalances needs to be implemented as soon as possible. This second priority is urgent, too: it should in the future allow the euro zone to avoid a new crisis, or at least to protect itself with proper instruments and surveillance. In this context, the European Parliament is being asked to "check the checkers" so as to give a real boost to Europeans' trust in their institutions.

Finally, it is necessary to ensure the proper functioning of European governance. Nothing has been lost, intelligent rules do exist: they must be applied after consultation. Inflation



targeting on the monetary side and a genuine golden rule of public finances on the budget side both need to emerge.

Communication to the European Parliament ECON Committee, 17 October 2011

Dear Honorable Members,

After almost two years of European turmoil related to the bad management of public finances in a few Eurozone countries, and more than four years after a deep worldwide crisis, time is certainly ripe for reaching European solutions to cure the crisis. Two emergencies are at stake: first, stopping distrust's contagion vis-à-vis Eurozone members; second, stopping misbehaviors' contagion among Eurozone members in the future. By the way, this second emergency certainly necessitates a separation between two periods: the short run and the longer run.

#### 1. Short run emergency 1: improving trust in the Euro

In order to cope with the first emergency, Eurozone countries need a more automatic solidarity mechanism. There have been different options discussed and implemented so far at the Eurozone level, from the EFSF (then future ESM) to Eurobonds, or the intervention of the ECB on secondary markets. They all need to be enforced and implemented as soon as possible without limitations, otherwise discrepancies in long-term yields on public bonds will continue to grow across Eurozone members, at the expense of countries with twin deficits and at the benefit of countries which are closer to twin balance. Without strong automatic interventions, Eurozone countries take the risk of feeding distrust in their ability to support the Euro. The consequence might be distrust in the future of the Euro, distrust in the future of the EU project.

#### 2. Short run emergency 2: enforcing the "6-pack" with improvement in its democratic content

In order to cope with the second emergency, the European Commission, the President H. van Rompuy and the European Parliament have dealt with the EU governance of the near future through a "6-pack" of legislative amendments which were adopted on 25 September 2011.

A major step has been made in the good direction: macro imbalances are no longer automatically related to deficits as they may also refer to surpluses; and a macro imbalance can be considered "excessive" only to the extent that it "jeopardizes or risks jeopardizing the proper functioning of the EMU". This is clear understanding that provided Eurozone countries are primarily partners rather than competitors, their trade links shall not be automatically confounded with risky imbalances for they do not impinge on the common currency, the Euro.

The "6-pack" also deals with the better enforcement of the Stability and Growth Pact, introducing earlier sanctions, and a more comprehensive fiscal surveillance framework. This is certainly necessary to make sure that the risk of moral hazard in the Eurozone is reduced to a minimum. However, the overall '6-pack' must pass beforehand criteria for the effectiveness of a fiscal rule.

There have been different ways to assess reform proposals for economic policies. A well-known and convenient one is a set of criteria first developed by George Kopits and Steven Symansky at a time when both were working at the IMF. According to them, a fiscal rule is effective if it is well-defined, transparent, simple, flexible, adequate relative to goal, enforceable, consistent and efficient. In an amendment by the European Parliament related to macro imbalances, one can read that the indicators in the scoreboard must be relevant, practical, simple, measurable and available; moreover, flexibility is advocated in the assessment of macro imbalances. The Kopits-Symansky criteria are thus still relevant, and only their seventh criterion, consistency, seems to have been forgotten from the list. Does it reveal that

through the current reform proposals, no one wishes to deal with monetary policy, which consistency with fiscal policies might well be assessed, and the other way round?

I have written elsewhere my own views on Kopits and Symansky's set of criteria ([Creel, 2003](#); [Creel and Saraceno, 2010](#)), but I think I need to insist on the simplicity one. I fear the existence of a so-called "simplicity" criterion when complex problems are arising. For instance, a strong public deficit may be due to 'bad times' (recession, slow GDP growth), interest rates hikes, wrong policies, a non-existing tax system, etc. A simple rule cannot handle the multiplicity of the causes for a deficit. I also fear that such a criterion is simply disrespectful towards the people: well-informed people can certainly approve complex rules if they believe that those who implement them target the common interest.

It leads me to propose that the "simplicity" criterion is changed into a "democratic" criterion. That change would not be substantial as regards Kopits and Symansky's justification of their criterion: simplicity is required, they say, to enhance the appeal of the rule to the legislature and to the public. Changing "simplicity" into "democratic" would thus be consistent with their view. It would add two advantages. First, there would be no need to target simple or simplistic rules, if more complex ones are required. Second, to enhance their appeal to the public, these rules should be endorsed and monitored by a Parliament: as their members are the representatives of the public, the latter would be fully informed of the nature and properties of the rule.

What would be the main consequences of assessing reform proposals through the lens of democratic content in the current context? First, the now-complex setting of fiscal rules in the EU, under the amendments of 25 September 2011, is well-defined but it is no longer simple. That should not lead us to assume that these rules will not be efficient. Second, if all European authorities, including the European

Parliament, approved a stricter surveillance mechanism for fiscal policies, macro imbalances, and employment guidelines, control over the misbehaving countries should be shared with all these authorities, hence also including the European Parliament. The implication of the latter, with that of the European Council, would enhance the appropriation of rules by the public, and the trust of the public in their institutions. Third, another consequence would be that automaticity in sanctions should not be an option for automaticity is contradictory with the essence of a democracy: contradictory debates.

Are the current reform proposals respecting the “democratic” criterion? The implication of the EP in these reforms already calls for a positive answer. Nevertheless, the implication of the EP in “checking the checkers” is necessary to achieve a definite positive answer. This implication might be very productive in reassessing the effectiveness of the policies which are undertaken in a country where suspicion of misbehavior is developing. The implication of the Economic Dialogue and the European Semester should also be used to improve trust in the EU institutions and the Eurozone governments, with due respect to the subsidiarity principle. Sharing information, analyses, data should be viewed by all partners as a way to achieve cooperation, keeping in mind that John Nash showed through his solutions that cooperative equilibria always lead to a win-win situation.

“Checking the checkers”, as I mentioned above, involves an informed assessment of the effectiveness of fiscal policies. Such an assessment is not dealt with in the current Stability and Growth Pact. During the procedure of fiscal surveillance, and before sanctioning a country, it is of the highest priority to gauge the effectiveness of a fiscal policy which has led to higher deficits and debts.

Discussions about fiscal policies are usually very pessimistic nowadays, as far as their effectiveness is concerned, but

those endorsing these discussions take the risk that the people have finally no trust in their governments, for they are said to follow the wrong policies, and in the European institutions that are not able to stop these policies.

It may be useful to recall (once again?) that a consensus exists in the economic literature about the sign of the fiscal multiplier: it is [positive](#). And because of that, the Chinese, US, German, French, etc. governments decided to increase their deficits through discretionary policies during the worldwide crisis: these governments were conscious that their policies were helpful. Why shouldn't they during other 'bad times'? Why should we all think that a contagion of fiscal restrictions in the EU will help us thrust again? Good policymaking requires that policies are contingent to the economic situation (GDP growth, inflation rate, level of unemployment, etc.).

In my view, at this stage, there are two important prerequisites to a rapid improvement in the EU governance, and I do not think they require a new Treaty. We all know that at the ECB and beyond, some argue that political pressures led this institution to buy public bonds, in contrast, they add, with the EU Treaty. Its independence would have been at stake. For this reason, the first prerequisite is in recalling the independence and mission of the ECB. The ECB is a young institution and it needs confidence in itself, as a teenager does. Once definitely adult, after full confidence is reached, the ECB will not fear coordination or cooperation with governments and the EP that fully respect its independence but may wish to improve the consistency of their policies with its.

The second prerequisite is in recalling the objectives of the EU, growth and stability, and in admitting that there is not a single way to achieve these objectives, for countries are still so different within the EU, even within the Eurozone. The 'one size fits all' is no longer an option, hence the necessity to complement fiscal rules with an assessment of

macro imbalances and with regular, transparent, and democratically-controlled assessments of the relevance of the underlying analyses by governments on the one hand, and controllers on the other. There is a strong role for the EP in acknowledging and managing this no 'one size fits all' way of dealing with fiscal rules.

### 3. Longer run emergency 2: more intelligent rules?

In the longer run, if improvements by the ECB in cooperating with governments have not materialized, a binding commitment to follow a cooperative behavior could be included in the statutes of the ECB. A change in its statutes might also be considered, with a view to adopting, for instance, a [dual mandate](#) similar to that of the Fed. That way, it would be clear that "if 5% inflation would have (Central bankers') hair on fire, so should 9% unemployment" (Ch. Evans, 2011). Another possibility would be to urge the ECB to implement full inflation targeting. That would require the ECB to make public its forecasts and minutes of decisions, thus enhancing information and potentially influencing the private sector.

Lastly, the most important debate on fiscal policymaking is in wondering what governments are doing with tax and spending, and how they finance them. The European Semester and the monitoring of indicators of macro imbalances certainly go in the good direction, but rather than a global view on the evolution of deficits and debts, Eurozone countries should think about circumscribing the good and bad parts of taxes and spending and make sure they all target the good policy, at their benefit and at the benefit of others. Of course, this is not an easy task, but it is a task that would make the EU fiscal rules ever more "intelligent".

Having common objectives within Europe 2020, it could be thought of having common tools to reach them: a higher EU budget? Or an authentic but modified [golden rule of public finance](#) where some expenditures proved to be productive, with

the agreement of all EU member states, would be left out of the scope of binding rules? That is not the hot topic of the day, but had it been before the SGP reform of 2005 that the stability of the Eurozone might not have been at stake the way it has been since the worldwide crisis.

I thank you for your attention.

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# From Trichet to Draghi: Results and prospects

By [Christophe Blot](#) and [Eric Heyer](#)

During eight years as head of the ECB, we have seen two Jean-Claude Trichets (JCT): one dogmatic, the other pragmatic. What will be the face of his successor, Mario Draghi of Italy, as he takes office during the unprecedented crisis facing the euro zone?

Over the first five years, the pre-crisis period, we had **JCT the dogmatist**: a very experienced central banker, he scrupulously stuck to his mandate, namely to keep inflation close to 2%. In light of this single criterion, considered essential by the Germans, JCT's record was good, as average inflation in the euro zone during the period was 2.1%. However, several criticisms can be leveled at his post-crisis activity: the first is that in trying to give flesh to the single currency and make it credible, JCT decided to make it "strong" – which is different from "stable". No arrangements were made to control the exchange rate, and he was pleased to see the euro rise from \$1.10 in 2003 to almost \$1.50 in late 2007, an appreciation of 37%. The dogma of the strong euro, of competitive disinflation, has certainly helped to contain

inflation, but at the expense of Europe's competitiveness and growth. A less strict interpretation of price stability would have led the ECB to pay more attention to the euro's exchange rate, which would in turn have promoted more vigorous growth and employment in the euro zone. Between 2003 and 2007, average annual growth in the euro zone was 0.6 percentage point lower than in the US and the UK (2.1% against 2.7%), and the unemployment rate was more than 3 points higher (8.4% in the euro zone against 5.1% in the US and UK), with comparable performances on inflation. The second criticism has to do with JCT's strict interpretation of the fight against inflation, which led him into a serious miscalculation: in the summer of 2008, just weeks before the collapse of Lehman Brothers, while the US economy was already in recession and fears were growing for Europe, the ECB decided to raise interest rates out of fear of renewed inflationary pressures fueled by the rising prices of energy and food raw materials. However, worrying about inflationary pressures at a time when the global economy was about to sink into the greatest crisis since the 1930s was not very perceptive.

For the past three years, a period of crisis, we've had the **JCT the pragmatist**: in the absence of a system of European governance, JCT has been a pillar of Europe's response to the crisis, as he engaged as equals with heads of state and made significant efforts to rescue the financial system. In this regard, and in contrast to the previous four years, he has taken some liberties with the mandate and statutes of the ECB by implementing unconventional measures, especially at the time of the sovereign debt crisis. But by raising rates since the beginning of the year, against a background of mass unemployment and substantial under-utilization of the euro zone's production capacity, JCT the pragmatist has committed the same error of interpretation as JCT the dogmatist did three years earlier: as the rise in inflation was not associated with the risk of an overheating European economy, but rather had its origin in the rising prices of food and



energy raw materials, the rate increases have not had any impact on inflation but, on the other hand, they have contributed a bit to further weakening European growth.

In fact, the ECB quickly revised its diagnosis, leaving the door open to a rapid cut in interest rates. It is also likely that Jean-Claude Trichet would have acted faster had he not been at the end of his term. In doing what he did, JCT avoided locking his successor into a specific scenario, and thus left him a range of options in his first steps at the head of the ECB. Mario Draghi quickly ended any suspense about his intentions by announcing a quarter point cut in interest rates at his first meeting on 3 November. While he was careful to point out that the ECB does not make any commitments to future decisions, the macroeconomic and financial situation points towards at least one further rate cut.

Yet if the question of interest rate policy is a central element of monetary policy and thus of Mario Draghi's mandate, the challenges facing him go far beyond this issue. In the context of the euro zone crisis, the eyes of the world are focused on the ECB's program of securities purchases, which raises the question of the ECB's role in European governance. This question actually involves a number of critical and interdependent matters: the role of lender of last resort, coordination between fiscal policy and monetary policy, and the ECB's role with respect to financial stability.

The current crisis illustrates the difficulties inherent in the functioning of a monetary union that lacks a fiscal union, since in actuality this means that a member of the union is taking on debt in a currency that it does not control. Even though in normal times monetary policy operations in the United States lead the Fed to hold government securities – mostly short-term – the crisis has prompted the US central bank to expand its purchases of securities and to change the structure of its balance sheet by buying government bonds on secondary markets. The Bank of England has taken similar

action by purchasing nearly 200 billion pounds of government bonds[1]. As for the Bank of Japan, it has amplified the unconventional measures that were already in place to fight the deflation that has plagued the archipelago since the late 1990s. In taking these actions, the central banks have put downward pressure on long-term interest rates, and they have ensured the liquidity of these markets by acting implicitly as lenders of last resort. While the ECB has also gotten involved in this area by buying more than 170 billion euros of government securities (Italian, Greek, Portuguese and Irish), the magnitude of its asset purchase program (2.1% of the total public debt of the euro zone countries) is still below the level implemented by the Federal Reserve and the Bank of England, which respectively own more than 10.5% and 16% of the public debt issued by their governments. Moreover, the ECB took care to specify that the program was temporary, had a limited budget and was designed to restore the effectiveness of monetary policy. In a recent comment, Paul de Grauwe compared the ECB's strategy to that of an army chief going off to war who declares that he would never use his full military potential and he would bring all the troops home as soon as possible, that is to say, without ensuring that final victory had been won. A strategy like this is doomed to failure. Only an open-ended commitment could stop the contagion affecting the euro zone countries plagued by budget problems. And only one central bank can offer such a guarantee, through the creation of money. Yet up to now Europe's countries have rejected this path, including at the summit of October 25, while at his first press conference Mario Draghi has only reiterated the strategy of the ECB, even adding that he did not believe that a lender of last resort is the solution to the crisis in the euro zone. As the size of the remaining EFSF is insufficient to halt the contagion, it is likely that the role of the ECB will once again take center stage. It is to be hoped that Mario Draghi and the members of the Board of Governors will be more pragmatic on this next occasion. It is urgent to recognize the ECB's role as lender of last resort by

making the financial stability of the euro zone an explicit objective of monetary policy.

Moreover, beyond the role of lender of last resort, the coordination of economic policy more generally also needs to be revised. The articulation of the policy mix is indeed a central element of performance in terms of growth. In the US, the complementarity between monetary and fiscal policy is now obvious, as by putting pressure on long rates, the Federal Reserve implemented a policy to ensure the sustainability of fiscal policy at the same time that it is promoting the impact on growth. The main criticism of this policy argues that this undermines the independence of the Central Bank. However, there is no evidence today to say that the Fed has abandoned the conduct of monetary policy in favor of the government. The question does not even arise, since the US central bank is pursuing the same objectives as the US government: growth, employment, price stability and financial stability [2]. These objectives are interdependent, and the euro zone will find its way to growth again only once all the authorities are rowing in the same direction.

While these issues are not all the exclusive responsibility of Mario Draghi – a reform of the Treaty could strengthen and legitimize his decisions – his position will nevertheless be decisive. The crisis in the euro zone calls for urgent decisions and will quickly reveal the ambitions and the capabilities of its new president.

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[1] The BoE has, however, just announced that its program to buy securities will be gradually expanded to 275 billion pounds sterling.

[2] See "[The Fed, the ECB and the dual mandate](#)".

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# The G20 Summit in Cannes: Chronicle of a Disappointment Foretold?

By [Jérôme Creel](#) and [Francesco Saraceno](#)

Too long and too technical, the [final declaration](#) of collective action of the G20 Summit in Cannes shows that no clear and shared vision of the economic and financial turmoil that is rocking the global economy has emerged at the Summit. And as Seneca reminds us, the disappointment would have been less painful if success had not been promised in advance.

According to the official announcements, the disappointment was palpable at the end of a G20 summit in which no significant progress was achieved – on the most important issues of the moment, the revival of growth in particular. The crucial issues of agriculture and finance gave rise simply to declarations of intent, with a reminder of the commitments made on these ... in 2008! The disappointment must be kept in perspective, however, as the G20 is primarily a forum for discussion rather than for decisions. Indeed, what remains of the commitments made in April 2009 by the G20 in London, mired in global recession? The expansionary fiscal policies? Forgotten, as a result of the public debt that they have produced – debt, by the way, that was perfectly predictable. Strengthened financial regulation? Repeatedly trotted out, but still not implemented, despite the determination displayed in Paris on 14 and 15 October 2011. The desire to avoid protectionism? Barely mentioned, nor did this succeed in

preventing the outbreak of 36 [trade disputes](#) brought before the WTO, including 14 involving China, the EU and / or the United States. All that remains is a monetary policy that is “expansionary as long as necessary”, in the words of the pre-Summit statements. So does the fate of the international monetary system depend simply on the good will of the central bankers, independent as they are?

The meeting was also troubled by the crisis hitting the euro zone, which virtually forced off the agenda such important issues as the resurgence of protectionism, which was relegated to paragraphs 65 to 68 of a 95-paragraph document. At Cannes, the emerging economies and the US were spectators of a drama unfolding between Paris, Berlin, Rome and Athens.

The crisis hitting the euro zone is a result of the heterogeneity of its constituent countries, much as the financial crisis triggered in 2007 was a result not just of a lack of financial regulation but also of the increasing heterogeneity between mercantile countries and countries presumed to be the El Dorados of investment, on the one hand China and Germany, and on the other, the United States and Ireland. This European heterogeneity, one of four deficiencies of the euro zone, has led countries with a surplus in their current accounts to finance countries running a deficit. Alone, and with its priority on the fight against inflation imposed by the Treaty of the EU, the ECB is unable to promote convergence within the euro zone. However, in the short term it can end the crisis in the euro by agreeing to provide full coverage of public debts in the euro zone (see [\[1\]](#), [\[2\]](#) or [\[3\]](#)), and by significantly increasing its [purchases of government debt in Europe](#). This would maintain European financial stability and perhaps generate inflationary expectations, thereby helping to lift Europe’s economy out of the [liquidity trap](#) in which it has been mired since the beginning of the financial crisis. Note that despite its activism, the US Federal Reserve has not so far managed to

create such expectations and remains caught in the same kind of liquidity trap.

In the longer term, it is necessary to review European economic governance. The active use of economic policy in the United States and China contrasts with the caution displayed by the ECB and with the European reluctance to pursue expansionary fiscal policies, and more generally with the decision to build European economic governance on a refusal of discretionary policies. It would be desirable for the ECB, while preserving its independence, to be able to pursue a [dual mandate](#) on inflation and growth, and for the [rules that discipline](#) fiscal policy to be “smarter” and more flexible.

Giving the economic policy authorities an opportunity to implement discretionary policies should not mean forgetting about the risks posed by the absence of a coordinated approach, which may lead the US Congress to threaten unilateral compensatory taxes on goods imported from countries whose currency is undervalued. This move is evoking the specter of protectionism, and the G20 countries should consider a mechanism to coordinate policy so as to avoid the trade wars that are already being more or less explicitly declared.

Furthermore, a currency war does not seem to be an effective way to protect our economies: the under-or overvaluation of a currency is a complex concept to apply, and the impact of a currency's value on exports and imports is made very uncertain by the international fragmentation that characterizes the production of goods and services. Rather than employing a defensive policy, it is definitely better to substitute an [active industrial policy](#) to take advantage of new technological niches that create business and jobs.

Finally, for words to have real meaning – to “build confidence and support growth” in the advanced economies and “support growth” while “containing inflationary pressures” in the

emerging economies ([G20 Communiqué](#), Paris, 14-15 October 2011) – we must challenge the “contagion of [fiscal contraction](#)” that is now shaking the euro area and, rather than an additional phase of rigor, put recovery plans on the agenda in the advanced economies while interest rates are still low. These plans must be targeted in order to generate growth and not jeopardize the solvency of public finances: it is thus necessary to encourage public investment. To maximize their overall impact, these plans need to be coordinated, including with the actions of the central banks, so that the latter can support them by maintaining low interest rates. The Summit in November 2011 was very timely for this kind of coordinated approach to emerge. Unfortunately, it didn't.

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# Why the developed countries should renounce their AAA rating

By [Catherine Mathieu](#) and [Henri Sterdyniak](#)

By their very nature, states with monetary sovereignty should renounce their AAA rating: indeed, what is the logic behind having the rating agencies rate a state whose default is rendered impossible by its ability to create its own money? To avoid dependence on the rating agencies and put an end to the crisis in Europe, the Member States of the euro zone must recover their monetary sovereignty through the joint, virtually complete guarantee of their public debts.

Since 1945, no developed country has defaulted on its debt.

There was no risk on the debt, since the states borrowed in their own currency and could always obtain financing from their central bank. The developed countries enjoyed “monetary sovereignty”. This is still the case today for Japan (which enjoys 10-year loans at 1% despite a debt of 210% of GDP), the United States (which borrows at 2% with a debt of 98% of GDP), and the United Kingdom (which borrows at 2.5% with a debt of 86% of GDP).

Banks and insurance companies cannot function if they do not have risk-free assets and if they have to guard against the failure of their own state, which is of course impossible: the amounts involved are enormous, and government securities serve to guarantee banking and insurance activities. The banks and insurance companies could not accumulate enough capital to withstand the bankruptcy of their own country or multiple euro zone countries. As we can see today with the sovereign debt crisis in the euro zone, such a requirement would lead to the general paralysis of the banking system.

It is fundamentally absurd that the rating agencies rate a state with monetary sovereignty, as if its default were an option worth considering. States with monetary sovereignty should renounce their AAA rating: by their nature, their debt is risk-free because it is guaranteed by the central bank’s power to create money.

The euro zone countries have lost their “monetary sovereignty”: under the Treaty of the European Union, the European Central Bank has no right to finance Member States, and the States are not bound by joint liability. The financial markets noticed this in mid-2009, and suddenly uncontrollable speculation erupted, targeting the most fragile countries in the zone: first Greece, Portugal, and Ireland, which had the fastest growth before the crisis, but will have to change their growth pattern, and then, like dominos, Italy, Spain, and even Belgium. Today, Belgium has to pay an interest rate of 3.8%, Spain 5.2% and Italy 5.6%, compared with 2.6% in



France and just 1.8 % for Germany. Greece, Ireland, and Portugal are now in the situation that the developing countries faced yesteryear: their debts have become risky assets subject to high risk premiums, and they are being brought under the yoke of the IMF.

The workings of the financial markets could completely paralyze fiscal policy. When a country enjoys monetary sovereignty, then in a recession the central bank can lower its maximum interest rate and if necessary commit to keeping it low in the long term; the state increases its deficit, but the low interest rates prevent the debt from snowballing; and it pushes exchange rates lower, which boosts activity. Since the debt is guaranteed by the creation of money, there is no risk of bankruptcy, and thus no reason to have to constantly *reassure* the markets. The central bank, by maintaining long-term rates at low levels in a recession, ensures that fiscal policy is effective. Fiscal policy does not need to worry about the markets. This is still the strategy of the United States today.

In the euro zone, the risk is that in the future a country could no longer increase its deficit for fear that the agencies might downgrade its rating and interest rates would then soar. The countries are therefore condemned to prove their virtue so as to appear as wise as Germany in the eyes of the markets. This renders their fiscal policy impotent, and their economic situation spins out of control (see, for example, [\*The impossible programme of the candidates for the presidential election\*](#)). The public debt becomes a permanent risk factor, since the states are at the mercy of the markets' insatiable appetite. Any economic policy should of course be assessed while taking into account the views of the markets. Yet the markets have no special competence in macroeconomics. They impose austerity policies during a recession and then turn around and complain about the lack of growth – which is exactly what they are doing today with respect to the euro

zone in general, and Italy and Greece in particular. They are promoting free market reforms such as cutting social welfare programs or the number of teachers. For countries to retain the ability to regulate their economic activity, the risk of default needs to be zero.

The euro zone must thus choose between dissolution and a reform that would guarantee the public debt of the Member States, which would re-gain their “monetary sovereignty”. European public debts should become risk-free assets, compensated at low rates but guaranteed in full (by European solidarity and fundamentally by the ECB). This is the only way to maintain the independence of fiscal policy, which is essential given the disparities in Europe and the loss by each country of its monetary and exchange rate instruments.

The functioning of the euro zone was not thought through at the time of its creation, particularly with respect to the trade-off between “autonomy of fiscal policy / single currency / monetary sovereignty”. Joint liability creates a moral hazard problem, as each country can increase its debt without limit, but a lack of a guarantee leaves the field open to the play of the financial markets, which are constantly on the lookout. The guarantee cannot be limited to countries that meet the automatic rules, which is unwarranted economically and fails to comply with the Stability Pact. It should be automatic and total. To avoid moral hazard, the European Treaty should include a provision for the extreme situation where a country carries out an unsustainable fiscal policy, in which case the new debt of the country would no longer be guaranteed – but this should never come to pass.

Freed of the need to reassure the markets, the euro zone countries could engage in differentiated but coordinated fiscal policies, with their main objective being to ensure a return to a satisfactory level of employment consistent with low inflation.