

# Central banks and public debt: dangerous liaisons?

By [Christophe Blot](#)

Since 2008, monetary policy has been in the forefront of efforts to preserve financial stability and stem the economic crisis. Though the Great Recession was not avoided, the lessons of the crisis of the 1930s were learned. The central banks quickly cut short-term interest rates and have kept them at a level close to zero, while developing new monetary policy instruments. These so-called unconventional measures led to an increase in the size of balance sheets, which exceed 20% of GDP in the United States, the United Kingdom and the euro zone and 45% in Japan. Among the range of measures employed was the central banks' purchase of public debt. The goal was to lower long-term interest rates, either by signalling that monetary policy will remain expansionary for an extended period, or by modifying the composition of the asset portfolios held by private agents. However, the Federal Reserve recently announced that it would gradually reduce its interventions ([see here](#)), which could cause a rapid rise in interest rates like that seen in May 2013 (Figure 1) upon the previous announcement of this type. In a context of high public debt, interest rate dynamics are crucial. The central banks need to take into account the enhanced interaction between monetary and fiscal policy by coordinating their decisions with those taken by governments.

In normal times [\[1\]](#), monetary and fiscal policy pursue common goals, foremost among them macroeconomic stability. There are therefore interactions between the decisions taken by the two authorities. A tightening of monetary policy via an increase in interest rates could for instance counteract a fiscal expansion, and vice versa. It is thus necessary to coordinate economic policy in order to ensure the best macroeconomic

balance. The implementation of unconventional monetary policy measures enhances these interactions. The adoption of unconventional measures has led central banks to buy government debt, to such an extent that, with the exception of the ECB, these banks hold a significant portion of the outstanding debt (Figure 2). In doing this, their operations are interfering with the management of debt, which is usually vested in the Treasury. The link between monetary policy and debt management is not new, though it receded as central banks became independent institutions with a primary objective of price stability, which they seek to achieve exclusively by changing the key interest rate. Goodhart [\[2\]](#) (2010) clarifies that this role was historically devolved on them. Nevertheless, the objectives of the central bank and of the agency responsible for issuing public debt may be contradictory (Blommestein and Turner [\[3\]](#), 2012), as the Treasury seeks to minimize the cost of debt service, regardless of the macroeconomic impact of its decisions. Two additional interactions can emerge. On the one hand, the government may partially counteract the central bank's actions on long-term rates by seeking to profit from their decline through additional issues on the maturities targeted by monetary transactions. The excess demand is then partially absorbed by an additional supply for a given maturity. This is what has happened in the United States, as the average maturity of the debt rose from 48.5 months in October 2008 to 64 months in May 2012. Recent work by Chadha, Turner and Zampolli [\[4\]](#) (2013) suggests that this policy of managing the maturity of the public debt supply has a significant impact on interest rates. The [minutes](#) of the US Treasury meeting on 2 November 2010 illustrate the potential conflict between objectives: "It was pointed out by members of the Committee that the Fed and the Treasury are independent institutions, with two different mandates that might sometimes appear to be in conflict. Members agreed that Treasury should adhere to its mandate of assuring the lowest cost of borrowing .... A couple [of] members noted that the Fed was essentially a

‘large investor’ in Treasuries and that the Fed’s behavior was probably transitory. As a result, Treasury should not modify its regular and predictable issuance paradigm to accommodate a single large investor.”

On the other hand, the reduction in the portfolio of government securities held by the central bank should lead to higher long-term rates. This is in any case what is suggested by some of the recent literature on the impact of unconventional monetary policies. The dynamics of bond yields observed in May 2013 (Figure 1), the first time that the markets anticipated [\[5\]](#) a steady decline in purchases by the Federal Reserve, shows that the increase may be rapid and cause high volatility on the financial markets. The explanation for this increase may be related to the end of or the unwinding of arbitrage operations carried out by investors who took advantage of low long-term interest rates in the industrialized countries in order to take on debt and seek more profitable investments in other markets, in particular the emerging markets. The consequences of such a scenario must be taken into account by the central banks. If the conduct of monetary policy involves making fewer central bank interventions, then the impact on debt service of this pull-back needs to be factored in. Despite the process of public debt reduction, government financing needs will stay high, and additional refinancing costs due to higher interest rates could lead States to strengthen fiscal consolidation, which would have adverse effects on economic activity. Conversely, the maintenance of low interest rates could greatly contribute to facilitating fiscal adjustment by allowing low-cost refinancing and by giving a stimulus to the economy, thereby reducing the recessionary impact of the fiscal adjustment.

Due to the nature of these interactions, to a macroeconomic context marked by a high level of public debt, and to the risk of financial instability, it is essential to coordinate

monetary and fiscal policy. This necessity is illustrated perfectly in the case of the United States in an observation by James Tobin quoted by Turner[6] (2011): “The Federal Reserve cannot make rational decisions of monetary policy without knowing what kind of debt the Treasury intends to issue. The Treasury cannot rationally determine the maturity structure of the interest-bearing debt without knowing how much debt the Federal Reserve intends to monetize.”

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

Figure 1. Interest rates on long-term public debt

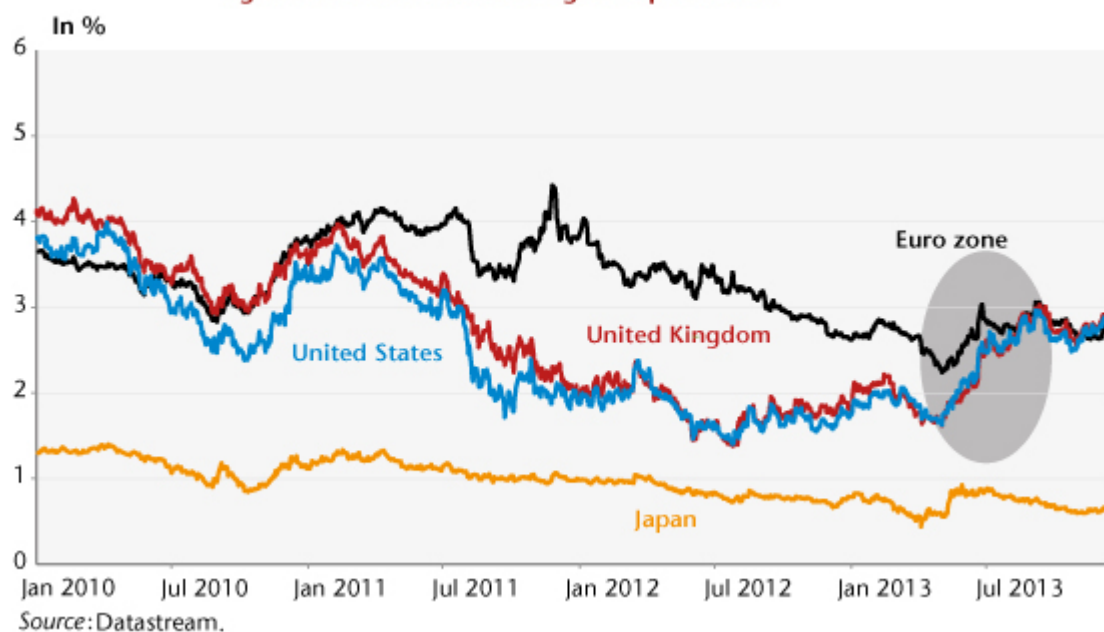
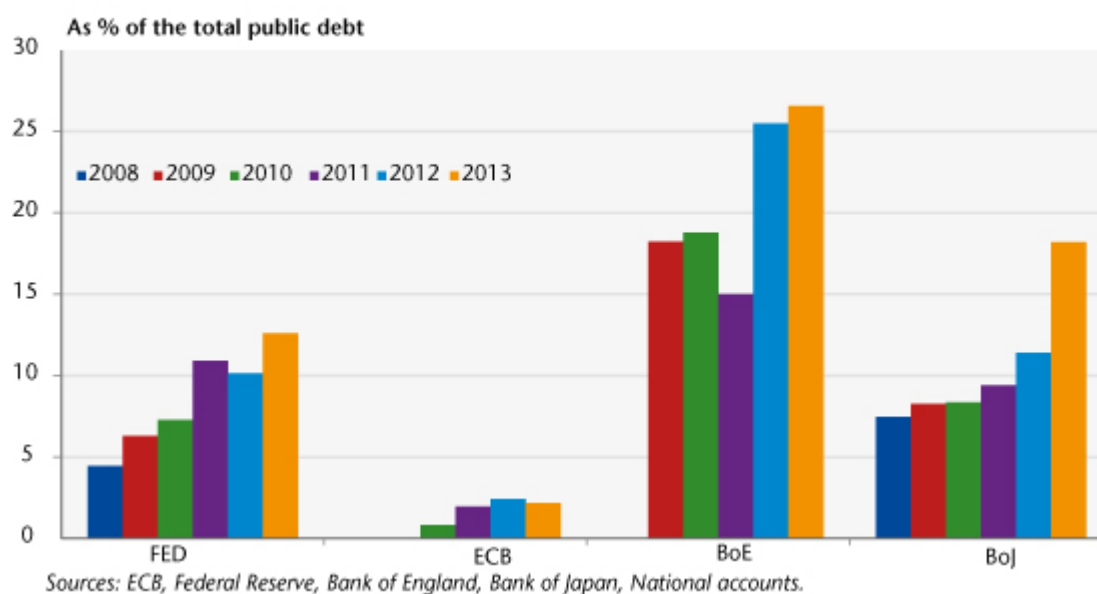


Figure 2. National public debt held by the central banks



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

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

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

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

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

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

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## The chiaroscuro of the ECB's "forward guidance" \*

By [Paul Hubert](#) and Fabien Labondance

"The Governing Council expects the key interest rates to remain at present or lower levels for an extended period of time." With this pronouncement on 4 July 2013 at the press conference following the monthly meeting of the European Central Bank Board of Governors, Mario Draghi initiated the adoption by the ECB of a new communication strategy called "forward guidance". Since then these words have always been included in his speech following announcements of the ECB's monetary policy, and he has repeated them again [today \[1\]](#). What should we expect? Forward guidance has recently been adopted by several central banks, but the methods chosen by the ECB differ and indicate that this measure will have only limited effectiveness in the euro zone.

Communication has become an integral part of the conduct of monetary policy since interest rates have been kept at a minimum level. More specifically, forward guidance consists of

announcing and making a commitment to the future path of key interest rates. By doing this, the central banks want to increase the transparency of their activities and anchor expectations. The aim is to clarify both their strategy and their predictions about trends in the economy. In the present case, the central banks want to affirm their desire not to raise interest rates in the near future. They also hope to influence private expectations about short-term rates, and thus long-term rates, in order to strengthen the transmission of monetary policy, and thus support the economy.

### **From the theory...**

The promoters of the forward guidance strategy, foremost among them Eggertsson and Woodford (2003), suggest that monetary policy can be made more effective by adopting a policy of stable interest rates that is well known in advance. This proposal is justified by the fact that demand for credit is highly dependent on expectations of long-term interest rates, which depend on expectations of short-term rates. Hence, by announcing the future levels of interest rates in advance, the central bank declares its intentions and dispels any uncertainty about its future decisions. This strategy is especially relevant in a situation of a liquidity trap, when nominal interest rates are close to zero, as is the case today. The traditional tool of central banks is then constrained, as nominal interest rates cannot be negative. Central banks can thus no longer influence the cost of the loans granted, but they can on the other hand influence volumes through unconventional measures [\[21\]](#). The channel of expectations and the transmission of signals to private agents then become paramount and complement quantitative easing.

It is important to note that the effect of forward guidance on long-term rates and thus on the economy passes through the term structure of the interest rates. Several theories attempt to explain how rates vary in accordance with the term. The term structure of interest rates can be considered from the



viewpoint of the theory of expectations, which assumes that long-term rates reflect a combination of expected future short-term rates, and thus that the different maturities are perfect substitutes. For its part, the theory of a liquidity premium implies that long-term interest rates include a premium linked to the existence of one or more long-term risks. Finally, another theory is based on the assumption of market segmentation and stipulates that financial instruments with different maturities cannot easily be substituted and that their prices move independently. If investors wish to hold liquid assets, they will prefer short-term instruments over long-term ones, and their prices will vary in opposite directions. Only in the case of the first two theories will forward guidance have the desired effect on long-term rates.

### **...to the practice**

This kind of strategy had already been implemented by some central banks even before the 2008 financial crisis, in particular in New Zealand since 1997, in Norway since 2005, and in Sweden since 2007. The United States also implemented this communication strategy several times when rates were very low. The Federal Open Market Committee (FOMC) implicitly introduced forward guidance in its communications in August 2003. At a time when its target rate was at a historic low, the FOMC stated that "...policy accommodation can be maintained for a considerable period". This terminology, specific to forward guidance, remained in FOMC communiqués until the end of 2005. It reappeared in December 2008, and in greater detail in August 2011, when Ben Bernanke, chairman of the US Federal Reserve (or the "Fed"), announced that economic conditions warranted maintaining the federal funds rate at a low level until at least mid-2013. Since then, the announcement on 13 September 2012 that the Fed will not raise its rates before mid-2015 continues this same strategy.

To understand what impact the ECB's forward guidance might have, it is important to distinguish two types of forward



guidance: one for which the action of the central bank is subject to a time period, and another which depends on economic variables, including thresholds that trigger an action on the bank's part. In the case of the Fed, the first statements mentioned above refer to a period of time, but since December 2012 it has conditioned its commitment to future rate changes on cyclical thresholds that act as triggers. The Fed has also announced that "this exceptionally low range for the [Fed Funds](#) rate will be appropriate at least as long as the unemployment rate remains above 6-1/2 percent, inflation between one and two years ahead is projected to be no more than a half percentage point above the Committee's 2 percent longer-run goal, and longer-term inflation expectations continue to be well anchored". The arrival of new FOMC members in January 2014 could, however, change the timing of the next monetary tightening. Likewise, in August 2013 Mark Carney, Governor of the Bank of England (BoE), set out a forward guidance strategy indicating his intention not to raise rates so long as the unemployment rate had not fallen below 7%. This commitment is nevertheless conditional on containing inflation, on stable inflation expectations and on the neutral impact of this commitment on financial stability.

There is a major disadvantage to conditioning forward guidance on a time period, as has been adopted by the ECB (and as will be described later): changes in economic conditions over the time period in question could render the commitment obsolete. The announcement thus has very little credibility. Conditioning forward guidance on thresholds for economic variables does not have this drawback. One criterion for the credibility of commitments conditioned on thresholds is, however, that the underlying variables chosen are observable (GDP rather than output gap) and that they do not suffer from measurement errors (inflation rather than inflation expectations), so that private agents can assess whether the central bank is acting in accordance with its commitments. Then and only then will the agents have confidence in the

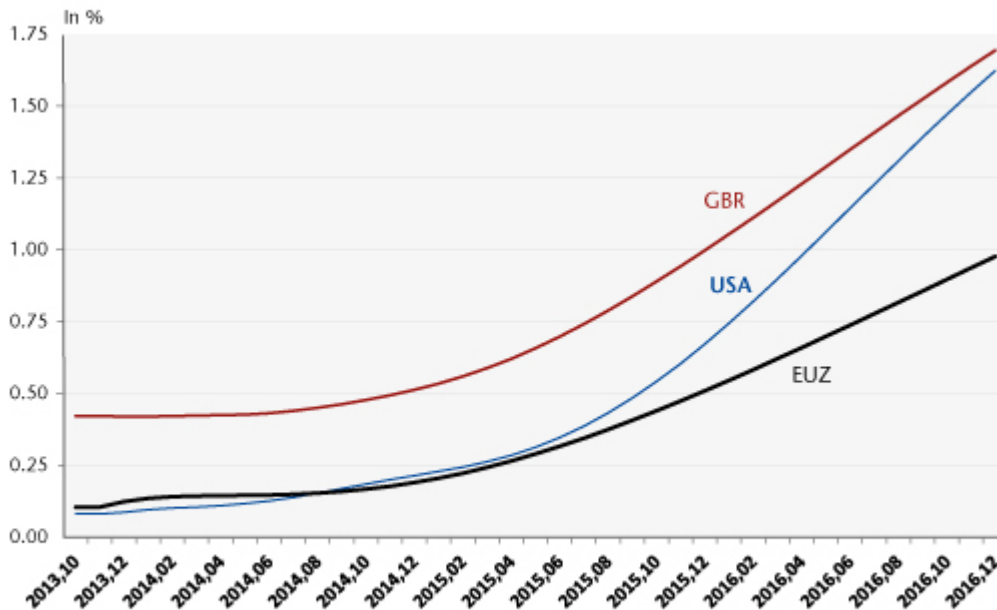
declarations and will the central bank be in a position to influence expectations of long-term rates. The relative advantages and disadvantages of the two types of forward guidance explain why the Fed switched from one to the other and why the BoE has also made  $\square$  a commitment linked to thresholds.

The establishment of forward guidance conditioned on a threshold for a macroeconomic variable may, however, contribute to muddying the waters on the ranking of the central bank's objectives. If several variables are targeted simultaneously and they begin to diverge, what will the bank decide? The Fed does not prioritize its objectives. As the economy emerges from crisis it is quite possible that the Fed may decide to ensure the strength of GDP, or to lower unemployment rather than inflation. For its part, the BoE follows a strategy of inflation targeting. It has therefore defined conditions ("knockouts") on inflation, inflation expectations and financial stability, which, when they are not met, will lead to an end to forward guidance and therefore to any commitment to keep rates unchanged. The hierarchy of objectives would thus be well respected and the BoE's credibility maintained.

How effective can forward guidance be? Kool and Thornton (2012) express serious doubts as to the results obtained through forward guidance. They assess the predictability of short-term and long-term rates in countries where this strategy has been adopted and show that forward guidance improves the ability of private agents to forecast future short-term rates only for periods of under one year, without improving the predictability of rates in the longer term. The chart below shows the expectations of 3-month rates by the financial markets in October 2013 for the coming months. Since benchmark rates change by a minimum of 0.25%, this figure indicates that no change in rates is expected for the time being, apart perhaps from the United States for the one-year

horizon.

Graphique. Current 3-month rates and anticipated 3-month rates at various dates, in October 2013



Note : The short-term rate anticipations that we consider are produced from forward rate agreements (FRAs) or futures contracts on anticipated market rates at a given date for different horizons (1 month, 2 months, etc.).

Source : Datastream.

## The timid adoption by the ECB

With regard to the ECB, which for its part sets a hierarchy of goals by giving priority to inflation, the introduction of forward guidance constitutes a conditional commitment to a period of time (“... for an extended period of time”) without any reference to thresholds. From this point of view, it goes against the current of the Fed and the BoE, which adopted conditional commitments to numerical thresholds. For the record, prior to July 4<sup>th</sup> the ECB gave clues to its decision in the following month in the form of expressions that were easily recognizable to observers. Thus, the insertion of the word “vigilance” in the ECB President’s speech at his press conference announced a probable tightening of monetary policy [\[3\]](#). By adding forward guidance to its basket of tools, the ECB wants to be less enigmatic. In particular, it seems that it wanted to respond to concerns over a possible rise in interest rates.

However, Benoit Coeuré, a member of the ECB Executive Board, said that this strategy does not call into question the rule, repeated many times at press conferences, that the ECB will never commit to future policies (“no pre-commitment rule”) and that forward guidance is to be re-evaluated at each meeting of the Board of Governors. Jens Weidmann, a member of the ECB’s monetary policy committee as president of the Bundesbank, confirmed that the ECB’s forward guidance “is not an absolute advanced commitment of the interest rate path”, while Vitor Constancio, ECB Vice-President, added an extra dose of confusion by saying that the ECB’s forward guidance “is in line with our policy framework as it does not refer to any date or period of time but is instead totally conditional on developments in inflation prospects, in the economy and in money and credit aggregates – the pillars of our monetary strategy”.

So how effective can a policy be that is poorly defined, that does not seem to have a consensus within the ECB Governing Council, and whose key to success – the credibility of the commitment – is openly questioned? Not very effective.

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Rosa, C. and G. Verga (2007). “On the Consistency and Effectiveness of Central Bank Communication: Evidence from the ECB”, *European Journal of Political Economy*, 23, 146-175.

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\* This text draws on a study, “Politique monétaire: est-ce le début de la fin?” [“Monetary policy: Is it the beginning of the end?”], forthcoming in [The OFCE outlook for the global economy in 2013-2014 \[in French\]](#).

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[1] Today’s 25-basis point cut in the benchmark rate is consistent with the ECB’s strategy of forward guidance.

[2] Unconventional measures refer to monetary policy practices that are not classified as traditional policy (*i.e.* changes in interest rates). These are measures that result in a change in the content or magnitude of the central bank balance sheet through purchases of government or private securities, which is generally referred to as “quantitative easing”.

[3] Rosa and Verga (2007) offer a description of these expressions.

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## **No surprises from the Fed\***

By Christine Riffart

Not surprisingly, at its meeting on 29 and 30 October the Monetary Policy Committee of the US Federal Reserve decided to maintain its unconventional measures and to leave the federal funds rate unchanged. Since the end of 2012, the Fed has been making massive purchases of securities (government bonds and mortgage debt) at a rate of \$85 billion per month. The aim is to put pressure on long-term rates and to support economic activity, including the real estate market.

The Federal Reserve, which is committed to a strategy of transparency and communication aimed at orienting investor expectations, also confirmed that it will hold the rate at between 0 and 0.25% so long as: the unemployment rate is greater than 6.5%; forecasts of inflation over 1 to 2 years do not exceed the long-term inflation target, set at 2%, by more than a half-point; and long-term inflation expectations remain stable. According to our forecast in October (see [The United States: capped growth](#)), the unemployment rate, which was 7.2% in September, could fall to 6.9% by end 2014. Finally, inflation, which was at 1.5% in the third quarter of 2013, should not exceed 1.8% in 2014. In these conditions, no rate increase is expected before the second half of 2015. Policy will thus remain particularly accommodating.

There is greater uncertainty about the withdrawal of the unconventional measures than about keeping long-term rates at artificially low levels. A cessation or reduction of these measures was announced last May and is thus expected by the markets, and in any case they were not meant to last. Between May and September 2013, foreign private and public investors had anticipated the beginning of their withdrawal and began offloading some of their securities. This influx of securities depressed prices and led to a one-point increase in long-term public rates in just a few weeks. But the fragile character of growth, inadequate job creation and especially the public relations efforts undertaken by the central banks to reassure the financial markets led to putting off the actual date the purchases are to be curtailed. Long-term rates fell once again, and have continued to fall in recent weeks following the October budget crisis.

If, in retrospect, it appears that it was premature to anticipate an early withdrawal of the unconventional measures, the question of timing still remains. In its press release, the Committee stated that any decision will depend on the economic outlook as well as on a cost-benefit analysis of the

programme. However, the economic situation is not expected to improve in the coming months. If Congress reaches a budget agreement before December 13, this will certainly be on the basis of cuts in public spending. This new fiscal shock will further dampen growth and penalize the labor market yet again. The issuance of new debt, which was compelled in 2013 by the statutory debt ceiling, might then grow very slowly in 2014 due to budget adjustments. Faced with this moderate growth in the supply of securities, the Federal Reserve could reduce its own purchases to the benefit of other investors. This could help maintain equilibrium in the securities market without a sharp fall in asset prices.

This normalization of monetary policy instruments should not be long in coming. But there are risks involved, and a sharp rise in long-term rates cannot be excluded. The markets are volatile, and the events of May and June have not been forgotten. But much of the movement has already been taken on board by the markets. The Federal Reserve will therefore have to beef up its communication strategy (by for example announcing in advance the date and scope of its decision) if it is to succeed the difficult balancing act of maintaining a highly accommodative monetary policy while gradually dispensing with its exceptional measures to maintain low interest rates. Let us assume that the exercise will be a success. Long-term public rates, at 2.7% in third quarter 2013, should not exceed 3.5% by the end of 2014.

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\*This text draws on the study “Politique monétaire: est-ce le début de la fin ?” [Monetary policy: Is it the beginning of the end?], which is to appear soon in the OFCE 2013-2014 outlook for the global economy.



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# Monetary policy and property booms: dealing with the heterogeneity of the euro zone

By [Christophe Blot](#) and Fabien Labondance

The transmission of monetary policy to economic activity and inflation takes place through various channels whose role and importance depend largely on the structural characteristics of an economy. The dynamics of credit and property prices are at the heart of this process. There are multiple sources of heterogeneity between the countries of the euro zone, which raises questions about the effectiveness of monetary policy but also about the means to be used to reduce this heterogeneity.

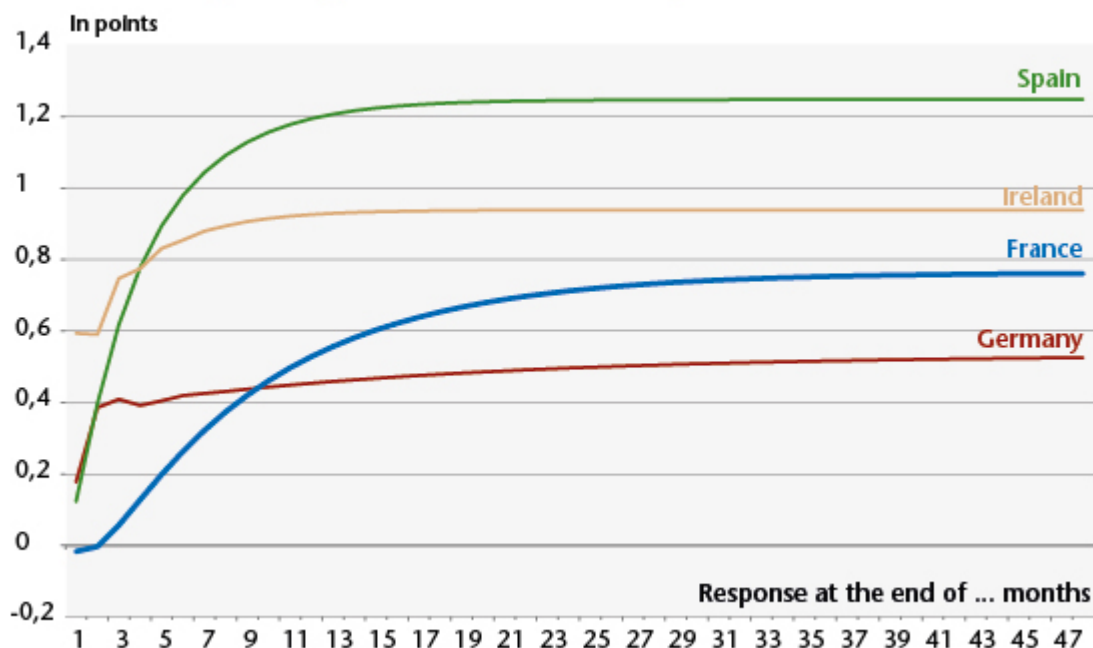
The possible sources of heterogeneity between countries include the degree of concentration of the banking systems (*i.e.* more or fewer banks, and therefore more or less competition), the financing arrangements (*i.e.* fixed or variable rates), the maturity of household loans, their levels of debt, the proportion of households renting, and the costs of transactions on the housing market. The share of floating rate loans perfectly reflects these heterogeneities, as it is 91% in Spain, 67% in Ireland and 15% in Germany. In these conditions, the common monetary policy of the European Central Bank (ECB) has asymmetric effects on the euro zone countries, as is evidenced by the divergences in property prices in these countries. These asymmetries will then affect GDP growth, a phenomenon that has been observed both “before” and “after”

the crisis. These issues are the subject of an article that we published in the OFCE's [Ville et Logement](#) (Housing and the City) issue. We evaluated heterogeneity in the transmission of monetary policy to property prices in the euro zone by explicitly distinguishing two steps in the transmission channel, with each step potentially reflecting different sources of heterogeneity. The first describes the impact of the interest rates controlled by the ECB on the rates charged for property loans by the banks in each euro zone country. The second step involves the differentiated impact of these bank rates on property prices.

Our results confirm the existence of divergences in the transmission of monetary policy in the euro zone. Thus, for a constant interest rate set by the ECB at 2%, as was the case between 2003 and 2005, the estimates made during the period preceding the crisis suggest that the long-term equilibrium rate applied respectively by Spanish banks and Irish banks would be 3.2% and 3.3%. In comparison, the equivalent rate in Germany would be 4.3%. Moreover, the higher rates in Spain and Ireland amplify this gap in nominal rates. We then show that the impact on bank rates of changes in the ECB's key rate is, before the crisis, stronger in Spain and Ireland than it is in Germany (figure), which is related to differences in the share of loans made at floating rates in these countries. It should be noted that the transmission of monetary policy was severely disrupted during the crisis. The banks did not necessarily adjust supply and demand for credit by changing rates, but by tightening the conditions for granting loans. [1] Furthermore, estimates of the relationship between the rates charged by banks and property prices suggest a high degree of heterogeneity within the euro zone. These various findings thus help to explain, at least partially, the divergences seen in property prices within the euro zone. The period during which the rate set by the ECB was low helped fuel the housing boom in Spain and Ireland. The tightening of monetary policy that took place after 2005 would also explain the more rapid

adjustment in property prices observed in these two countries. Our estimates also suggest that property prices in these two countries are very sensitive to changes in economic and population growth. Property cycles cannot therefore be reduced to the effect of monetary policy.

**Figure. Impact on bank rates of a 1 point hike in ECB rates**



Source : Authors' calculations.

To the extent that the recent crisis has its roots in the macroeconomic imbalances that developed in the euro zone, it is essential for the proper functioning of the European Union to reduce the sources of heterogeneity between the Member states. However, this is not necessarily the responsibility of monetary policy. First, it is not certain that the instrument of monetary policy, short-term interest rates, is the right tool to curb the development of financial bubbles. And second, the ECB conducts monetary policy for the euro zone as a whole by setting a single interest rate, which does not permit it to take into account the heterogeneities that characterize the Union. What is needed is to encourage the convergence of the banking and financial systems. In this respect, although the proposed banking union still raises many problems (see [Maylis Avaro and Henri Sterdyniak](#)), it may reduce heterogeneity. Another effective way to reduce asymmetry in the transmission

of monetary policy is through the implementation of a centralized supervisory policy that the ECB could oversee. This would make it possible to strengthen the resilience of the financial system by adopting a means of regulating banking credit that could take into account the situation in each country in order to avoid the development of the bubbles that pose a threat to the countries and the stability of the monetary union (see [CAE report no. 96](#) for more details).

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[1] [Kremp and Sevestre \(2012\)](#) emphasize that the reduction in borrowing volumes is not due simply to the rationing of the supply of credit but that the recessionary context has also led to a reduction in demand.

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## **What monetary policy for the ECB in 2013?**

By Paul Hubert

After the monthly meeting of the Board of Governors of the European Central Bank on 7 February 2013, the ECB decided to hold its key interest rate at 0.75%. The analysis of the economic situation by Mario Draghi made  during the press conference afterwards pointed to contrasting developments justifying the status quo. In a recent study, we showed that the inflation forecasts of the ECB can shed new light on future trends in interest rates.

The status quo can be explained by a number of mutually

offsetting factors. The banks have started to repay some of the cash obtained through the LTRO facility (140 billion euros out of 489 billion), which reflects an improvement in their financial position, while at the same time lending to non-financial firms is continuing to contract (-1.3% in December 2012) and consumer loans are still at very low levels.

From a macroeconomic viewpoint, the situation in the euro zone is not giving clear signals about future monetary policy: after shrinking by 0.2% in the second quarter of 2012, real GDP in the euro zone fell another 0.1% in the third quarter, while inflation, as measured on an annual basis, decreased from 2.6% in August 2012 to 2% in January 2013 and is expected to drop below the 2% mark in the coming months based on the figures for GDP growth and for current and anticipated oil prices.

Furthermore, the inflation expectations of private agents, as measured by the *Survey of Professional Forecasters*, remain firmly anchored around the ECB's inflation target. In the fourth quarter of 2012, expectations were for 1.9% inflation for the years 2013 and 2014. Given that the target of "below but close to 2%" has now been reached, and with a euro zone in recession and unemployment at record levels, the ECB could give a boost to real activity. However, it anticipates that economic activity should gradually pick up in the second half of 2013, partly due to the accommodative monetary policy being followed today.

Given expectations, and in light of the historically low levels of key interest rates and the lag in the transmission of monetary policy to the real economy [\[1\]](#), a future rate cut seems very unlikely. One final element is sending out mixed messages: the recent rise of the euro – though it is still far from record levels – could nip in the bud the weak economic recovery that is underway, and could in the eyes of some justify support for export sectors [\[2\]](#).

In a recent [OFCE working paper](#) (No. 2013-04), we discuss how the ECB could use its inflation forecasts to improve the implementation of its monetary policy. We propose a new element to shed light on future developments in interest rates, based on the macroeconomic projections published quarterly by the ECB. In this study on the effects of the publication of the ECB's inflation forecasts on the inflation expectations of private agents, we show that a 1 percentage point reduction in the ECB's inflation projections is associated with a key interest rate cut by the ECB of 1.2 percentage points in the next two quarters. We conclude that the ECB's inflation forecasts are a tool that helps to better understand current monetary policy decisions and to anticipate future decisions.

The latest inflation projections, published in December 2012, were 1.6% and 1.4% for the years 2013 and 2014, respectively. The publication on March 7<sup>th</sup> of new projections could provide a further indication of the direction monetary policy is likely to take in 2013.

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[\[1\]](#) On average, a change in the key rates is estimated to have an impact on inflation after 12 months and on GDP after 18 months.

[\[2\]](#) Remember, however, that about 64% of trade in the euro zone is conducted with euro zone partners, and thus is independent of fluctuations in exchange rates.

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# Is it possible to get over a banking crisis? Comparative analysis of Ireland and Iceland

By [Céline Antonin](#) and [Christophe Blot](#)

In economics, miracles sometimes prove to be mirages. Iceland and Ireland are witnesses. These two small open economies, paradises of liberalized deregulated finance, harboured growth in the early 2000s, but were hit hard by the financial crisis. The subsequent almost complete nationalization of their financial systems has had a negative impact on the public debt of the two countries. To stem the rising debt and the risk of unsustainability, since 2010 the two governments have implemented fiscal austerity plans, but with a difference: Ireland belongs to the euro zone, while Iceland doesn't. The latest [Note of the OFCE \(no. 25 dated 4 February 2013 \[in French\]\)](#) reviews the recent macroeconomic and financial situation of the two countries to show the extent to which different policy mixes may account for different trajectories for a recovery.

While in Iceland the banking crisis was amplified by a currency crisis, the depreciation of the crown was then a factor in the recovery, so that the country is now growing again. GDP was very volatile: between the third quarter of 2007 and the second quarter of 2011, GDP declined by more than 13%, but has rebounded by 5.7% since. There was less volatility and a shorter recessionary phase in Ireland than in Iceland (8 quarters), and the amplitude of the decline was smaller (-10.7%). However, the recovery is more timid, with GDP growth of only 3.4% since late 2009.



Our analysis leads us to two main conclusions: first, an internal devaluation is less effective than an external devaluation; and second, fiscal consolidation is less costly when it is accompanied by favourable monetary conditions and exchange policy. It is in light of these points that one can redefine the optimal policy mix in the euro zone, as we suggest in more detail in the [iAGS](#) report. An active monetary policy is essential to allow the refinancing of the public debt. The European Central Bank should therefore act as lender of last resort for the member countries. The countries running a surplus need a “reflationary” policy to help reduce their current account imbalances. Fiscal adjustments should be relaxed or even postponed to allow a more rapid return to growth.

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## Has monetary policy become ineffective?

By [Christophe Blot](#), [Catherine Mathieu](#) and Christine Riffart

This text summarizes the [special study](#) of the October 2012 forecast.

Since the summer of 2007, the central banks of the industrialized countries have intervened regularly to counter the negative impact of the financial crisis on the functioning of the banking and financial system and to help kick-start growth. Initially, key interest rates were lowered considerably, and then maintained at a level close to 0 [\[1\]](#). In a second phase, from the beginning of 2009, the central banks implemented what are called unconventional measures.

While these policies may differ from one central bank to another, they all result in an increase in the size of their balance sheets as well as a change in the composition of their balance sheet assets. However, three years after the economies in the United States, the euro zone and the United Kingdom hit bottom, it is clear that recovery is still a ways off, with unemployment at a high level everywhere. In Europe, a new recession is threatening [\[2\]](#). Does this call into question the effectiveness of monetary policy and of unconventional measures more specifically?

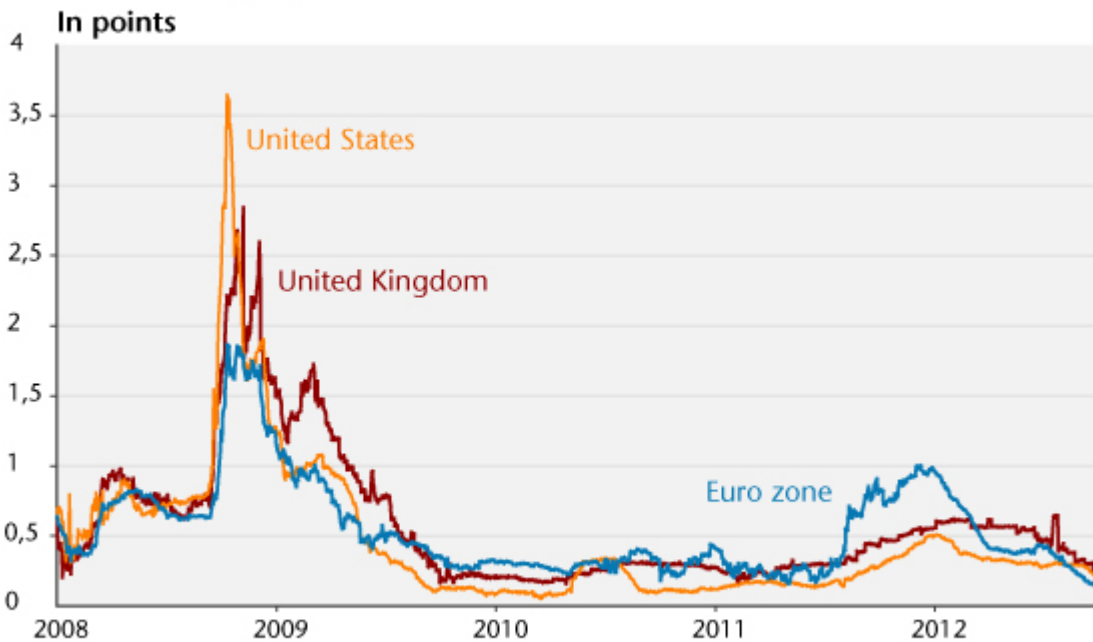
For almost four years, a wealth of research has been conducted on the impact of unconventional monetary policies [\[3\]](#). Cecioni, Ferrero and Sacchi (2011) [\[4\]](#) have presented a review of recent literature on the subject. The majority of these studies focus on the impact of the various measures taken by the central banks on financial variables, in particular on money market rates and bond yields. Given the role of the money market in the transmission of monetary policy, the ability of central banks to ease the pressures that have emerged since the beginning of the financial crisis constitutes a key vector for effective intervention. More recently, this was also one of the reasons motivating the ECB to conduct an exceptional refinancing operation in two stages, with a maturity of 3 years. This intervention has indeed helped to reduce the tensions on the interbank market that had reappeared in late 2011 in the euro zone, and to a lesser extent in the United States and the United Kingdom (see graph). This episode seems to confirm that central bank action can be effective when it is dealing with a liquidity crisis.

Another critical area of debate concerns the ability of unconventional measures to lower interest rates in the long term and thereby to stimulate activity. This is in fact an important lever for the transmission of monetary policy. The findings on this issue are more mixed. Nevertheless, for the United States, a study by Meaning and Zhu (2012) [\[5\]](#) suggests

that Federal Reserve programs to purchase securities have contributed to lowering the rates on 10-year US Treasury bills: by 60 points for the first “Large-scale asset purchase” program (LSAP1) and by 156 points for LSAP2. As for the euro zone, Peersman [\[6\]](#) (2011) shows that the impact of unconventional measures on activity has in general closely resembled the effect of lowering the key interest rate, and Gianone, Lenza, Pill and Reichlin [\[7\]](#) (2012 ) suggest that the various measures taken by the ECB since the beginning of the crisis have helped offset the rise in the unemployment rate, although the impact is limited to 0.6 point.

Under these conditions, how is it possible to explain the weakness or outright absence of a recovery? One answer evokes the hypothesis of a liquidity trap [\[8\]](#). Uncertainty is still prevalent, and the financial system is still so fragile that agents are continuing to express a preference for liquidity and safety, which explains their reluctance to undertake risky projects. Thus, even if financing conditions are favourable, monetary policy will not be sufficient to stimulate a business recovery. This hypothesis probably explains the timidity of the recovery in the United States. But in the euro zone and the United Kingdom this hypothesis needs to be supplemented with a second explanation that recognizes the impact of restrictive fiscal policies in holding back recovery. The euro zone countries, like the UK, are pursuing a strategy of fiscal consolidation that is undermining demand. While monetary policy is indeed expansionary, it is not able to offset the downward pressure of fiscal policy on growth.

### Graphique. Tensions on the interbank markets\*



\* The tensions are measured by the spread between the interbank rates (Libor ou Euribor) and the overnight interest rate swap (OIS).

Source : Datastream.

[1] One should not, however, forget the exception of the ECB, which prematurely raised its key interest rate twice in 2011. Since then it has reversed these decisions and lowered the key rate, which has stood at 0.75% since July 2012.

[2] The first estimate of UK GDP for the third quarter of 2012 indicates an upturn in growth following three quarters of decline. However, this rebound is due to unusual circumstances (see [Royaume-Uni: l'enlissement](#)), and activity will decline again in the fourth quarter.

[3] Unconventional monetary policies have already been analyzed repeatedly in the case of the Bank of Japan. The implementation of equivalent measures in the United States, the United Kingdom and the euro zone has contributed to greatly amplifying the interest in these issues.

[4] ["Unconventional monetary policy in theory and in practice"](#), *Banca d'Italia Occasional Papers*, no.102.

[5] ["The impact of Federal Reserve asset purchase programmes:](#)

[another twist](#)", *BIS Quarterly Review*, March, pp. 23-30.

[6] "[Macroeconomic effects of unconventional monetary policy in the euro area](#)", ECB Working Paper no.1397.

[7] "[The ECB and the interbank market](#)", CEPR Discussion Paper no. 8844.

[8] See [OFCE](#) (2010) for an analysis of this hypothesis.

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# The euro zone: confidence won't be enough

By [Céline Antonin](#), [Christophe Blot](#) and Danielle Schweisguth

*This text summarizes the OFCE's October 2012 forecasts for [the economy of the euro zone](#).*

After more than two years of crisis in the euro zone, this time the meeting of the European Council, held on 18 and 19 October, had nothing of the atmosphere of yet another last-chance summit. Even though discussions on the future banking union [\[1\]](#) were a source of tension between France and Germany, there was no sword of Damocles hanging over the heads of the European heads of state. However, it would be premature to assume that the crisis is coming to an end. It is sufficient to recall that the GDP of the euro zone has still not regained its pre-crisis level, and in fact declined again by 0.2% in the second quarter of 2012. This decline is forecast to continue, as we expect GDP to fall by 0.5% in 2012 and by 0.1%

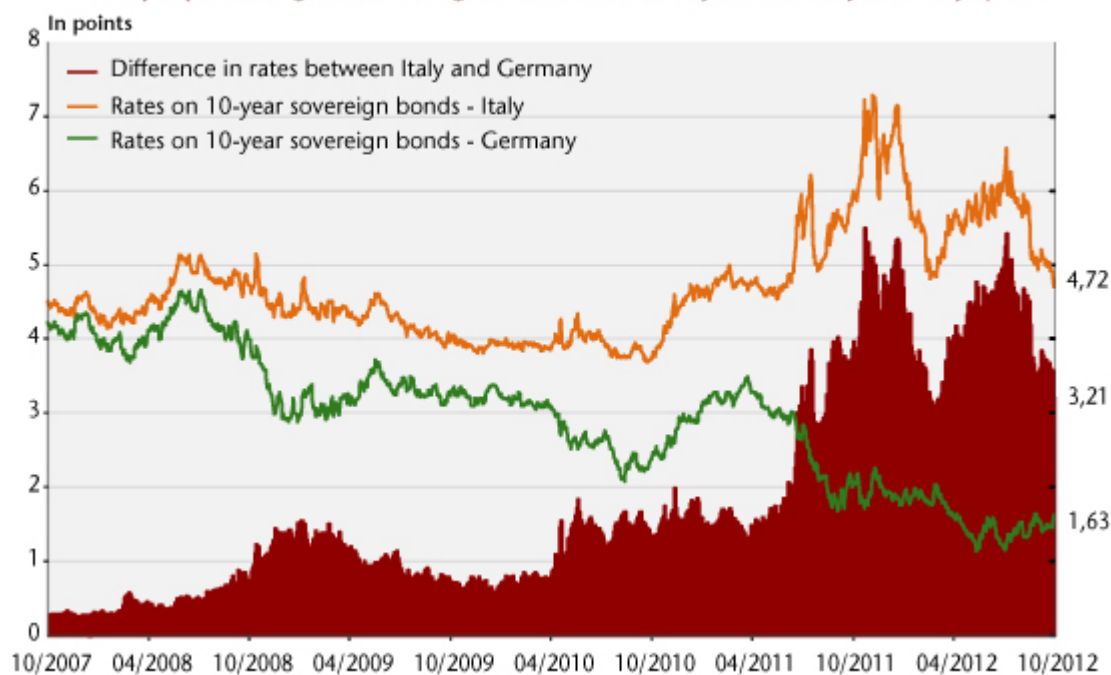
in 2013. Consequently, the unemployment rate in the euro zone, which has already surpassed its previous historical record from April 1997, will rise further, reaching 12.1% by end 2013. What then are the reasons for the lull? Can the euro zone quickly resume its growth and hope to finally put an end to the social crisis?

Since the end of 2011, Europe has adopted a new treaty (the Treaty on stability, coordination and governance, the TSCG) which is being ratified in the 25 signatory countries. The new law is specifically intended to strengthen both budgetary discipline – through the adoption of national golden rules – and solidarity through the creation of the European Stability Mechanism (ESM), in so far as the use of the ESM is conditional on ratification of the TSCG. On 6 September, the ECB unveiled the basic points of its new conditional purchase of sovereign debt ([see here](#)), which is aimed at reducing the interest rates of countries subject to the ESM. Thus, the risk premium, as measured by the difference between the Italian and Spanish sovereign interest rates and the German rate, after peaking on 24 July 2012, decreased respectively by 2.2 and 2.5 points (Figures 1 and 2). This is of course still far from normal, but this lull is nevertheless welcome and it shows that the spectre of a breakup of the euro zone has receded.

Could this new wave of optimism be a precursor to an upturn in the economy of the euro zone? The answer to this question is, unfortunately, negative. The fiscal policies of countries in the zone are still highly restrictive, a situation that has even intensified in 2012, pushing Italy and Spain back into recession and deepening the recession that was already hitting Portugal and Greece. For the euro zone as a whole, the fiscal stimulus will come to 1.7 percent of GDP in 2012 (table). The series of votes on national budgets confirms this strategy of a forced reduction of budget deficits for 2013, with the overall fiscal consolidation for the euro zone as a whole coming to 1.3%. There will be significant differences between

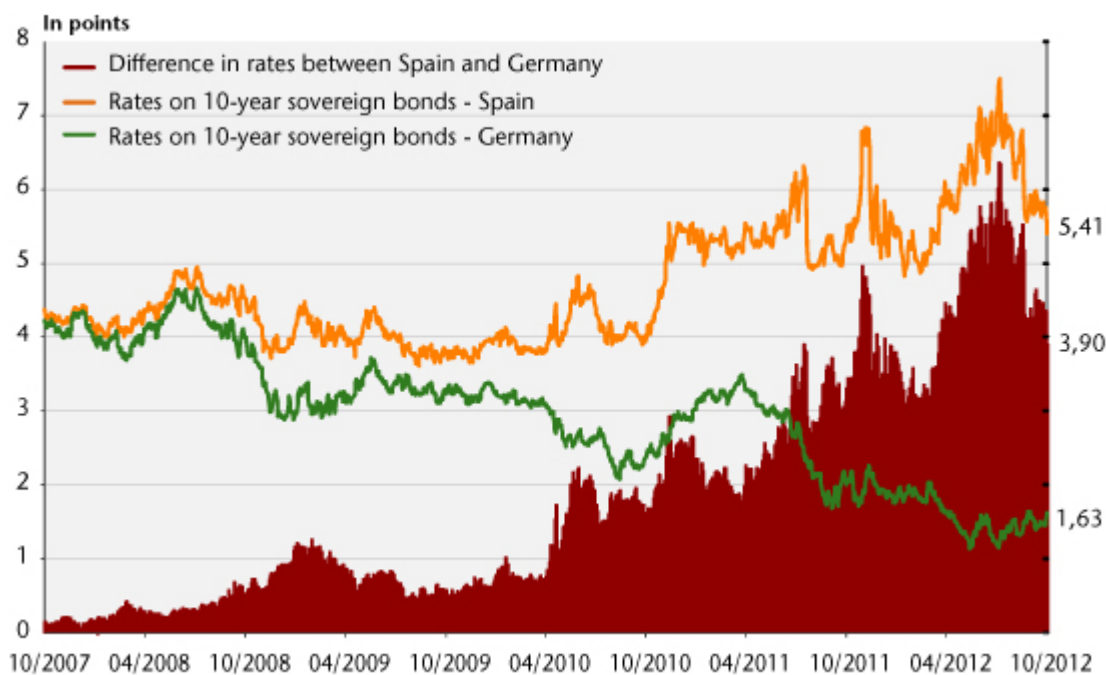
the countries, since in Germany the fiscal stimulus will barely be negative (-0.2 point) while in Spain, Italy and Greece it will be more than -2 GDP points. However, the recessionary impact of this synchronized fiscal consolidation will be even greater given that the euro zone countries are still at the bottom of the economic cycle. In these conditions, the targets for budget deficit reduction will not be met, which will inevitably raise the question of the appropriateness of further budget cuts. More and more Member States thus risk being caught in a vicious circle where low growth calls for further fiscal adjustments that in turn deepen the economic and social crisis. It is essential that any decision about improving the governance of the European Union or the transmission of monetary policy restores confidence and creates the conditions for a return to growth. But this will be insufficient to escape the recession and should not obscure the impact of the fiscal strategy.

**Graphique 1. Long-term sovereign interest rates in Italy and the Italy-Germany Spread**





**Graphique 2. Long-term sovereign interest rates in Spain and the Spain-Germany Spread**



Source : Datastream.

**Tableau. Fiscal stimulus in the euro zone countries**

In GDP points

	2009	2010	2011	2012	2013
Germany	0,7	1,5	-0,9	-0,5	-0,2
Austria	0,4	0,6	-1,6	-0,1	-0,9
Belgium	1,9	-0,3	-0,1	-1,1	-0,8
Spain	3,8	-2,5	-1,1	-3,4	-2,4
Finland	0,4	1,5	-1,6	-0,4	-1,3
France	2,3	-0,5	-2,9	-1,6	-1,8
Greece	3,2	-8,0	-5,3	-5,0	-3,9
Ireland	2,2	-4,4	-1,5	-2,4	-1,8
Italy	0,8	-0,4	-1,2	-3,2	-2,1
Netherlands	4,0	-1,1	-0,2	-1,0	-1,2
Portugal	5,0	-0,7	-3,7	-3,7	-1,8
Euro zone 11*	1,8	-0,3	-1,3	-1,7	-1,3

\* Excluding Cyprus, Luxembourg, Malta, Slovakia, Slovenia and Estonia.

Note : The fiscal stimulus is measured by the opposite of the variation in the cyclically adjusted primary balance, that is, excluding interest charges and exceptional revenue: it approximates the discretionary budget policy.

Sources : OFCE calculations and forecasts, October 2012.

tab

[1] See [here](#) for an analysis of the importance of the proposed banking union and the questions it raises.

