The dual mandate, the Fed and the ECB

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Since 21 September 2011, the US Federal Reserve has launched Operation Twist to reallocate its balance sheet to reduce long-term interest rates. This American activism contrasts once again with the caution displayed by the European Central Bank. On 7 September 2011, a US central banker declared that an unemployment rate of 9% in the US was as serious as an inflation rate of 5% would be. He concluded that US monetary policy needed to make the fight against unemployment a priority. We believe that this should be even more the case for the euro zone economy, which leads us to re-consider the mandate of the ECB.

Through Operation Twist, the Federal Reserve will be trading in 400 billion dollars worth of short-term government bonds for long-dated Treasuries. The Fed's strategy of reallocating its balance sheet is aimed at reducing the long-term interest rate. This approach is consistent in spirit with the recent remarks of the President of the Chicago Fed.
The speech by Charles Evans on 7 September is worthy of our attention for at least two reasons. First, it indicates that today, even though the United States has slipped into crisis, with persistent unemployment and a new recession threatening, attention is being paid too much to inflation and public deficits rather than to the kind of action that would counter the crisis by conducting a policy commensurate with its scale. Using a target-function of the Fed and Okun's law, Charles Evans said that an unemployment rate of 9% of the US workforce would be as worrying as an inflation rate of 5 %: the 3-point gap with each of the two targets – a "natural" rate of unemployment of 6% (which he calls a conservative assumption, as the unemployment rate should fall if the United States were

to recover the 8 growth points lost during the crisis) or an inflation rate of 2% (again, a conservative assumption) – is very comparable in a country like the United States that does not impose any hierarchy between the targets of inflation and of growth (more precisely, between inflation and maximum employment, see here). Evans noted that the unemployment rate in the United States has actually come to differ by 3 points from its target, but inflation hasn't … and he then observes: "So, if 5% inflation would have our hair on fire, so should 9% unemployment." This led Evans to consider that the inflation target, legitimate in the medium term, is not the priority, and therefore that an expansionary monetary policy should be accentuated by conventional or unconventional means, even at the cost of a short-term boom in prices (which is unlikely in an economy in crisis).

The second factor that leads us to take an interest in this discourse is the rapprochement, or rather the great difference, with European policies. Indeed, in reading these words and observing the actions of the Fed, the contrast with the discourse and actions of the ECB is striking. The ECB's difficulties in pursuing a policy suited to the state of the euro zone result from an overly orthodox approach to monetary policy, with all due respect to certain members who have resigned from the ECB. This is rooted in the fundamental Treaty on the European Union, where priority is given to inflation rather than growth (Articles 119 par. 2 and 127 par. 1). This leads the ECB to neglect the target of growth, to minimize it or, when circumstances ultimately so require (in a period of recession or slow growth) to pursue it in a non-transparent and thus ineffective way. We only have to look at the new joint effort, between in particular the Federal Reserve and the ECB, to ensure dollar liquidity for Europe's banks, without any change in the key rate. The repeated procrastinations in European monetary policy from 2007 to 2008 – which were of course in support of the private banks, but, because of rising commodity prices, over which the ECB has no control, did not give any impetus to active monetary policy to counter the deterioration in activity – should not be repeated today. Consumer price inflation in the euro zone in July 2011 is close to the medium-term target imposed by the ECB (2.5%), and it is being pushed upwards by rising raw materials prices (energy, coffee, tea, cocoa), by their impact on the prices of certain services (transport), and by the products used as the basis for the taxes that governments are wont to raise to try to restore a semblance of balance in their public finances (tobacco). Ultimately, in July 2011 the rate of inflation excluding energy and processed food products came to 1.5%. The unemployment rate in the euro zone is, for its part, on the order of 10% of the workforce. To paraphrase Charles Evans, one can say that while 5% inflation would certainly raise the hair on the heads of Europe's central bankers – and fortunately we are far from this – this should also be the case when the unemployment rate reaches 10% of the workforce!

The big difference between a Fed official's expansionist drive and the ECB's policy of prudence in comparable economic circumstances (the gaps between the inflation and unemployment rates from their respective targets are more or less the same) also finds a striking parallel in the fiscal policy speeches and actions on either side of the Atlantic. While the European debates almost invariably concern the imposition of additional constraints on the fiscal policies of the euro zone countries (the adoption of "golden rules" in Germany and Spain; the litany of fiscal austerity programs, the latest being in Italy), the need in the euro zone to be able to rely on a strong economic policy instrument comes down solely to the ECB. But this is not necessarily the case in the United States, where the federal government has proposed a new plan to revive the economy in the short term, together with fiscal consolidation over the next 10 years. The speech by Charles Evans should be given by Jean-Claude Trichet, but we are a long way from that. Standing firmly on the impeccable character of the ECB's past actions (see the nuanced critique by Paul Krugman), the ECB Chairman, when he does talk, does not seem to take the measure of its responsibility for the future performance of its current policies. If the ECB fails to take the lead in boosting activity in a period of low inflation, then the governance of the euro needs to be reviewed. Two critical choices for the future are posed. The euro could disappear, which would not take place without serious difficulties (see the note from Jean Pisani-Ferry about Greece, whose conclusions could be extended to all the euro zone countries, including Germany) and must be firmly rejected. The status of the system of euro zone central banks could be amended to give equal dignity to the goals of economic growth and inflation, along the lines of the Fed, whose performance has made it possible to minimize the fears of an explosion of inflation.