

He who sows austerity reaps recession

By the Department of Analysis and Forecasting, headed by [X. Timbeau](#)

This article summarizes [OFCE note no.16](#) that gives the outlook on the global economy for 2012-2013.

The sovereign debt crisis has passed its peak. Greece's public debt has been restructured and, at the cost of a default, will fall from 160% of GDP to 120%. This restructuring has permitted the release of financial support from the Troika to Greece, which for the time being solves the problem of financing the renewal of the country's public debt. The contagion that hit most euro zone countries, and which was reflected in higher sovereign rates, has been stopped. Tension has eased considerably since the beginning of 2012, and the risk that the euro zone will break up has been greatly reduced, at least in the short term. Nevertheless, the process of the Great Recession that began in 2008 being transformed into a very Great Recession has not been interrupted by the temporary relief of the Greek crisis.

First, the global economy, and especially the euro zone, remains a high-risk zone where a systemic crisis is looming once again. Second, the strategy adopted by Europe, namely the rapid reduction of public debt (which involves cutting public deficits and maintaining them below the level needed to stabilize debt), is jeopardizing the stated objective. However, since the credibility of this strategy is perceived, rightly or wrongly, as a necessary step in the euro zone to reassure the financial markets and make it possible to finance the public debt at acceptable rates (between 10% and 20% of this debt is refinanced each year), the difficulty of reaching the goal is demanding ever greater rigor. The euro zone seems to be pursuing a strategy for which it does not hold the

reins, which can only fuel speculation and uncertainty.

Our forecast for the euro zone points to a recession of 0.4 percentage point in 2012 and growth of 0.3 point in 2013 (Table 1). GDP per capita in the euro zone should decline in 2012 and stabilize in 2013. The UK will escape recession in 2012, but in 2012 and 2013 annual GDP growth will remain below 1%. In the US, GDP growth will accelerate from 1.7% per year in 2011 to 2.3% in 2012. Although this growth rate is higher than in the euro zone, it is barely enough to trigger an increase in GDP per capita and will not lead to any significant fall in unemployment.

The epicenter of the crisis is thus shifting to the Old Continent and undermining the recovery in the developed countries. The United States and United Kingdom, which are faced even more than the euro zone with deteriorating fiscal positions, and thus mounting debt, are worried about the sustainability of their public debts. But because growth is just as important for the stability of the debt, the budget cuts in the euro zone that are weighing on their activity are only adding to difficulties of the US and UK.

By emphasizing the rapid reduction of deficits and public debt, euro zone policymakers are showing that they are anticipating a worst case scenario for the future. Relying on so-called market discipline to rein in countries whose public finances have deteriorated only aggravates the problem of sustainability by pushing interest rates up. Through the interplay of the fiscal multiplier, which is always underestimated in the development of strategies and forecasts, fiscal adjustment policies are leading to a reduction in activity, which validates the resignation to a worse "new normal". Ultimately, this is simply a self-fulfilling process.

Outlook for global growth

Annual growth rate (%)	GDP in volume			
	Weight in the total (1)	2011	2012	2013
USA	4.2	3.1	0.1	0.8
USA	3.1	1.7	0.1	0.7
UK	2.6	0.8	1.7	-0.9
EU*	2.8	0.7	-1.5	-0.6
EU2	1.8	1.5	1.7	0.5
BR	0.6	1.9	0.1	0.8
BR	0.5	3.1	0.4	0.8
BR	0.5	2.7	0.7	1.1
FR	0.3	-1.3	-2.9	0.2
CH	0.3	-0.1	-0.3	-0.5
IN	0.2	0.8	-0.6	0.9
IT	15.5	1.5	-0.4	0.3
CH	3.2	0.9	0.7	0.9
IN	0.5	4.0	0.8	1.6
CH	0.3	1.1	0.6	1.1
EU-15	19.4	1.5	-0.2	0.4
12 euro member states	2.7	3.1	1.1	2.1
EU-27	20.8	1.7	-0.3	0.6
CH	0.3	1.9	0.1	1.0
NO	0.4	2.5	2.1	2.8
Europe	20.9	1.8	0.0	0.6
USA	20.8	1.7	2.1	2.4
IN	-0.3	-0.6	1.9	1.0
CAN	1.8	2.3	2.0	2.3
Industrialized countries	10.5	1.8	1.2	1.5
EU candidate countries (2)	1.5	3.6	1.7	4.3
BR	3.3	4.5	3.1	3.8
Other CEE (3)	1.1	3.9	3.7	4.2
CH	11.3	9.2	8.1	8.1
Other Asian countries	13.2	5.6	3.8	6.3
Latin America	8.7	4.0	3.1	3.5
Sub-Saharan Africa	2.1	4.9	1.8	1.3
Middle East and North Africa	4.8	3.1	3.1	3.6
World	100	3.5	1.1	1.4

1 Weighted according to GDP and 2008 PPP, estimated by the IAI.
2 Excludes Republic of Moldova and Serbia.
3 Commonwealth of Independent States.
Source: IAI, 2012. Last updated: March 2012. 2012 calculations and forecasts.

A carbon tax at Europe's borders: Fasten your seat belts!

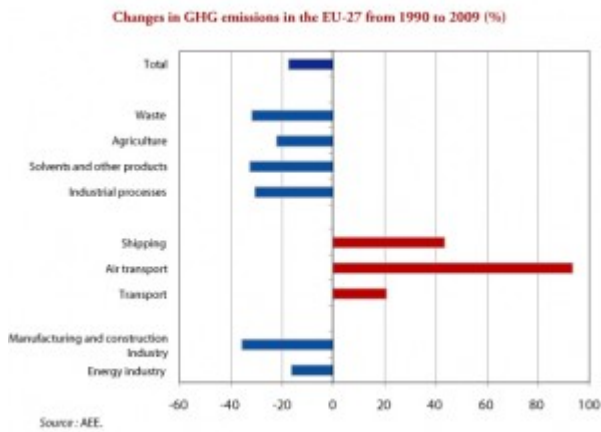
By [Éloi Laurent](#) and [Jacques Le Cacheux](#)

How can the current deadlock in international climate negotiations be resolved? By an optimal mix of incentives and constraints. In the case that currently opposes the European Union and the international air carriers, the EU is legitimately bringing this winning combination to bear by imposing what amounts to a carbon tax on its borders. It is brandishing a constraint, the threat of financial penalties, to encourage an industry-wide agreement that is long overdue among the airlines to reduce their greenhouse gas (GHG) emissions.

The ongoing face-off with the carriers of several major countries, which, with the more or less open support of their governments, are contesting the application of these new regulations on GHG emissions from planes flying into or out of the EU is, from this perspective, a crucial test. It is an issue with considerable symbolic value, as it represents a first: all the airlines serving airports in the EU are subject to the new measure, regardless of their nationality. On March 9th, European officials reaffirmed their determination to maintain this regulation, so long as a satisfactory solution has not been proposed by the International Civil Aviation Organization (ICAO). However, 26 of the 36 member states of the ICAO Board, including China, the United States and Russia, have expressed their opposition to the new European requirement, advising their airlines not to comply. And the Chinese government is now threatening to block or outright cancel orders for 45 Airbus aircraft, including 10 A380 super-jumbos, if the European measure is not repealed.

Air emissions up sharply

GHG emissions attributable to air transport account for only about 3% of global and European emissions (about 12% of total emissions from transport in the EU). But despite the progress made by aircraft manufacturers in energy intensity, these emissions, which are still modest compared to road transport, have been experiencing explosive growth over the last 20 years, and are rising much faster than those in all other sectors, including shipping (see chart). They must be controlled.



In addition, in most countries, in particular in the EU, airline fuel is not subject to the usual taxation applied to oil products, which obviously distorts competition with other modes of transport.

A robust legal framework

The [new European regulations](#), which took effect on 1 January 2012, require all airlines serving any EU airport to acquire emission permits in an amount corresponding to 15% of the CO₂ emissions generated by each trip to or from that airport. The measure is non-discriminatory, since it affects all airlines flying into or out of European air space, whatever their nationality or legal residence. This requirement, which is grounded in environmental protection, is therefore fully consistent with the Charter of the World Trade Organization (WTO).

The measure is also of course in compliance with European treaties as well as with the various provisions of international law in the field of civil aviation, as is reiterated in the [judgment of 21 December 2011](#) by the Court of Justice of the European Union, in a case brought by several US carriers challenging its legality. The legal framework for this new provision is thus robust.

Towards the death of air transportation?

The airlines and the governments of the countries that are

major emitters of greenhouse gases and that are hostile to this measure justify their outright opposition by arguing its poor timing, given the current economic climate of low growth and rising fuel costs, and its excessive cost, *i.e.* that the resulting rise in passenger air fares would be likely to further depress an already fragile industry.

In reality, the measure is largely symbolic and the cost is almost insignificant. Judge for yourself: according to the [Air France calculator approved by the French environmental agency, the ADEME](#), emissions per passenger amount to just over one tonne of CO₂ for a Paris-New York return trip, and approximately 1.4 tonnes for Paris-Beijing. The current price of a tonne of carbon on the European carbon market on which companies must buy emissions permits, the ETS, is just under 8 euros. The additional cost per ticket thus amounts, respectively to 2 euros for Paris-New York and 1.7 euros for Paris-Beijing! (estimates using [the ICAO calculator](#) are even lower).

Towards a trade war?

Given the current state of the legislation, the threats to cancel Airbus orders or similar retaliatory trade measures are obviously out of proportion to the economic impact of the tax on the European skies. To fear that this might trigger a “trade war” is also to forget that such a war has already been declared in industry, particularly in the aviation sector (with the multiplication of [more or less disguised subsidies, including in Europe](#), and with the use of [exchange rates as a veritable weapon of industrial policy](#)). Furthermore, agreements or cancellations of orders in this sector are in any case very often influenced by the political context, sometimes for dubious reasons (as in the case of diplomatic reconciliation with relatively distasteful regimes). In this case the cause, the defence of the integrity of Europe’s climate policy, is legitimate.

The various threats and blackmail attempts being taken up by the pressure groups targeted, in this case air passengers, are intended to sway governments for obtaining short-sighted gains. They are targeting particular countries, foremost among them Germany and Poland, which are currently dragging their feet in accepting the EU Commission's proposal to accelerate the pace of European emissions reduction by raising the goal of emissions reduction for 2020 from 20% to 30% (compared to 1990 levels). As is their right, on the climate issue Germany and Poland have been following an approach that is in accordance, respectively, with a growth strategy based on exports and an energy strategy based on coal. In both cases, these are national decisions that should not take precedence over the European approach. From the perspective of Europe's interests, there is therefore no valid reason to yield to these pressures even if some member states become involved.

By confirming its determination, the EU can provide proof that leadership by example on the climate can go beyond simply setting a moral example and lead to actual changes in economic behaviour. The EU can ensure that everyone sees that, despite the impasse at the global level, a regional climate strategy can still be effective. If its approach is confirmed, the success of the European strategy, which consists of encouraging cooperative strategies under the threat of credible sanctions, would point towards a way to break the deadlock on climate negotiations.

The European Union will, in the coming weeks, be passing through a zone of turbulence (yet another) on the issue of its border carbon tax. It would be legally absurd and politically very costly to make a U-turn now: instead, let's fasten our seat belts and wait calmly for the stop light to change.

Positions of French and German Banks in European interbank lending network

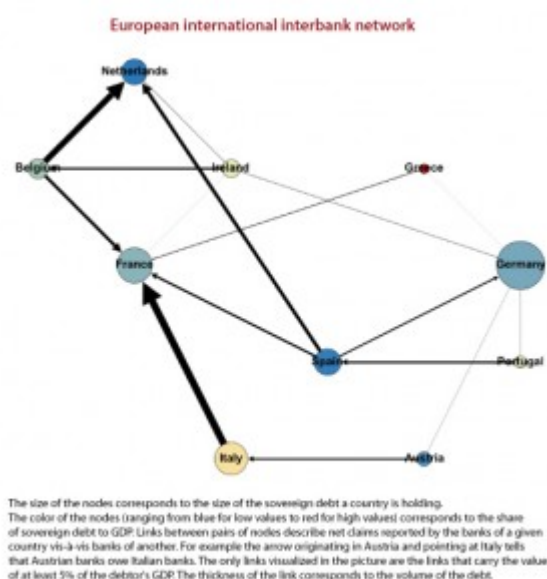
by [Zakaria Babutsidze](#)

Recent desperate cries for help from French and other European banks raise the question of exactly what type and how much trouble have they managed to get themselves into. The question can be approached from many angles. Here I try to gain insights into the topic by analyzing the cross-border interbank lending network. This is a network that facilitates the flow of much needed liquidity across the sovereign borders within the Eurozone. Due to high interconnectedness, banks in each country affect (and are affected) directly or indirectly (by) the banks in all other countries. Banks of different countries play different roles in this vital network: some are net creditors, others are net debtors. In this post I take on the challenge of contrasting the behavior of the two largest creditors in the system (the banking sectors of France and Germany) who are often blamed for the recklessness in their lending practices.

Inspired by [visualization of the network](#) by The New York Times, I use the data on Consolidated Banking Statistics issued in December 2011 by the [Bank for International Settlements](#). The data comprises the claims of banks in a given country filed vis-à-vis banks in other countries as of June 2011. Numbers do not include holdings of sovereign debt. The data is available only for 10 out of 17 Eurozone countries: France, Germany, Italy, Spain, The Netherlands, Austria, Ireland, Belgium, Portugal and Greece. As I am interested in

the role of national financial systems in European network I cancelled out the counter-claims across the borders and proceeded with the volume of the net claims of one European country banking sector vis-à-vis others.

The resulting network connects each of the 10 countries to the other nine. Each connection has a direction that reflects the current debt balance of a country's banks vis-à-vis another country's banks. I apply simple weighted network analysis to the data in order to dissect the European interbank lending network. The volume of mismatch between the claims vis-à-vis partners is used for weighting the links in the network. To make the methodology clearer consider a hypothetical example. Banks of country A owe 100 Euros to the banks of country B. At the same time, banks of country B owe 40 Euros to banks of country A. Then the mismatch between the countries amounts to 60 Euros which country A owes to country B. This way I determine the direction of each link in our network, or who is the creditor and who is the debtor. In addition to this, I take into account the value of the mismatch in the following way. If country C owes country D 30 Euros, we say that the link between A and B, which we have discussed earlier, is twice stronger than that between C and D.



A quick glance at the network visualization on Figure 1 is

enough to notice the special role French and German banks are playing in the system. Banks in these two countries are the ones that are exposed the most to the problems in other European countries.

Recognizing that European cross-border interbank lending network is tightly embedded into global interbank lending network I augment the data with the three largest global players: The United Kingdom, The United States and Japan. In what follows I report two sets of results: one – for isolated European interbank lending network (that I call a closed network), the other – for the extended (open) network that includes three large international players. In the latter case, non-Eurozone countries are taken into account in the calculations but are excluded from the presented rankings.

There are a few important characteristics of the network that we can look at. I concentrate on country rankings with respect to statistics describing country's banks' access to interbank loans, their importance in facilitating interbank liquidity flow and their overall role as lender's or receivers of the loans.

Ranking of countries with respect of different measures for closed and open European cross-border interbank networks

Panel A		Panel B	
Closeness		Betweenness	
	Closed	Open	
1	Belgium	France	Netherlands
2	Germany	Germany	Italy
3	Netherlands	Belgium	Austria
4	Italy	Netherlands	Portugal
5	Austria	Austria	Spain

Panel C		Panel D	
In-Degree		Eigenvector	
	Closed	Open	
1	France	Germany	France
2	Germany	France	Netherlands
3	Netherlands	Spain	Germany
4	Italy	Netherlands	Belgium
5	Spain	Italy	Italy

Note: France and Germany are highlighted with uniform colors.

The measure that allows us to rank the countries in our network with respect to their access to loans is closeness

centrality. This statistic measures the distance of the country's banks to the banks of all the other countries in the network. Higher centrality implies shorter distance. This, in its turn, means that banks do not have to go far in search of financial resources. Panel A of Table 1 presents the ranking of the countries with respect to closeness centrality. When the European network is considered in isolation from the rest of the world it is Germany that has the easiest access to liquidity, while France does not appear in first half of the list. However, when European network is regarded as being embedded in global interbank lending network France tops the list leaving Germany at close second. This allows to conclude that French banks go mainly outside the Eurozone for borrowing money, while German banks balance their borrowings between European and non-European banks.

Panel B of Table 1 presents rankings with respect to betweenness centrality, which measures how much control do a country's banks have over the liquidity flow through the network. This statistic calculates the frequency with which the country appears on the routes that money has to travel from every country to every other country. Higher centrality means that the banking system of the country lies on large number of routs between pairs of other countries. In this respect the closed European network is independent of influence of France and Germany. This points to the fact that banks in the system can reach each other without necessarily going through Germany or even France. The major brokers within the Eurozone seem to be the Dutch banks. Once extra-European links are considered French banks lead the board, while Germany does not appear in top five. France's top seat in open network implies that it plays the role of a broker between European and non-European banks.

Next measure is the in-degree of the country in the weighted network. This statistic basically measures how important of a creditor a given country is for the other members of the

network. Being largest creditors France and Germany swap the places as we move from closed to open network. From here we can conclude that Germany, although being larger creditor than France, has heavier non-European presence. This, clearly, is good for German banks in such turbulent times for Europe. In contrast French banks are more exposed to European risk.

Finally, Eigenvector centrality measures the importance of the country's banks in the system more accurately. It takes into account not only creditor and debtor positions in the network but also the identity of the countries that a given country has ties with. According to this measure French banks play an absolutely central role in the network under discussion. Germany comes second once we discuss an open network. The difference between France and Germany is driven by the differences in their European/non-European credit ratio as well as by the differences in composition of European credit. The most notable difference is France's extreme exposure to troubled Italy.

A broader view at Table 1 allows us to make an additional conclusion regarding the behavior of French and German banking systems. From the table it is apparent that going from closed to open network (which adds American, British and Japanese banking systems to the picture) affects positions of France much more than those of Germany. This implies that German banks keep balance in their activity between European and non-European partners. They diversify their risk more efficiently. While French banks put all their eggs in one basket – Europe, which might not be the best strategy to pursue.

All in all, the present analysis shows that the prize for reckless lending goes rather to French than to German banks. They are central in the network by virtually any measure. In visualization in Figure 1 French credit, directly or indirectly, can reach all countries except Germany and Netherlands, while German credit only extends to four

countries. And, importantly, that list of four does include Italy.

Austerity is not enough

By André Grjebine and [Francesco Saraceno](#)

It is certainly possible to question whether the role acquired by the rating agencies in the international economy is legitimate. But if in the end their message must be taken into account, then this should be done based on what they are really saying and not on the economic orthodoxy attributed to them, sometimes wrongly. This orthodoxy is so prevalent that many commentators are continuing to talk about the decision by Standard & Poor's (S&P) to downgrade the rating of France and other European countries as if this could be attributed to an insufficiently strong austerity policy.

In reality, the rating agency [justifies](#) the downgrade that it has decided with arguments opposed to this orthodoxy. For instance, the agency criticises the agreement between European leaders that emerged from the EU summit on 9 December 2011 and the statements that followed it, making the reproach that the agreement takes into account only one aspect of the crisis, as if it "... stems primarily from fiscal profligacy at the periphery of the euro zone. In our view, however, the financial problems facing the euro zone are as much a consequence of rising external imbalances and divergences in competitiveness between the EMU's core and the so-called 'periphery'. As such, we believe that a reform process based on a pillar of fiscal austerity alone risks becoming self-defeating, as domestic demand falls in line with consumers' rising concerns about job security and disposable incomes,

eroding national tax revenues.”

Based on this, S&P believes that the main risk facing the European states could come from a deterioration in the fiscal positions of certain among them “in the wake of a more recessionary macroeconomic environment.” As a result, S&P does not exclude a further deterioration in the coming year of the rating of euro zone countries.

So if the European countries do indeed take into account the explanations of the rating agency, they should implement economic policies that are capable of both supporting growth and thereby facilitating the repayment of public debts while at the same time rebalancing the current account balances between the euro zone countries. This dual objective could be achieved only by a stimulus in the countries running a surplus, primarily Germany.

Unsustainable debt

The budget adjustments being imposed on the countries of the periphery should also be spread over a period that is long enough for its recessionary effects to be minimised. Such a strategy would accord with the principle that in a group as heterogeneous as the euro zone, the national policies of member countries must be synchronised but certainly not convergent, as is being proposed in some quarters. Such a policy would boost the growth of the zone as a whole, it would make debt sustainable and it would reduce the current account surpluses of some countries and the deficits of others. The least we can say is that the German government is far from this approach.

Didn't Angela Merkel respond to the S&P statement by calling once again for strengthening fiscal discipline in the countries that were downgraded, that is to say, adopting an analysis opposed to that of the rating agency? Given its argumentation, one begins to wonder whether the agency

wouldn't have been better advised to downgrade the country that wants to impose austerity throughout the euro zone rather than wrongly to give it a feeling of being a paragon of virtue by making it one of the few to retain its AAA rating.

Estonia: a new model for the euro zone?

By [Sandrine Levasseur](#)

In the wake of the Swedish and German models, should Europe now adopt the Estonian model? Despite Estonia's *success story*, the answer is no. Here's why.

Estonia has been a source of continuous surprise in recent years. First, it wrong-footed those who, in the autumn of 2008, thought the country had no alternative but to abandon its [currency board](#) and massively devalue its currency. However, Estonia chose a different path, as it strengthened its monetary anchor by adopting the euro on 1st January 2011. The winter of 2008 saw another surprise when the country decided on a significant reduction in civil servant salaries in the hope of creating a "demonstration effect" for the private sector, particularly for businesses exposed to international competition. The government's objective was clearly to help the economy to become more competitive. This strategy, called an "internal devaluation", worked in the sense that the total wage bill actually declined, with wage losses that could reach up to 10% to 15% at the peak of the

crisis. Surprisingly, this decline in wages, which affected every sector of the economy, was relatively well accepted by the population. It was met by only a few strikes and demonstrations, even when the government decided to introduce more flexibility into the labour market (easier redundancy procedures, lifting administrative authorization for the reduction of working time, etc.). Finally, [the ultimate surprise](#) was undoubtedly GDP growth of around 8% in 2011, a fall in the unemployment rate to less than 11%, and a trade deficit of only 2% of GDP (versus 16% before the crisis). Estonia's public debt was contained at 15.5% of GDP, and for 2011 the country even recorded a budget surplus of 0.3% of GDP! This is the stuff of dreams for the other euro zone countries!

Despite all this, the strategy adopted by Estonia cannot be turned into a model for the other euro zone countries. In fact, Estonia's success story is due to a convergence of favourable factors, with two conditions being critical:

1. A strategy of lowering wages makes it possible to become more competitive relative to a country's main partners only if it is conducted in isolation. If in Europe, particularly in the euro zone, every country were to lower its wage bill, the result would simply be sluggish domestic demand, with no positive impact on the countries' exports. To date, among the members of the euro zone, only Estonia and Ireland (two "small" countries) have played the card of lowering wages in the context of the crisis. We can scarcely imagine the impact on the euro zone if Germany or France ("large" countries) had drastically lowered wages at the height of the crisis. In addition to weak demand, this would have inevitably led to a trade war between the countries, which ultimately would not have benefited anyone.

2. A strategy of lowering wages is good for the country that implements it only so long as its major trading partners are on a trajectory of growth. In this regard, the upturn in

Sweden and Finland partly explains Estonia's good export performance. In 2011, GDP increased by 4.1% in Sweden and 3% in Finland (against "only" 1.6% in the euro zone). We might expect that exports from Estonia would have been less dynamic (+33% in 2011!) if the growth rate of its two major trading partners had been lower, since between them Finland and Sweden represent 33% of Estonia's export markets.

But does this mean that a slowdown in activity in [Sweden](#) and [Finland](#) – as can be anticipated for 2012 or 2013 – would negate the efforts made by Estonia's workers in terms of pay concessions? In other words, with respect to the long-term prospects of Estonia's economy, has the reduction in wages been in vain? The answer is no, it hasn't. In Estonia (as well as in the other Baltic states), the decline in wages was in fact necessary to offset the strong wage hikes granted before the crisis, which were largely disconnected from any gains in productivity. The loss of competitiveness of the Estonian economy that resulted could be seen in the winter of 2007, when GDP decelerated significantly and the trade deficit reached an abysmal level. By the spring of 2008, it had become clear that the growth model of Estonia (and of the other Baltic states), based on the equation "consumption + credit + greatly expanded construction", was [unsustainable](#) and that "adjustments" were inevitable in order to reorient the economy towards exports.

A detailed analysis of the adjustments made in the Estonian labour market during the economic crisis (see [here](#)) helps to measure the impact on business competitiveness of the pay cuts, the reduction in working time and the massive layoffs. Overall, the [real effective exchange rate](#) (measured by the unit labour costs of Estonia relative to those of its trading partners) has depreciated by some 23% since 2009. The loss of purchasing power suffered by Estonia's workers is estimated at 9% (in real terms) since 2009, or even at 20% of the gains in purchasing power obtained in 2004-2008. Among the

institutional and societal factors that led Estonians to accept the wage cuts and a more flexible labour market, the absence of strong union representation seems to be an important explanatory factor. For example, in Estonia, fewer than 10% of employees are covered by collective bargaining agreements (against 67% in France). The other key explanatory factor seems to have been the desire to join the euro zone. In these difficult times for the single currency, if this willingness seems surprising, it is nevertheless still [relevant for a certain number of EU countries](#) that have not yet adopted the euro.

“Buy French”: From the slogan to the reality

By [Jean-Luc Gaffard](#), [Sarah Guillou](#), [Lionel Nesta](#)

The current election campaign is lending weight to simplistic proposals like the slogan “buy French”, which evokes the need for France to re-industrialize. And to accomplish this, what could be simpler than to convince the population to buy native products designated with a special label? This is also more politically correct than advocating a straightforward return to protectionism. Employment is expected to benefit, along with the balance of trade. But if we look more closely, not only is it difficult to identify the geographical origin of products, but even if that were possible, any preference that these products might enjoy could well wind up in job losses. This solution for dealing with the need for re-industrialization ultimately reflects a refusal to get to the bottom of the problem.

Can we really define what it means to “buy French”? Does it mean buying the products of French companies? What about buying products made in France by foreign companies instead of buying products made abroad by French companies? These simple questions show that it is not so easy to pin down what is “Made in France”. One major difficulty is that the final goods produced in a country usually incorporate intermediate goods manufactured abroad. It may even happen that the components of a final product are manufactured by a competitor in another country. The iPhone is emblematic of this [fragmentation](#). Should we refrain from purchasing intermediate goods from low-wage countries even though this makes it possible to produce final goods at a lower cost and boost exports by being more competitive on price? Those who think so should no longer be touting German industry as an example, since everyone knows about the growing share of imported inputs in the production of the final goods Germany exports (OECD, *Measuring Globalisation: OECD Economic Globalisation Indicators 2010*, p. 212).

Imagine, nevertheless, domestic consumers who are able to identify products with a high labour content and are ready to make sacrifices out of a spirit of economic patriotism. Don't the polls tell us that over two-thirds of consumers would be willing to pay more for French goods? While there are doubts about whether they would actually do this, it would be risky to ignore the opportunity cost of such a choice. Buying more expensive products simply because they are French reduces purchasing power. Other goods and services would not be purchased or would be bought for less abroad. The balance sheet for employment is far from certain.

Should this exercise in economic patriotism actually materialize, it would be a way that consumers form attachments to certain types of products, in this case based on their place of manufacture, which would in turn reduce the intensity of competition. This could lead the companies concerned to cut

back on their efforts to become more competitive on price and other factors. Why, indeed, should they shell out for expensive and risky investments when have a guaranteed customer base? It's a safe bet that they will not do this much, if at all. The national economy would then be locked in a low technology trap, doomed to slower growth, obviously with damaging consequences for employment in the medium and long term. This would also deprive the economy of the means to innovate and improve the competitiveness of its products.

Finally, it is likely that the willingness to buy French products would benefit products that replace goods made elsewhere in Europe rather than goods made in developing countries, either because the latter are no longer manufactured at all in France or because the price differences with French products would still be prohibitive. Ultimately it would not be possible to avoid further shifts in production to low-wage countries, with the consequent job losses. Furthermore, from a European perspective the non-cooperative character of this kind of measure could lead our European partners to adopt reciprocal measures, which would be detrimental to exports and employment.

The slogan "buy French" masks a refusal to see that the downturn is a global phenomenon which calls for a comprehensive response at the European level, and a refusal to consider a proactive industrial policy that takes into account the realities of supply as well as demand.

This is not just a matter of looking the other way. France is undergoing a deindustrialization process that threatens its capacity for growth. But who can deny that this phenomenon has accelerated with the crisis and that this acceleration is set to increase [as the general austerity measures and restrictions on bank credit further undermine domestic and European demand](#) for consumer durables? Unless we are willing to accept that an entire segment of industry in France and elsewhere in Europe is destroyed, with no hope of ever returning, and with as a

consequence still greater disparities between countries and sharper conflicts of interest, it is clearly urgent to support this kind of demand.

Is this kind of support “the solution”? Of course not: propping up demand will not be enough, as an industrial policy aimed at strengthening the supply side is also needed. The point is not to protect domestic production nor to promote the conquest of foreign markets through competition on taxation or social charges, but to stimulate investments designed to produce new goods and services, which is the only way to create stable jobs. Rather than try to rely on dubious slogans, the goal should be [to consolidate production that has the advantage of being high quality in terms of design, safety and reliability](#), and which corresponds to what French and European consumers genuinely want.

AAA, AA+: much Ado About nothing?

by [Jérôme Creel](#)

The loss of France’s AAA rating on Friday the 13th of January 2012 was a historic event. It poses three questions: should the austerity measures announced in autumn 2011 be strengthened? Why has Germany been singled out? And what is to be done now?

The loss of the AAA rating on French government bonds is not

surprising – far from it. The sovereign debt crisis that has shaken the euro zone for over two years, starting in the autumn of 2009, was not managed properly because it occurred during a recession, at a time when all the EU Member States had their eyes glued to their own economic difficulties. In the absence of a concerted response that included immediate solidarity and mutual guarantees by the euro zone Member States of the zone's entire public debt, with the support of the European Central Bank (cf. Catherine Mathieu and Henri Sterdyniak, [here](#)), the foreseeable contagion occurred. The objective public finance mistakes committed by successive Greek governments followed by the vagaries of the Irish banks have now led to a systemic crisis in Europe.

By implementing austerity measures simultaneously, Europe's governments have magnified the economic difficulties: economic stagnation and even recession are now on the agenda for the euro zone (cf. Xavier Timbeau *et al.*, [here](#)). A downgrade of debt ratings in the euro zone was thus to be expected. It does, however, raise three questions.

1. Should the austerity measures be strengthened? In a commentary on the supplementary 7 billion euro French austerity plan announced in November 2011, Mathieu Plane (see in French [here](#)) pointed out that the race for the AAA rating had already been lost. The impact of this austerity plan on economic growth was objectively inconsistent with the fiscal consolidation target – and Standard & Poor's was surely not unaware of this argument.
2. Why did S&P single out Germany and Slovakia, the only economies in the euro zone not downgraded on Friday 13 January? While their commercial links are undeniable (cf. Sandrine Levasseur, 2010, [here](#)), which could justify their comparable treatment, the main markets for both of these economies, and particularly Germany, lie in the euro zone. Slowing growth in the euro zone

outside Germany will not leave the other side of the Rhine unaffected (cf. Sabine Le Bayon, in French [here](#)). It is difficult to see how the contagion of the crisis could stop at the borders of Germany and Slovakia. The recent take-up of German government 6-month bonds at a negative interest rate could even be interpreted to reflect extreme distrust of Germany's commercial banks. In any case, its economy, situated in the euro zone, is no less fragile than that of France.

3. What should be done now in France? The loss of the AAA rating reflects a negative outlook both for the state of public finances and for economic growth. While Germany has not been downgraded, it is possible that this is because S&P takes a positive view of its non-cooperative strategy in the past. From this perspective, the principle of a social VAT measure can be considered a way to help France catch up with Germany in terms of competitiveness, as Jacques Le Cacheux points out ([here](#)): if the Germans did it, why can't we? This would help boost tax revenue by increasing the competitive advantage of businesses established in France. If such a measure were to be adopted, Germany and France would be on equal footing. The two countries could then sensibly consider a cooperative policy for a recovery in Europe. Some possible focuses include: industrial policy (cf. Sarah Guillou and Lionel Nesta, in French [here](#)); social policy; an ambitious climate and energy policy (cf. Eloi Laurent, [here](#)); and a financial policy that includes a common tax on financial transactions, with the revenue raised being used to ensure that the taxpayer would never again need to bail out the private banks, which would free up additional maneuvering room for the first three policies. The policy outlines would of course need to be defined, but it is crucial to recognize that policy action is urgently needed.

Post-Durban: For a Sino-European axis

By [Eloi Laurent](#)

The European Union absolutely must stay the course at the Durban conference and afterwards, not only by reaffirming its climate goals but even more by consolidating these through the improved control of its carbon linkages (see the OFCE note in French: [The European Union in Durban: Hold the course](#)), that is to say, the overall impact of its economic growth. This requires moving – on its own if necessary – from a target for 2020 of a 20% reduction in its greenhouse gas emissions to a target of 30% of its emissions, which is more in synch with the goal that it has endorsed of limiting global warming to 2°C compared to the pre-industrial era.

The possibility of transitioning the global economy towards a low-carbon economy depends on Europe's determination. As the largest market in the world, the EU possesses great power over the environmental policies of the world's other countries: the more ambitious it is in terms of the climate, the more its influence and leadership will spur the ambitions of other countries too.

But the pursuit of the de-carbonization of the European economy requires the reform and coherent articulation of EU and national economic policy tools.

For France, this means achieving its climate targets (the division of its emissions by four by 2050, called the “factor 4” approach) by introducing a price signal to contain emissions from diffuse greenhouse gas emissions (*i.e.* from housing and transport) that are not included in the European

carbon market. To be clear, it will be necessary to introduce a carbon tax that spells out how it will be integrated into the French tax system. [A recent study by the OFCE](#) shows that this may well generate a dual dividend, both social and environmental. The [Perthuis report](#) is quite clear on this point: with the support of a price signal, the French climate transition will generate jobs. This transition should not, however, neglect issues of social justice, starting with the urgent problem of fuel poverty.

The European Union must also speed up the reform of its carbon markets, whose price signal is now almost inoperative (a tonne of CO₂ has fallen to 7 euros). These markets could be significantly affected by the outcome of the Durban conference, as was the case after the summit in Copenhagen. Various options exist, such as to establish a Europe-wide central carbon bank.

Finally, the introduction of a carbon tariff at the borders of the European Union could restore coherence to the region's climate policy by addressing the problem of carbon leakage and imported emissions and by providing a source of funding for the Green Fund, whose architecture might be the only genuine accomplishment of Durban.

There are, ultimately, three fundamental reasons why the EU needs to confirm and reinforce its climate goals at Durban and especially "post-Durban":

1. The first concerns the human security of Europeans: the EU needs to reduce its emissions of greenhouse gases because, as is shown by a recent report by the IPCC, these are at the origin of the proliferation of extreme weather events on our planet, and this will be even more the case in the future. The European Union has experienced nearly 350 of these events during the

Noughties alone, almost four times more than in the 1980s. The heat wave of summer 2003, alone, cost the lives of 70,000 Europeans.

2. The second reason relates to the economic prosperity of Europeans. The EU needs to strengthen its comparative environmental advantage and free itself as soon as possible from the fossil fuel trap. Europe's dependence on carbon has only increased over the past two decades. The rate of energy dependence of the EU member countries rose by an average of about 10 percentage points over the last fifteen years, to 53% in 2007, including 82% for oil and 60% for natural gas, which between them account for 60% of all energy consumed in the EU. Conversely, the short-term economic cost (not including the longer-term benefits) of switching from a 20% target for the reduction of emissions to a 30% reduction by 2020 is minimal, on the order of about 0.6% of the EU's GDP per year (estimated by the European Commission).
3. The third reason, and perhaps the most fundamental, concerns the need today for the political cohesion of the European Union. What is necessary now is nothing less than rebuilding the European Union, which has been devastated economically and politically by the global crisis. The prospect of the coordinated economic depression currently being proposed to European citizens by their governments will signal the breakup of the euro zone but also in turn, it can be feared, a halt to the construction of Europe and even its unraveling. The ecological transition may indeed "save the climate", but it can also save Europe by giving it a future once again.

The best hope for what is already being called "post-Durban" may well lie in the establishment of a Sino-European axis on the climate: China is becoming aware that its impact on climate change is matched only by the impact of climate change on it (the world's largest emitter, it will in turn be the

first victim of its emissions). As a result of the desertion by the US, Europe can confirm its role as global leader on the climate.

Europe's leaders sometimes seem annoyed to be alone among the developed countries to assume this responsibility, and they are tired of suffering the criticisms reserved for the one who wields the baton, even though the EU is the only region in the world to have met its Kyoto commitment, the only one to have set itself interim targets on the reduction of greenhouse gas (GHG) emissions, and the only one capable of meeting these goals. This European annoyance is misplaced: given the disasters that science is warning us of, the fight against climate change could be Europe's greatest contribution to the future of humanity. Holding the course on the climate is a compelling duty. It also just happens to be in Europe's interest.

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.

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.

[\[1\]](#) 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](#)".