

# Does Price Stability entail Financial Stability?

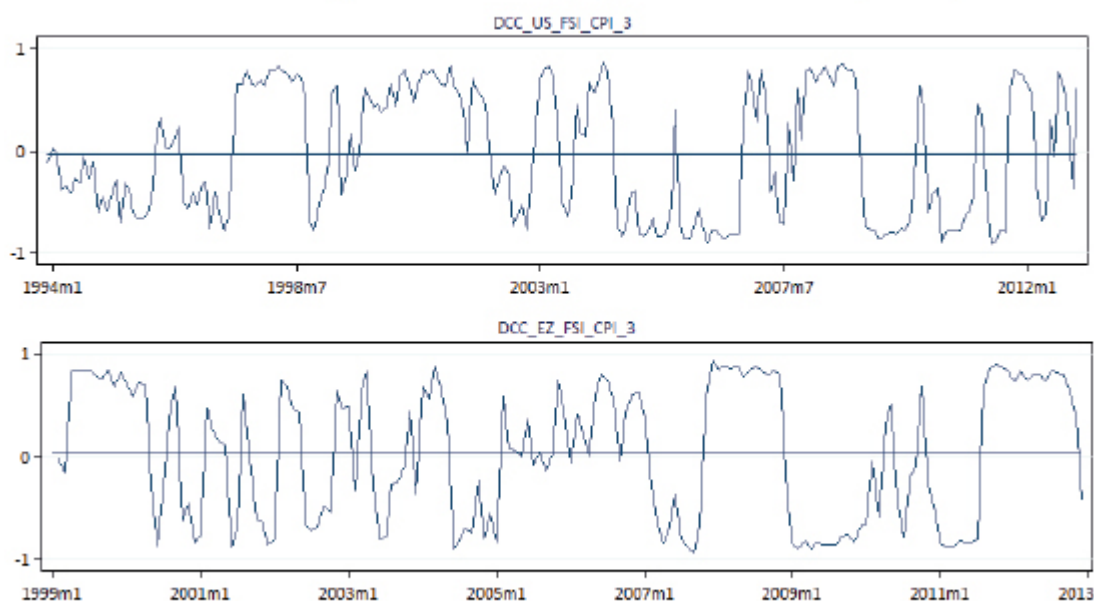
by [Paul Hubert](#) and [Francesco Saraceno](#) (@fsaraceno)

[Paul Krugman](#) raises the very important issue of the impact of monetary policy on financial stability. He starts with the well-known observation that, contrary to the predictions of some, expansionary monetary policy did not lead to inflation during the current crisis. He then continues arguing that tighter monetary policy would not necessarily guarantee financial stability either. If the Fed were to revert to a more standard Taylor rule, financial stability would not follow. As Krugman aptly argues, *“That rule was devised to produce stable inflation; it would be a miracle, a benefaction from the gods, if that rule just happened to also be exactly what we need to avoid bubbles.”*

Krugman in fact takes position against the “conventional wisdom”, which has been widespread in academic and policy circles alike, that a link exists between financial and price stability; therefore the central bank can always keep in check financial instability by setting an appropriate inflation target.

The global financial crisis is a clear example of the fallacy of this conventional wisdom, as financial instability built up in a period of great moderation. A [recent analysis](#) by Christophe Blot, Jérôme Creel, Paul Hubert, Fabien Labondance and Francesco Saraceno shows that the crisis is no exception, as over the past few decades, in the US and the Eurozone, the link between price and financial stability has been unclear and moreover unstable over time, as shown on the following figure.

**Figure. Coefficient of correlation between consumer price index and financial stability index for the US (top) and the Euro area (bottom)**



Source: Authors' computations. For more details on data and methodology, please refer to: <https://ideas.repec.org/a/eee/finsta/v16y2015icp71-88.html>

We therefore subscribe to Krugman's view that financial stability should be targeted by combining macro- and micro-prudential policies, and that inflation targeting is largely insufficient. In another [work](#), Christophe Blot, Jérôme Creel, Paul Hubert and Fabien Labondance argue that the ECB should be endowed with a triple mandate for financial and macroeconomic stability, along with price stability. They further argue that the ECB should be given the instruments to effectively pursue these three, sometimes conflicting objectives.

---

## The ECB's quantitative easing exercise: you're never too young to start

By [Christophe Blot](#), [Jérôme Creel](#), [Paul Hubert](#) and Fabien Labondance

The ECB decision to launch a quantitative easing (QE) programme was widely anticipated. Indeed, on several occasions in the second half of 2014 Mario Draghi had reiterated that the Governing Council was unanimous in its commitment to take the steps needed, in accordance with its mandate, to fight against the risk of a prolonged slowdown in inflation. Both the scale and the characteristics of the ECB plan announced on 22 January 2014 sent a strong, though perhaps belated signal of the Bank's commitment to fight the risk of deflation, which has been spreading in the euro zone, as can be seen in particular in inflation expectations over a two-year horizon (Figure 1). In a [special study entitled, "Que peut-on attendre du l'assouplissement quantitatif de la BCE?"](#) ["What can we expect from the ECB's quantitative easing?"], we clarify the implications of this new strategy by explaining the mechanisms for the transmission of quantitative easing, drawing on the numerous empirical studies on previous such programmes in the US, the UK and Japan.

Figure. Inflation expectations in the euro



Source : ECB (Survey of Professional Forecasters).

The terms of the quantitative easing decided by the ECB are indeed similar to those adopted by other central banks,

especially by the US Federal Reserve and the Bank of England, which make comparisons legitimate. It appears from the American, British and Japanese experience that the measures implemented have led to a decline in sovereign interest rates and more generally to an improvement in the financial conditions of the overall economy[1]. This has been the result of sending a signal about the present and future stance of monetary policy and a reallocation of investors' portfolios. Some studies [2] also show that the US QE caused a depreciation of the dollar. The transmission of QE from the ECB to this variable could be critical in the case of the euro zone. An analysis using VAR models shows that the monetary policy measures taken by the ECB will have a significant impact on the euro but also on inflation and inflationary expectations. It is likely that the effects of the depreciation of the euro on European economic activity will be positive (cf. [Bruno Ducoudré and Eric Heyer](#)), which would make it easier for Mario Draghi to bring inflation back on target. The measure would therefore have the positive effects expected; however, it might be regrettable that it was not implemented earlier, when the euro zone was mired in recession. Inflation in the euro zone has fallen constantly since late 2011, reflecting a gathering deflationary risk month after month. In fact, the implementation of QE from March 2015 will consolidate and strengthen a recovery that would undoubtedly have occurred anyway. Better late than never!

---

[1] The final impact on the real economy is, however, less certain, in particular because the demand for credit has remained stagnant.

[2] Gagnon, J., Raskin, M., Remache, J. and Sack, B. (2011). "The financial market effects of the Federal Reserve's large-scale asset purchases," *International Journal of Central Banking*, vol. 7(10), pp. 3-43.

---

## Is the ECB impotent?

[Christophe Blot](#), [Jérôme Creel](#), [Paul Hubert](#) and [Fabien Labondance](#)

In June 2014, the ECB announced a set of new measures (a detailed description of which is provided in a special study entitled, "[How can the fragmentation of the euro zone banking system be fought?](#)", *Revue de l'OFCE*, No. 136, in French) in order to halt the lowering of inflation and sustain growth. Mario Draghi then clarified the objectives of the ECB's monetary policy by indicating that the Bank wanted to expand its balance sheet by a trillion euros to return to a level close to that seen in the summer of 2012. Among the measures taken, much was expected from the new targeted long-term refinancing operation (TLTRO), which gives banks in the euro zone access to ECB refinancing with a maturity of 4 years in return for providing credit to the private sector (excluding mortgages). However, after the first two allocations (24 September 2014 and 11 December 2014), the picture has become rather complicated, with the amounts allocated well below expectations. This reflects the difficulty the ECB is having in fighting effectively against the risk of deflation.

Indeed, having allotted 82.6 billion euros in September (versus anticipations of between 130 and 150 billion), the ECB granted "only" 130 billion on December 11, *i.e.* once again a

lower amount than had been anticipated. So we are a long way from the maximum amount of 400 billion euros that had been evoked by Mario Draghi in June 2014 for these two operations. Moreover, these first two allotments were clearly insufficient to boost the ECB's balance sheet significantly (Figure 1), and all the more so as banks are continuing to reimburse the three-year loans that they received in late 2011 and early 2012 in the very long-term refinancing operation (VLTRO) [\[1\]](#). What explains the banks' reluctance to make use of this operation, even though it allows them to refinance the loans granted at a very low rate for a 4 year term?

The first is that the banks already have very broad and very advantageous access to ECB liquidity through the monetary policy operations already implemented by the ECB [\[2\]](#). These operations actually offer a lower interest rate than does the TLTRO (0.05% against 0.15%). Similarly, a TLTRO is not more attractive than some long-term market financing, especially since many banks do not have financing constraints. TLTRO is thus of marginal interest, due to the maturity of the operation, and more restrictive because it is conditioned on the distribution of credit. For the first two operations conducted in September and December 2014, the allotment could not exceed 7% of outstanding loans to the non-financial private sector in the euro zone, excluding loans for housing, as of 30 April 2014. A new series of TLTRO will be conducted between March 2015 and June 2016, on a quarterly basis. This time the maximum amount that can be allocated to the banks will depend on the growth in outstanding loans to the non-financial private sector in the euro zone, excluding loans for housing, between 30 April 2014 and the date of the operation in question.

The second explanation is that the weakness of credit in the euro zone is not simply the result of supply factors but also demand factors. Sluggish activity and private agents' efforts to shed debt are holding back lending.

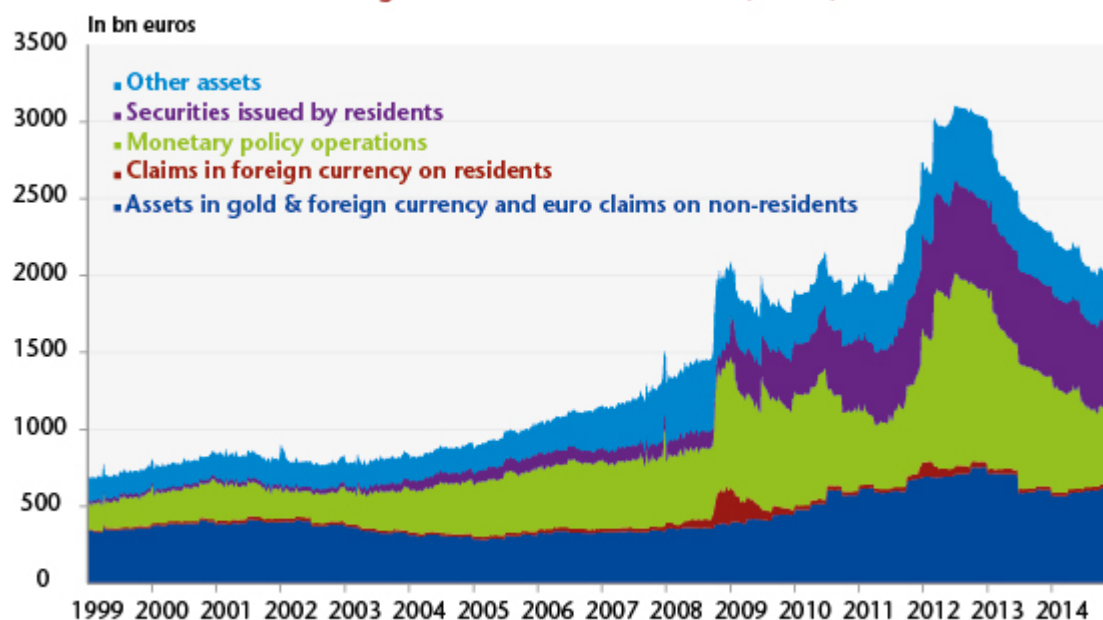
Third, beyond banks' ability to find refinancing, it is also possible that they are trying to reduce their exposure to risk. The problem is thus related to their assets. However, non-performing loans are still at a very high level, especially in Spain and Italy (Figure 2). In addition, although the Asset Quality Review (AQR) conducted by the ECB has revealed that insolvency risks are limited in the euro zone, the report also points out that some banks are highly leveraged and that they have mainly used the available liquidity to buy government bonds in order to meet their capital requirements. They are then reducing their balance sheet risk by limiting loans to the private sector.

Finally, two uncertainties are also reducing the banks' participation in the TLTRO. The first concerns the stigma attached to the conditionality of the TLTRO and to the fact that banks that do not meet their commitments on the distribution of credit will be required to repay the financing obtained from the ECB after two years. So banks facing uncertainty about their ability to increase their lending may very well wish to avoid the prospect of having to repay the funds sooner. The second factor concerns uncertainties about the programs for purchasing ABS and covered bonds[3]. The banks could also turn to these programs to get cash in exchange for the sale of assets that they would like to get rid of.

Has monetary policy become totally ineffective? The answer is certainly no, since by giving banks a guarantee that they can refinance their activity through various programs (TLTRO, ABS, covered bonds, etc.), the ECB is reducing the risk that credit will be rationed due to the deteriorated state of some banks' liabilities. Monetary policy is thus helping to free up the credit channel. But its effects are nevertheless limited, as is suggested by [Bech, Gambacorta and Kharroubi \(2012\)](#) , who show that monetary policy is less effective in periods of recovery following a financial crisis. Can we get out of this

impasse? This observation on the effectiveness of monetary policy shows that the ECB should not be viewed as the be-all and end-all. It is still essential to complement its support for activity through an expansionary fiscal policy across the euro zone. This point was also reiterated by the President of the ECB during this summer's [conference at Jackson Hole](#): "Demand side policies are not only justified by the significant cyclical component in unemployment. They are also relevant because, given prevailing uncertainty, they help insure against the risk that a weak economy is contributing to hysteresis effects."

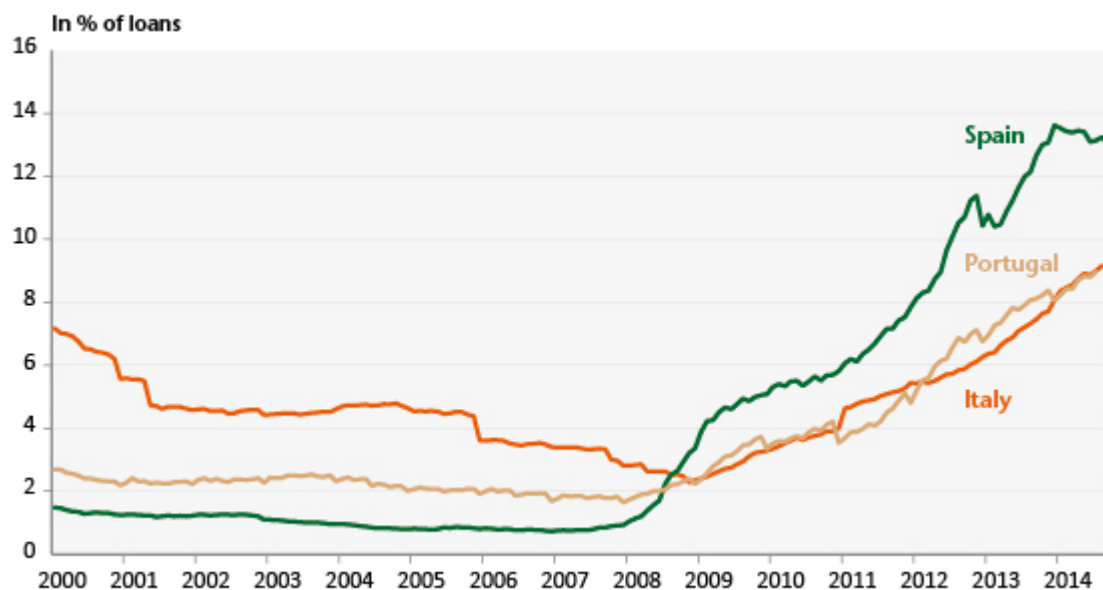
**Figure 1. ECB balance sheet (assets)**



Source: ECB.



Figure 2. Bad debt



Source: National central banks.

---

[1] See the special study in the *Revue de l'OFCE* no. 136, "[Comment lutter contre la fragmentation du système bancaire de la zone euro?](#)" for an examination of the various monetary policy measures taken by the ECB since the onset of the financial crisis and an estimate of their impact on the real economy.

[2] This includes standard monetary policy operations as well as the VLTRO operation through which the ECB provided liquidity for an exceptional term of 3 years in December 2011 and February 2012.

[3] This involves programs for the purchase of securities in the market and not cash distributed directly to the banks. The covered bonds and ABS are securities pledged on assets whose remuneration depends on that of the underlying asset, which is by necessity a mortgage in the case of covered bonds and which

in the case of ABS may include other types of loans (credit cards, cash loans to businesses, etc.).

---

# Dealing with the ECB's triple mandate

By [Christophe Blot](#), [Jérôme Creel](#), [Paul Hubert](#) and [Fabien Labondance](#)

The financial crisis has sparked debate about the role of the central banks and monetary policy before, during and after the economic crisis. The prevailing consensus on the role of the central banks is eroding. Having price stability as the sole objective is giving way to the conception of a triple mandate that includes inflation, growth and financial stability. This is *de facto* the orientation that is being set for the ECB. We delve into this situation in one of the [articles](#) of the OFCE issue entitled *Reforming Europe* [\[1\]](#), in which we discuss the implementation of these three objectives.

The exclusive pursuit of the goal of price stability is now insufficient to ensure macroeconomic and financial stability. [\[2\]](#) A new paradigm is emerging in which the central banks need to simultaneously ensure price stability, growth and financial stability. This has been the orientation of recent institutional changes in the ECB, including its new responsibility for micro-prudential supervision. [\[3\]](#) Furthermore, the conduct of the euro zone's monetary policy shows that the ECB has also remained attentive to trends in growth [\[4\]](#). But if the ECB is indeed pursuing a triple mandate, what then is the proper relationship between these missions?

The crucial need for coordination between the different actors in charge of monetary policy, financial regulation and fiscal policy is lacking in the current architecture. Furthermore, certain practices need to be clarified. The ECB has played the role of lender of last resort (with banks and to a lesser extent States) even though it has not specifically been assigned this role. Finally, in a new framework in which the ECB plays a greater role in determining the euro zone's macroeconomic and financial balance, we believe it is necessary to strengthen the democratic accountability of the Bank. The definition of its objectives in the Maastricht Treaty in fact gives it strong autonomy in interpretation (see in particular the discussion by Christophe Blot, [here](#)). Moreover, while the ECB regularly reports on its work to the European Parliament, the latter does not have any way to direct this [\[5\]](#).

Based on these observations, we discuss several proposals for coordinating the ECB's three objectives more effectively henceforth:

1 – Even without modifying the treaties in force, it is important that the heads of the ECB be more explicit about the different objectives being pursued [\[6\]](#). The declared priority of price stability no longer corresponds to the practice of monetary policy: growth seems to be an essential objective, as is financial stability. More transparency would make monetary policy more credible and certainly more effective in preventing another financial and banking crisis in particular. The use of exchange rate policy [\[7\]](#) should not be overlooked, as it can play a role in reducing macroeconomic imbalances within the euro zone.

2 – In the absence of such clarification, the ECB's extensive independence needs to be challenged so that it comes up to international standards in this area. Central banks rarely have independence in deciding their objectives: for example, the US Federal Reserve pursues an explicit dual mandate, while

the Bank of England's actions target institutionalized inflation. An explicit triple mandate could be imposed on the ECB by the governments, with the heads of the ECB then needing to make effective tradeoffs between these objectives.

3 – The increase in the number of objectives pursued has made it more difficult to deal with tradeoffs between them. This is particularly so given that the ECB has *de facto* embarked on a policy of managing the public debt, which now exposes it to the problem of the sustainability of Europe's public finances. The ECB's mandate should therefore explicitly spell out its role as lender of last resort, a normal task of central banks, which would clarify the need for closer coordination between governments and the ECB.

4 – Rather than calling the ECB's independence completely into question, which would never win unanimity among the Member States, we call for the creation *ex nihilo* of a body to supervise the ECB. This could emanate from the European Parliament, which is responsible for discussing and analyzing the relevance of the monetary policy established with respect to the ECB's expanded objectives: price stability, growth, financial stability and the sustainability of the public finances. The ECB would then not only be invited to report on its policy – as it is already doing to Parliament and through public debate – but it could also see its objectives occasionally redefined. This “supervisory body” could for example propose quantified inflation targets or unemployment targets.

---

[1] *Reforming Europe*, edited by Christophe Blot, Olivier Rozenberg, Francesco Saraceno and Imola Strehö, *Revue de l'OFCE*, no. 134, May 2014. This issue is available in [French](#) and [English](#) and has been the subject of a post on the [OFCE blog](#).

[2] This link is examined in [“Assessing the Link between Price and Financial Stability”](#) (2014), Christophe Blot, Jérôme Creel, Paul Hubert, Fabien Labondance and Francesco Saraceno, *Document de travail de l’OFCE*, 2014-2.

[3] The implementation of the banking union gives the ECB a role in financial regulation (Decision of the Council of the European Union of 15 October 2013). It is henceforth in charge of banking supervision (particularly credit institutions considered “significant”) in the Single supervisory mechanism (SSM). As of autumn 2014, the ECB will be responsible for micro-prudential policy, in close cooperation with national organizations and institutions. See the article by Jean-Paul Pollin, “Beyond the banking union”, in *Revue de l’OFCE, Reforming Europe* .

[4] Castro (2011), [“Can central banks’ monetary policy be described by a linear \(augmented\) Taylor rule or by a nonlinear rule?”](#), *Journal of Financial Stability* vol.7(4), p. 228-246. This paper uses an estimation of Taylor rules between 1991:1 and 2007:12 to show that the ECB reacted significantly to inflation and to the output gap.

[5] In the United States, the mandate of the Federal Reserve is set by Congress, which then has a right of supervision and can therefore amend the Fed’s articles and mandate.

[6] Beyond clarifying objectives in terms of inflation and growth, the central bank’s fundamental objective is to ensure confidence in the currency.

[7] This issue is considered in part in a recent OFCE [post](#).

---

# What do we know about the end of monetary unions?

By [Christophe Blot](#) and [Francesco Saraceno](#)

The European elections were marked by low turnouts and increasing support for Eurosceptic parties. These two elements reflect a wave of mistrust vis-à-vis European institutions, which can also be seen in confidence surveys and in the increasingly loud debate about a return to national currencies. The controversy over a country leaving the euro zone or even the breakup of the monetary union itself started with the Greek crisis in 2010. It then grew more strident as the euro zone sank into crisis. The issue of leaving the euro is no longer taboo. If the creation of the euro was unprecedented in monetary history, its collapse would be none the less so. Indeed, an analysis of historical precedents in this field shows that they cannot serve as a point of comparison for the euro zone.

Although there seem to be a number of cases where monetary unions split apart, few are comparable to the European Monetary Union. Between 1865 and 1927, the Latin Monetary Union laid the foundations for closer monetary cooperation among its member states. This monetary arrangement involved a gold standard regime that established a principle of monetary uniformity with a guarantee that the currencies set up by each member state could move freely within the area. Given the absence of a single currency created *ex nihilo* as is the case today with the euro, the dissolution of the Union that occurred in 1927 holds little interest for the current debate. In fact, experts in monetary unions instead characterise this type of experience as “areas of common standards”. A study in 2007 by Andrew Rose (see [here](#)) assesses 69 cases of exits from a currency union since the Second World War, which would indicate that there is nothing unique about the break-up of

the euro zone. However, this sample of countries that have left a currency union cannot really be used to draw meaningful lessons. A large number of these cases involve countries that gained their political independence in the process of decolonization. These were also small developing economies whose macroeconomic and financial situations are very different from those of France or Greece in 2014. The most recent experience was the break-up of the rouble zone, following the collapse of the USSR, and of Yugoslavia, both of which involved economies that were not very open commercially or financially to the rest of the world. In these circumstances, the impact on a country's competitiveness or financial stability of a return to the national currency and any subsequent exchange rate adjustments are not commensurate with what would happen in the case of a return to the franc, the peseta or the lira. The relatively untroubled separation of the Czech Republic and Slovakia in 1993 also involved economies that were not very open. Finally, the experience most like that of the EMU undoubtedly involves the Austro-Hungarian Union, which lasted from 1867 to 1918. It had a common central bank in charge of monetary control but no fiscal union [\[1\]](#), with each State enjoying full budgetary prerogatives except with regard to expenditure on defence and foreign policy. It should be added that this Union as such could not go into debt, as the common budget had to be balanced. While the Union established trade and financial relations with many other countries, it is important to note that its break-up occurred in the very specific context of the First World War. It was thus on the ruins of the Austro-Hungarian Empire that new nations and new currencies were formed.

It must therefore be concluded that monetary history does not tell us much about what happens at the end of a monetary union. Given this, attempts to evaluate a scenario involving an exit from the euro are subject to a level of uncertainty that we would call "radical". While it might be possible to

identify certain positive or negative results of exiting the euro, going beyond this to give specific calculations of the costs and benefits of a break-up comes closer to writing fiction than to robust scientific analysis. As for the positive side, it can always be argued that the effects on competitiveness of a devaluation can be quantified. [Eric Heyer and Bruno Ducoudré](#) have performed such an exercise for a possible fall in the euro. But who can say how much the franc would depreciate in the case of an exit from the euro zone? How would other countries react if France left the euro zone? Would Spain leave too? In which case, how much would the peseta fall in value? The number of these variables and their potential interactions lead to such a multiplicity of scenarios that no economist can foresee the result in good faith, let alone calculate it. The exchange rates between the new European currencies would once again be determined by the markets. This could result in a panic comparable to the currency crisis experienced by the countries in the European Monetary System (EMS) in 1992.

And what about the debt of the private and public agents of the country (or countries) pulling out? The legal experts are divided about what share would be converted by force of law into the new currency (or currencies) and what would remain denominated in euros, which would add to agents' debt burden. So it is likely that an exit would be followed by a proliferation of litigation, with unpredictable outcomes. After the Mexican crisis in 1994, and again during the Asian crisis in 1998, both of which were followed by devaluations, there was an increase in agents' debt, including government debt. Devaluation could therefore increase the problems facing the public finances while also creating difficulties for the banking system, as a significant share of the debt of private agents is held abroad (see [Anne-Laure Delatte](#)). The risk of numerous private defaults could therefore be added to the risk of default on the public debt. How would one measure the magnitude of such impacts? Or the increase in the default



rate? What about the risk that all or part of the banking system might collapse? How would depositors respond to a bank panic? What if they seek to prop up the value of their assets by keeping deposits in euros and opening accounts in countries that they consider safer? A wave of runs on deposits would follow, threatening the very stability of the banking system. It might be argued that, upon regaining autonomy for our monetary policy, the central bank would implement an ultra-expansionary policy, the State would gain some financial leeway, put an end to austerity and protect the banking system and French industry, and capital controls would be re-established in order to avoid a bank run ... But once again, predicting how such a complex process would unfold amounts to astrology ... And if the example of Argentina [\[2\]](#) in late 2001 is cited to argue that it is possible to recover from a currency crisis, the context in which the end of the “currency board” took place there should not be forgotten[\[3\]](#): a deep financial, social and political crisis that does not really have a point of comparison, except perhaps Greece.

In these circumstances, we believe that attempting to assess the cost and benefits of leaving the euro leads to a sterile debate. The only question worth asking concerns the political and economic European project. The creation of the euro was a political choice – as would be its end. We must break with a sclerotic vision of a European debate that opposes proponents of leaving the euro to those who endlessly tout the success of European integration. There are many avenues open for reform, as has been demonstrated by some recent initiatives ([Manifesto for a euro political union](#)) as well as by the contributions collected in issue 134 of the *Revue de l'OFCE* entitled [“Réformer l'Europe”](#). It is urgent that all European institutions (the new European Commission, the European Council, the European Parliament, but also the Eurogroup) take up these questions and rekindle the debate about the European project.

---

[1] For a more detailed analysis of comparisons that can be drawn between the European Monetary Union and Austro-Hungary, see Christophe Blot and Fabien Labondance (2013): “Réformer la zone euro: un retour d’expériences”, *Revue du Marché Commun et de l’Union européenne*, no. 566.

[2] Note that Argentina was not in a monetary union but rather under what was called a “currency board”. [See here](#) for a classification and description of various exchange rate regimes.

[3] See Jérôme Sgard (2002): “L’Argentine un an après: de la crise monétaire à la crise financière”, *Lettre du Cepii*, no. 218.

---

## What is a weaker euro likely to mean for the French economy?

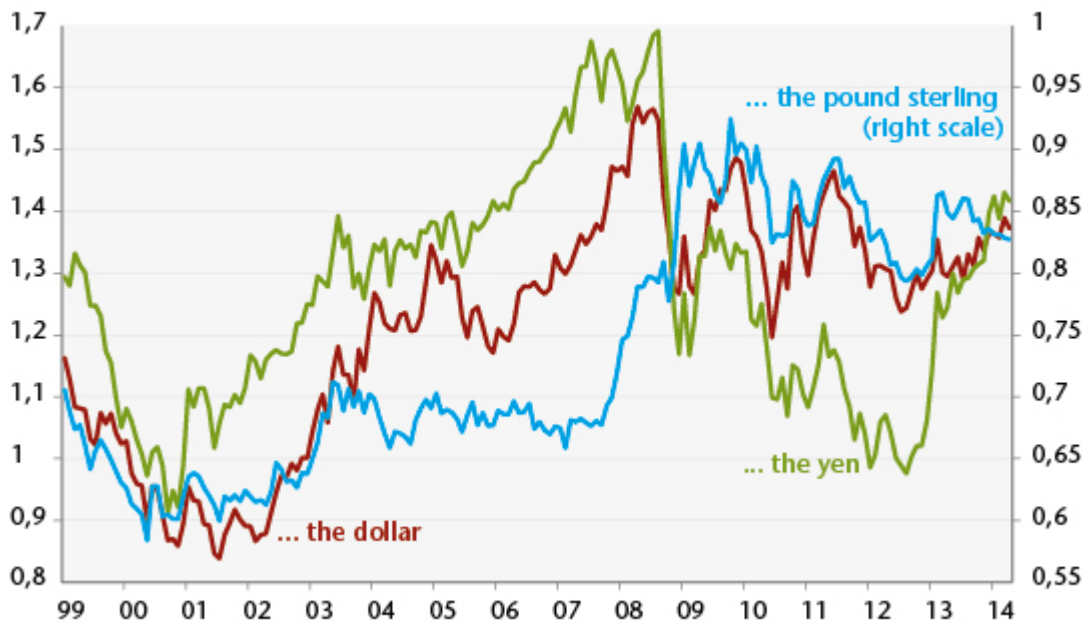
By [Bruno Ducoudré](#) and [Eric Heyer](#)

Faced with the rising risk of deflation in the euro zone, which has been reinforced since mid-2012 by the continued appreciation of the euro against other currencies, the heads of the European Central Bank have begun to change their tone in their communications with the financial markets: [they are now evoking the possibility of conducting a new round of quantitative easing](#). These measures are likely to lower the exchange rate of the euro. This would provide valuable support

for the euro zone economies by shoring up their price competitiveness vis-à-vis competitors outside the zone, in a context where fiscal consolidation policies will continue to dampen [the growth expected in the zone in 2014 and 2015](#). What are the likely consequences for the French economy from reducing the euro's value against other currencies? We briefly review past episodes of exchange rate changes, and then present the impact expected from a 10% depreciation of the euro against other currencies using the *emod.fr* model. These effects are more moderate than those projected by the government.

Quantitative easing measures have been used extensively by the US Federal Reserve, the Bank of England and the Bank of Japan. Since mid-2012, the balance sheets of these three banks has continually increased, by respectively 6.5 percentage points of GDP, 1.3 GDP points and 15.3 GDP points. [During this same period, the ECB balance has on the contrary declined by 8.4 GDP points](#). This difference in strategy has led to a continued rise in the strength of the euro: now at 1.38 dollars, the euro has seen its value against the dollar increase by 12% since June 2012. During the same period, the single currency has appreciated 49% against the yen and about 3% against the pound sterling (Figure 1).

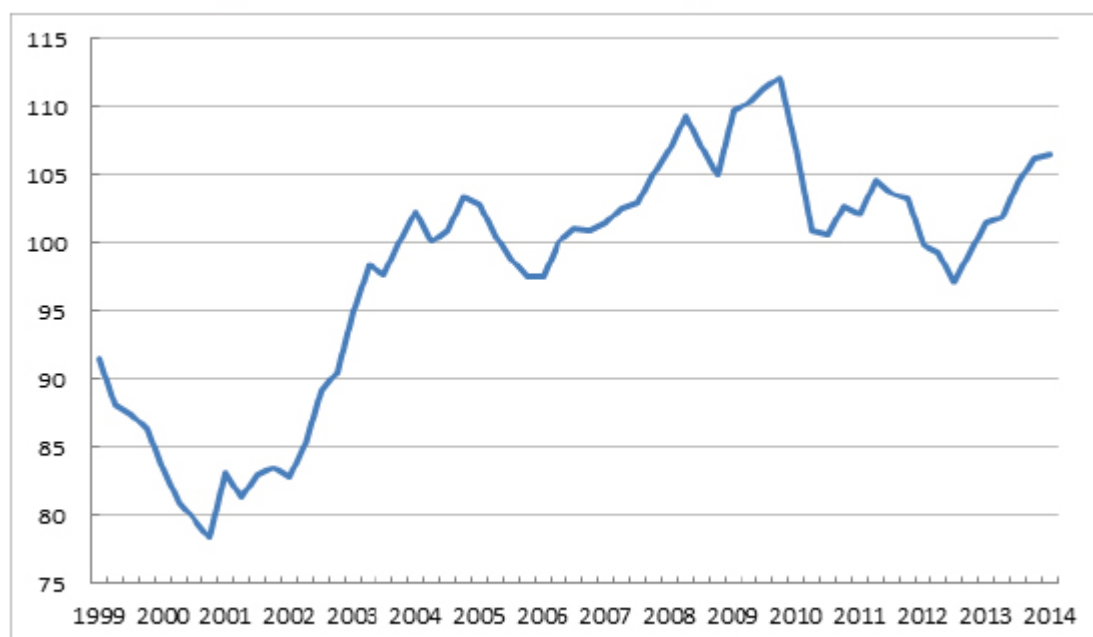
Figure 1. Exchange rate of the euro against...



Source : Datastream.

The nominal effective exchange rate of the euro, which weights the different exchange rates depending on the structure of trade in the euro zone, has thus appreciated by 9.5% since the third quarter of 2012 (Figure 2). This appreciation, combined with austerity policies and the competitive disinflation carried out within the euro zone, has held down GDP growth in the zone, which was negative in 2012 and 2013, as well as inflation. The absence of inflationary pressures and the past appreciation of the euro have now given the ECB leeway to try to influence the course of the euro against other currencies.

**Figure 2. Nominal effective exchange rate of the euro**



Source : OECD.

### **What would be the impact of a devaluation of the euro against all currencies?**

The depreciation of the euro would have a dual effect:

- **An income effect:** a weak euro would increase the prices of imports. This would result in higher energy costs, a rise in companies' prices of production and a loss of household purchasing power;
- **A substitution effect:** a weak euro would decrease the prices of exports and increase their volume. Depreciation would also decrease the competitiveness of rival manufacturers, causing a decline in imports in favour of domestic production.

These opposite effects would apply only to trade outside the euro zone. Trade with our European partners would not be directly impacted, as the prices of imports and exports to and from this area would remain unchanged. On the other hand, intra euro zone trade would be impacted by a weaker euro. But this involves the channel of addressed demand.

**Table 1. Impact on the French economy of a 10% depreciation in the exchange rate of the euro against all currencies combined**

(Difference with the reference scenario in %)	n	n+1	n+2	n+8
GDP	0,3	0,4	0,5	0,0
Total waged employment (1000s)	22	53	74	34
Household consumer prices	0,9	1,4	1,9	3,9
Public financing capacity (% of GDP)	0,0	0,2	0,3	0,2

Note: The euro's depreciation would be favourable to short-term activity due to an improvement in France's price competitiveness relative to countries outside the euro zone. The positive impact of the euro's depreciation on the activity of our euro zone partners and the negative impact on our partners outside the zone are taken into account.

Source : *emod.fr*

As is summarized in Table 1, a 10% depreciation of the euro against all currencies leads to a gain in price competitiveness for French exports vis-à-vis the rest of the world. Other countries in the euro zone would benefit from the same gain in competitiveness across all export markets. In this case, the impact on activity would amount to 0.3% in the first year, 0.5% after three years, and none after nine years. The increase in demand due to this improvement in the activity of our European partners would be broadly offset by a reduction in demand addressed to France from the rest of the world. As for the labour market, this depreciation would create 22,000 jobs in the first year and 74,000 jobs after 3 years. The public deficit would in turn improve by 0.3 GDP point within 3 years.

These results, while more moderate than those [published by the DG Treasury\[1\]](#), are nonetheless significant and are welcome in an economic situation like today's that is marked by sluggish growth and the risk of deflation. A depreciation of the single currency would also undercut the process of competitive deflation engaged in by countries in the euro zone.

---

[1] The publication of the DG Treasury argues that a 10% decrease in the effective exchange rate of the euro (against all currencies) would do the following: increase our GDP by

0.6 percentage point of GDP in the first year and 1.2 GDP points after three years; create 30,000 jobs in the first year and 150,000 jobs within three years; and reduce the government deficit by 0.2 GDP point in the first year and 0.6 GDP point after three years.

---

## Abenomics and the new monetary policy

This post summarizes a paper written by [Mahito Uchida, in Revue de l'OFCE, n° 135.](#)

With the arrival of Shinzo Abe at the end of 2012, Japan's economic policy started clearly focusing on the risk of deflation. This new policy combines a highly accommodative monetary policy with a fiscal stimulus based on public investment. In an article published by the OFCE, Mahito Uchida of SEIJO University, analyses the first stage of implementation of the new Japanese monetary policy. In that paper, Mahito Uchida investigates the Bank of Japan's (BOJ) monetary policy effects under Abenomics at the initial stage. First, he describes briefly what is "Abenomics" and "New monetary policy under Abenomics" since April 2013. He also examines the causes of the sharp response of the yen and Japanese stock prices, the increase in consumer price index and the change in public's expectations of the economic activity and prices from surveys. In the second part he explains why the new monetary policy was effective in 2013, comparing the previous policy until 2012. Although there is not much difference between monetary policies before and after

2012 theoretically, he points out the importance of the strong commitment by central bank, the cooperation with the government and “psychological impact” on public. The third part discusses the durability of the new monetary policy. The policy effects will be sustainable if a price becomes lastingly positive, which needs a durably positive output gap. Therefore, Abenomics’ growth strategy plays an important role. He also points out that the BOJ has to perform the policy over side effects such as the impact on the government bond markets, the impact on other financial markets and on capital flows overseas.

---

## **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 constraint, 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 [\[2\]](#). 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

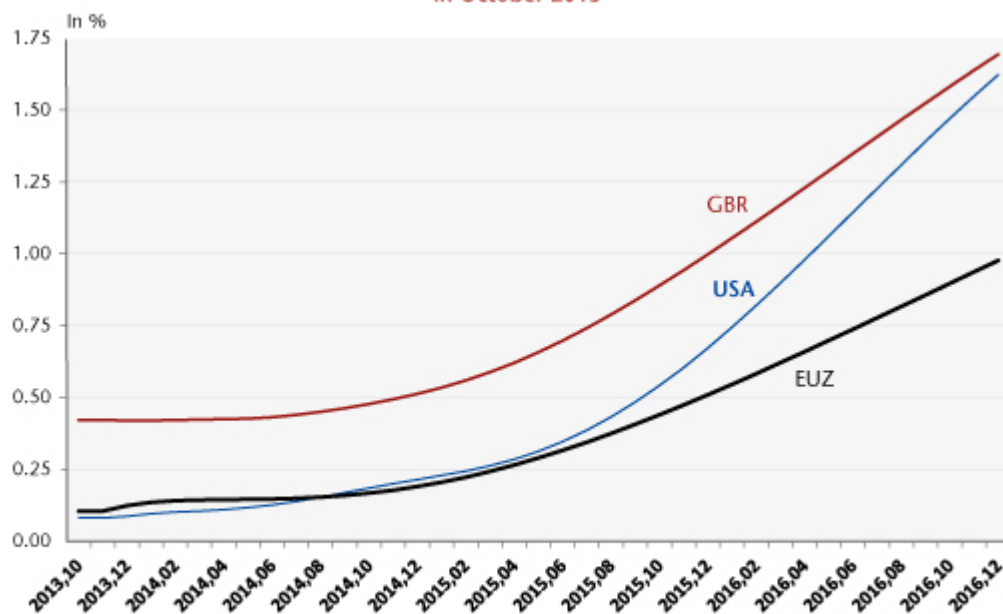
central bank is acting in accordance with its commitments. Then and only then will the agents have confidence in the declarations and will the central bank be in a position to influence expectations of long-term rates. The relative advantages and disadvantages of the two types of forward guidance explain why the Fed switched from one to the other and why the BoE has also made 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.

### **Bibliographic references**

Eggertsson, G. and M. Woodford (2003). “Optimal monetary policy in a liquidity trap”, *NBER Working Paper* (9968).

Kool, C. and D. Thornton (2012). “How Effective is Central Forward Guidance?”, *Federal Reserve Bank of Saint Louis Working Paper Series*.

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.

---

\* 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 \[in French\]](#).

---

[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.

---

## **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.

—

\*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.

---

# Shocks, unemployment and adjustment – the limits of the European union

By [Christophe Blot](#)

In an article published in 2013 in *Open Economies Review* [\[1\]](#), C. A. E. Goodhart and D. J. Lee compare the mechanisms for recovering from the crisis in the United States and Europe. Based on a comparison of the situation of three states (Arizona, Spain and Latvia) faced with a property crash and recession, the authors explore the reasons for the growing divergence observed among the euro zone countries, a divergence that is not found in the United States. Their analysis is based on the criteria for optimum currency areas, which enable the members of a monetary union to adjust to adverse shocks and to avoid a lasting difference in their unemployment rates during an economic slowdown or downturn. While Latvia is not formally part of a monetary union [\[2\]](#), its currency nevertheless has remained firmly anchored to the euro during the crisis. Thus none of the countries studied by Goodhart and Lee resorted to a nominal devaluation to absorb the financial and real shocks that they faced. The authors conclude that while Arizona dealt with the shocks better than Spain, this was due both to the greater fiscal solidarity that exists between the states of the United States and to the greater integration of the US banking system, which helps to absorb shocks specific to each state.

In addition to *de jure* or *de facto* membership in a monetary union, Arizona, Spain and Latvia also all went through a real estate boom in the 2000s, followed by a correction that began

in 2006 in Arizona and Latvia, and a year later in Spain (Figure 1). The real estate crisis was accompanied by a recession, with the same time lag persisting between Spain and the other two states. Latvia recorded the sharpest downturn in activity (-21% between 2007 and 2010). However, the downturns experienced by Arizona (-5.5% since 2007) and Spain (5% since 2008) were comparable. While the downward adjustment of the property market stopped in Arizona (recovery is underway in the US state), the recession is continuing in Spain. Overall, this difference in adjustment is reflected in a continuing increase in unemployment in Spain, whereas it has fallen by 2.8 percentage points in Arizona from the peak in the first quarter of 2010 (Figure 2).

Spain's inability to pull out of the recession along with the increasing divergence of the economies in the euro zone raises the question of the capacity of the euro zone countries to adjust to a negative shock. The theory of optimum currency areas, originally developed by Mundell in 1961 [3], can help to evaluate the conditions in which a country may have an interest in joining a monetary union. The optimality of this choice depends on the country's ability to absorb shocks without resorting to currency devaluation. Different adjustment mechanisms are involved. These consist mainly of the following: [4] the flexibility of prices and in particular of wages; labour mobility; the existence of fiscal transfers between the countries in the monetary union; and financial integration. Price flexibility corresponds to an internal devaluation mechanism. As for depreciation, the point is to become more competitive – by lowering relative labour costs – to stimulate exports and growth during a negative shock. However, this type of adjustment generally takes much longer and is more costly, as is suggested by the recent examples of Iceland and Ireland. [5] Labour mobility makes for an adjustment whenever the recession leads people to migrate from a state with high unemployment to one where it is lower. The implementation of fiscal transfers occurs when various

mechanisms in states where growth is slowing make it possible to benefit from stabilizing transfers from other states in the union or from a higher level of government. Finally, Goodhart and Lee also consider the stabilizing role of the local banking system. In this case, in the euro zone, the less the local banking system has been weakened by the real estate crisis or the public debt crisis, the greater is its capacity to absorb the shock.

The authors analyzed the adjustment of the economies in question in the light of these four criteria. They studied in particular the degree of price flexibility and labour mobility as a function of unemployment in the three states. Then they evaluated the importance of fiscal transfers and the architecture of the banking landscape. Their findings were as follows:

1. Price flexibility has played only a marginal role in adjustment, except in Latvia where rising unemployment has led to a decline in unit labor costs. These costs did not on the other hand react significantly to the rise in unemployment in Spain and Arizona.
2. Though migration is more marked in the United States than in Europe, the differences are still not able to explain the gap in the adjustment of unemployment rates. However, it appears that the role of migration as an adjustment mechanism has strengthened in Europe. Nevertheless, this is still insufficient to ensure the convergence of unemployment rates.
3. In 2009 and 2010, Arizona received substantial transfers from the federal government, whereas at the European level there is no automatic mechanism for transfers between states. Even so, Latvia received assistance from the IMF in 2009, while the euro zone countries came to the aid of Spain's banks. Nevertheless, in the absence of a more substantial EU budget, the European countries can benefit only from emergency assistance, which, while

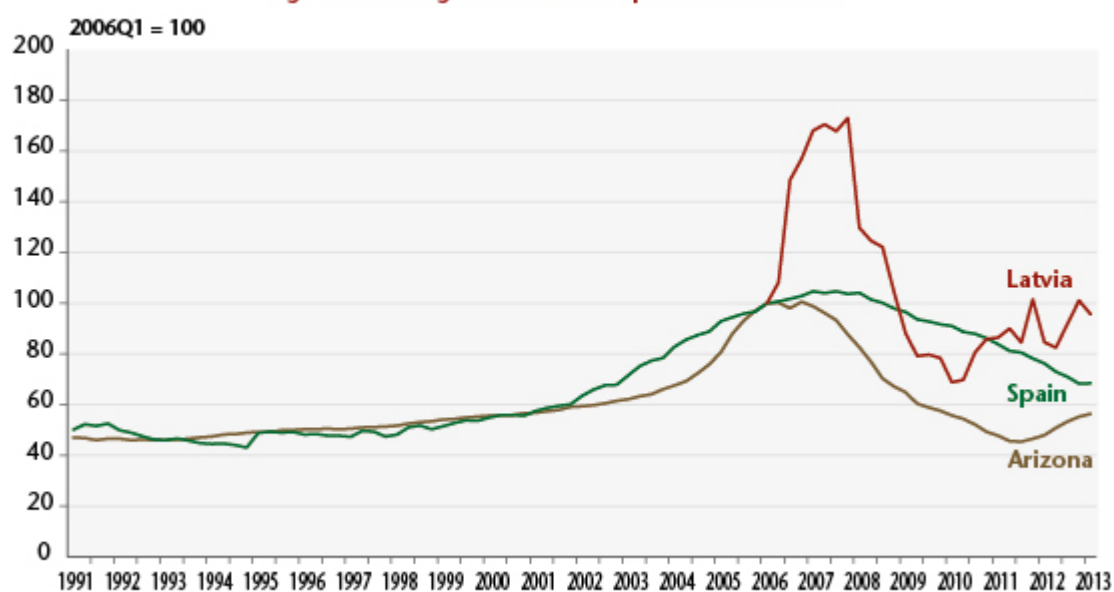
able to meet a specific need for funds, is not sufficient to play the role of an economic stabilizer.

4. Finally, the authors emphasize that the financial amplification of the shocks was on a lesser scale in Arizona in so far as the bulk of the banking business is conducted by national banks that are consequently less sensitive to local macroeconomic and financial conditions. The risk of credit rationing is thus lessened, which helps to better absorb the initial shock. In Spain, with the exception of a few banks with international operations, which enables them to diversify their risks, banking depends on local banks, which are therefore more vulnerable. This increased fragility pushes the banks to restrict access to credit, which reinforces the initial shock. Latvia is in an alternative position in that its financial activity is carried out mainly by foreign banks. The nature of risk thus differs, because local financial activity is disconnected from Latvia's macroeconomic situation and depends instead on the situation in the country where these banks conduct their principal activity (*i.e.* Sweden, to a great extent).

The crisis in the euro zone thus has an institutional dimension. From the moment the countries freely consented to surrender their monetary sovereignty, they in effect also abandoned the use of a currency devaluation to cushion recessions. However, it is essential that alternative adjustment mechanisms are operative in order to ensure the "sustainability" of monetary unification. In this respect, the article written by Goodhart and Lee is a reminder that such mechanisms are still lacking in the euro zone. Negotiations over the EU budget have not offered any prospect for the implementation of fiscal transfers to stabilize shocks at the European level. The discussion on Eurobonds has stalled. Although the European Stability Mechanism (ESM) acts as a tool for solidarity between Member States, it meets a different

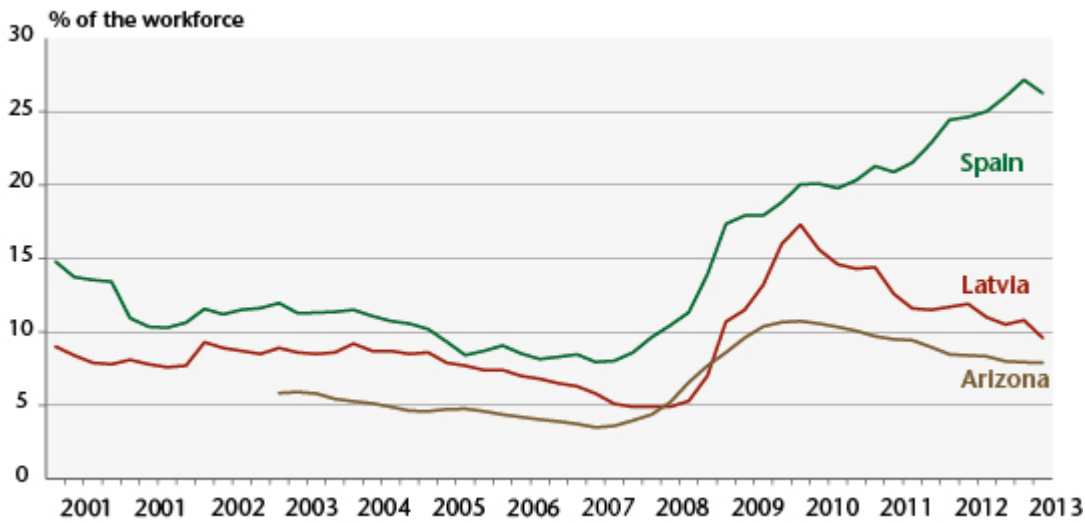
need, because it involves only emergency financial assistance and is not a mechanism for automatic stabilization. Banking integration could also help dampen fluctuations. However, the crisis has led to greater fragmentation of European banking markets. The latest report on financial integration in Europe, published by the ECB, shows a 30% decrease in cross-border bank flows in the recent period. Similarly, despite the common monetary policy, the interest rates charged by European banks have recently diverged [6] (Figure 3). Thus, despite the European banking passport created by the European Directive of 15 December 1989 on the mutual recognition of authorizations of credit institutions, cross-border banking in Europe is still relatively undeveloped. The retail banking model is based on the existence of long-term relationships between the bank and its clients, which undoubtedly explains why the integration process is taking much longer than for the stocks, bonds and currency markets. It is nevertheless still the case that a banking union could be a further step in this difficult process of integration. This would promote the development of transnational activity, which would also help to de-link the problem of bank solvency and liquidity from the problem of financing the public debt.

**Figure 1 : Changes in real estate prices in real terms**



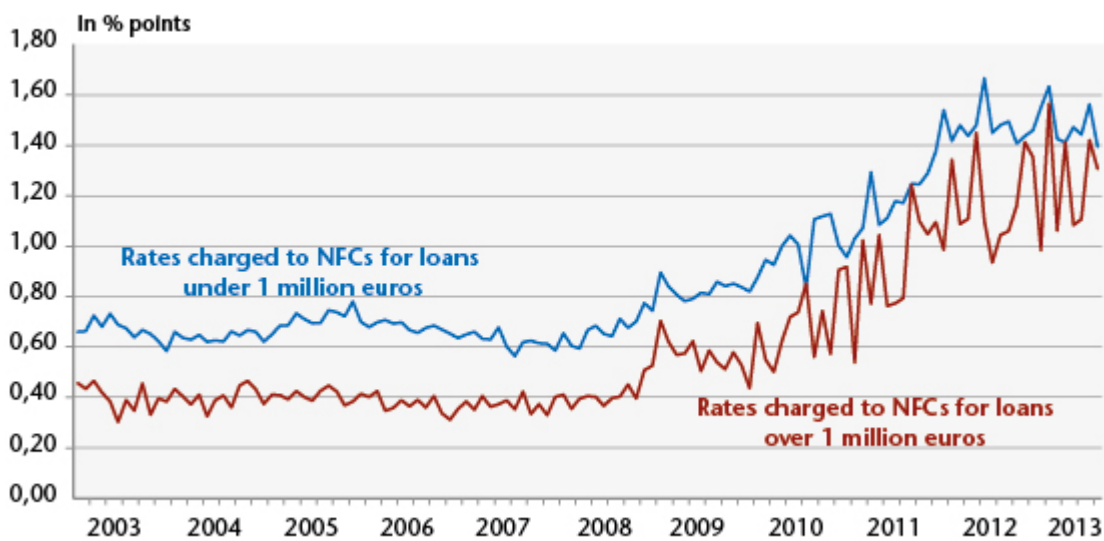
Source : Bank of International Settlements, Federal Housing Finance Agency.

Figure 2 : Unemployment rates



Sources : Bureau of Labor Statistics, Instituto Nacional de Estadísticas, Agence nationale pour l'emploi (Latvia).

Figure 3 : Dispersion of rates charged by banks in the euro zone



Source : European Central Bank. NFC = Non-financial corporation.

---

[1] "Adjustment mechanisms in a currency area", *Open Economies Review*, January 2013. A preliminary version of this article can be downloaded at: <http://www.lse.ac.uk/fmg/workingPapers/specialPapers/PDF/SP212.pdf>

[2] Latvia has been part of the European currency mechanism

since 2005 and is to adopt the euro on 1 January 2014.

[3] “A theory of optimum currency areas”, *American Economic Review*, vol. 51, 1961.

[4] One could also add the level of an economy’s openness or the degree of diversification of production. Mongelli (2002) offers a detailed review of these various criteria. See: [“New views on the optimum currency area theory: what is EMU telling us?”](#), *ECB Working Paper*, no. 138.

[5] See [Blot and Antonin \(2013\)](#) for a comparative analysis of the cases of Ireland and Iceland.

[6] C. Blot and F. Labondance (2013) offer an analysis of the transmission of currency policy to the rates charged by the banks to non-financial companies ([see here](#)) and to real estate loans ([see here](#)).