

The economic crisis is a crisis of economic policy

By [Jean-Luc Gaffard](#)

The simultaneous increase of inflation and unemployment in the 1970s indicated that Keynesian theory and policy had run into a wall. No longer was it simply possible to arbitrate between the two evils and fine-tune economic activity by acting solely on aggregate demand through the budget channel. This failure together with the persistence of high inflation eventually convinced policymakers of the need and urgency of prioritising the fight against inflation.

The economic theory devised by the new classical school came in support of this policy decision with the claim that inflation and unemployment were distinct phenomena that should be handled with distinct methods. If inflation takes off, it is because of a lack of monetary discipline. If unemployment rises, it is due to increased rigidities in the functioning of the markets. The famous Phillips curve, the basis for arbitrating between the two, theoretically becomes vertical, at least in the long run. Macroeconomic policies thus become dissociated from structural policies: the first are intended to stem inflation, the second to curb unemployment. The only relationship that they have with each other is that cyclical policy does not allow the economy to escape for long from the position determined by structural policy, a position that reflects the so-called natural unemployment rate. One attraction of this theory is the simplicity of its recommendations to government. Policymakers can (and should) meet a single target, inflation, by using a single instrument wielded by a central bank that is now independent, especially as hitting this target also ensures that the natural employment level will be achieved at the lowest cost in terms of inflation. If by chance the unemployment rate is considered

too high, policymakers should take the view that this reflects dysfunctions in the markets for goods and labour, and they can then decide to introduce a well-organised set of structural reforms designed for market liberalisation. In this wonderful world, reducing the budget deficit is always profitable. The basic model teaches that, after such a reduction, income and employment decrease initially, but then, thanks to a reduction in interest rates, private investment quickly increases and with it income and employment. The new medium-term equilibrium may even correspond to a higher level of income and employment, as private investment expenditure is considered to be more efficient than government expenditure. An independent central bank and financial markets that are deemed efficient play the role of disciplining the government by punishing any inappropriate budget deficits.

Europe has been a prime testing ground for this theory. Monetary policy is in the hands of a central bank, and its governing treaties ensure that it is independent and that its sole objective is price stability. Structural policies and reforms are a matter for the states, which are responsible for choosing the natural unemployment rate that they consider acceptable or, if they consider unemployment to be too high, they can impose reforms. If unemployment is higher in one country than in another, in the medium term, this can only be due to structural differences, in other words, to the existence of greater rigidities in the way the markets in this country operate. Once the recommended reforms are implemented, things will get back to normal. The theory thus formulated is expected to survive the crisis: for Europe to regain its lost coherence is a simple matter of policy choices. Excessively indebted countries need to reduce their budget deficits and make the structural reforms that they have put off for too long in order to restore growth, full employment and price stability. At most, some are proposing that debts be pooled in return for a commitment to implement structural reform. Germany, which has preceded the others down this particular

path to virtue, has nothing to fear from this scenario, since the renewed growth of its partners will ensure the long-term viability of its commercial outlets. Furthermore, the European Central Bank does not need to concern itself with financial stability, as markets punish impecunious States and force them into fiscal austerity by driving up the interest rates paid on their borrowings.

This entire beautiful structure rests on assumptions that are not very robust, in particular that any increase in market rigidities, particularly on the labour market, *e.g.* due to an increase in unemployment benefits, redundancy costs or employee bargaining power, shifts the long-term equilibrium position of the economy and inevitably produces an increase in the “natural” unemployment rate. It is, of course, always possible to compare long-run equilibria that are distinguished only by the value of certain structural data. It is riskier to deduce the path that leads from one to another. We should have learned from the experience of the 1930s that rigidities in prices and wages are a way to stem rising unemployment in a depressed economy, that is to say, when it becomes important to block reductions in prices and wages that are increasing the burden of private debt and putting downward pressure on aggregate demand. It should also be clear that structural reforms intended to reduce the natural rate of unemployment often lead immediately to a redistribution and reduction in income, which leads in turn to higher unemployment. But nothing says that this increase will only be temporary and will not trigger a chain reaction through the channel of aggregate demand. Rigidities remain a factor in reducing the risk of instability inherent in any structural change, whether this involves reforms in market organisation, the emergence of new competitors on the market or technological breakthroughs. A better allocation of resources may justify calling these rigidities into question, but care must be taken to avoid the inherent risk of instability. Certainly, when structural reforms aimed at introducing more flexibility undermine

domestic demand, the latter can then be boosted by stimulating external demand with lower prices. The unemployment rate may then fall. But it is actually exported to countries that might well not yet have undertaken such reforms, where unemployment thus inevitably exceeds the level deemed natural. "Every man for himself" begins to prevail over solidarity.

Europe is currently going through this scenario. Germany, in particular, carried out the structural reforms required by the prevailing theory, but at the cost of the segmentation of its labour market and the growth of low-paid insecure jobs, which resulted in turn in a slowdown in domestic demand. The improvement in Germany's export performance, based on the quality of its goods as well as on the international fragmentation of the production process, has been offsetting the slowdown and helping to contain or even reduce the budget deficit. The unemployment rate has been rising in many other European countries in parallel to their budget deficits. The correction required by the experts (and in fact imposed by the financial markets), which involves simultaneously reducing public spending, raising taxes and making structural reforms, will very likely further reduce domestic demand in these countries, increase their budget deficits and ultimately hit German exports. [Recession, if not a general depression, lies at the end of this path.](#) The cause is a series of internal and external imbalances. And things could get even more complicated if performance gaps in the countries concerned widen even further and lead to divergences in their goals and interests.

Economic policy is unfortunately more complex than modern macroeconomics would have it. The long term is not independent of the short term; and the goals pursued are not independent of each other, and not always inter-compatible. Policies that are categorised as cyclical and structural are not really independent of each other, nor can they be targeted exclusively at a single goal. If there must be structural

reforms, they need to be accompanied by expansionary cyclical policies to counteract the immediate recessionary effects that they may amplify. Even so, cyclical policies are not sufficient in themselves to ensure strong, steady growth.

It is unrealistic and dangerous to expect to break free of the current impasse through generalised fiscal austerity in Europe. Compromises are needed that involve the acceptance of some disequilibria in order to alleviate others. The only way out is to accept budget deficits for a while longer. Without a recovery in the balance sheets of both firms and households, there will be no positive outcome from the rebalancing of public accounts, if indeed that even occurs.

There is of course no doubt that we must achieve greater harmony in the fiscal positions of countries belonging to the same monetary zone. Fiscal federalism is necessary to deal with monetary federalism. But federalism does not stop with the actions of a central bank that has been stripped of its basic functions and is unable to carry out common national fiscal contractions. It demands genuine budget solidarity, including to intervene to prevent the insolvency of States that are facing exorbitant interest rates. It also involves structural policies that not only refrain from reforms that could exacerbate fiscal and social competition, but also promote industrial and technological projects funded by a common European budget that has been strengthened through the establishment of a federal tax. State budget deficits will not be contained and the objectives and interests of states will not converge without the implementation of the cyclical and structural policies needed for a general recovery of growth.

Monetary policy: Open-Market Operations or Open-Mouth Operations?

By [Paul Hubert](#)

Can the communications of a central banker influence agents' expectations in the same way as they change interest rates? To believe Ben Bernanke, the answer is yes.

In a [speech on 18 October 2011](#), Ben Bernanke, governor of the US central bank, highlighted his interest in finding new tools to help businesses and consumers anticipate the future direction of monetary policy. Thus we learn that the bank's Federal Open Market Committee ([FOMC](#)) is exploring ways to make its macroeconomic forecasts more transparent. Indeed, if the publication of the forecasts influences the formation of private expectations about the future, then this could be treated as another tool of monetary policy.

It is worth pointing out that the impact of communicating the central bank's forecasts depends on the bank's credibility. Any impact that the publication of the forecasts has on the economy is neither binding nor mechanical, but rather is channelled through the confidence that businesses and consumers place in the statements of the central bank. So if a statement is credible, then the action announced may not be needed any more or its amplitude may be reduced. The mechanism is straightforward: publishing the forecast changes private expectations, which in turn modifies decision-making and therefore the economic variables. Ben Bernanke's determination to implement what he calls "[forward policy guidance](#)" and the

emphasis he is giving to the importance of the central bank's forecasts suggest that the Fed is seeking to use its forecasts as another instrument to implement its monetary policy more effectively.

Based on the inflation expectations of private agents collected through quarterly surveys called the Survey of Professional Forecasters (available [here](#)), it appears that the FOMC inflation forecasts, published twice yearly since 1979, have a persistent positive effect on private expectations (see the [working document](#)). Expectations rise by 0.7 percentage point when the Fed increases its forecast by one percentage point. Two interpretations of this effect could be offered: by raising its forecast, the Fed influences expectations and in a certain sense creates 0.7 percentage point of inflation. The effectiveness of such an announcement would therefore be questionable. In contrast, it is conceivable that an increase of 1 percentage point of inflation will occur and that by announcing it, the Fed sends a signal to private agents. They then expect a response from the Fed to counter the increase, and so reduce their expectation of the increase. The Fed's communication would therefore have succeeded in preventing a 0.3 percentage point increase in future inflation, meaning that the announcement has been effective.

This last mechanism, called "Open-Mouth Operations" in an [article](#) published in 2000 dealing with the central bank of New Zealand, would therefore act as a complement to the bank's [open market operations](#) that are intended to modify the central bank's key rates so as to influence the economy.

In order to shed light on the reasons why private expectations have increased, it would help to characterize the mechanisms underlying the influence of the FOMC forecasts. If the FOMC forecasts are a good leading indicator of the Fed's future key rates, they provide information about future decisions. It appears from this study that an increase in the FOMC forecasts signals that there will be an increase in the Fed's key rates

18 to 24 months later.

Furthermore, the FOMC forecasts do not have the same impact as the bank's key rates on macroeconomic variables, nor do they respond in the same way to macroeconomic shocks: the responses of key rates to macroeconomic shocks are substantial and rapid in comparison with the responses of the forecasts. This suggests that the FOMC forecasts are an *a priori* instrument intended to implement monetary policy over the long term, whereas the key rates are an *a posteriori* instrument that responds to shocks to the economy, and thus to the short-term cycle.

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](#)".

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

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

Too long and too technical, the [final declaration](#) of collective action of the G20 Summit in Cannes shows that no clear and shared vision of the economic and financial turmoil that is rocking the global economy has emerged at the Summit.

And as Seneca reminds us, the disappointment would have been less painful if success had not been promised in advance.

According to the official announcements, the disappointment was palpable at the end of a G20 summit in which no significant progress was achieved – on the most important issues of the moment, the revival of growth in particular. The crucial issues of agriculture and finance gave rise simply to declarations of intent, with a reminder of the commitments made on these ... in 2008! The disappointment must be kept in perspective, however, as the G20 is primarily a forum for discussion rather than for decisions. Indeed, what remains of the commitments made in April 2009 by the G20 in London, mired in global recession? The expansionary fiscal policies? Forgotten, as a result of the public debt that they have produced – debt, by the way, that was perfectly predictable. Strengthened financial regulation? Repeatedly trotted out, but still not implemented, despite the determination displayed in Paris on 14 and 15 October 2011. The desire to avoid protectionism? Barely mentioned, nor did this succeed in preventing the outbreak of 36 [trade disputes](#) brought before the WTO, including 14 involving China, the EU and / or the United States. All that remains is a monetary policy that is “expansionary as long as necessary”, in the words of the pre-Summit statements. So does the fate of the international monetary system depend simply on the good will of the central bankers, independent as they are?

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

The crisis hitting the euro zone is a result of the heterogeneity of its constituent countries, much as the financial crisis triggered in 2007 was a result not just of a

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

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

Giving the economic policy authorities an opportunity to implement discretionary policies should not mean forgetting about the risks posed by the absence of a coordinated approach, which may lead the US Congress to threaten

unilateral compensatory taxes on goods imported from countries whose currency is undervalued. This move is evoking the specter of protectionism, and the G20 countries should consider a mechanism to coordinate policy so as to avoid the trade wars that are already being more or less explicitly declared.

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

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

Can the central banks influence the expectations of private agents?

By Paul Hubert

Can the forecasts of a central bank influence the expectations of private agents, and if so what are the reasons for this? A few hours after the press conferences of Ben Bernanke and Mario Draghi, here are some explanations.

The awarding of the [2011 Nobel Prize in Economics](#) to Thomas Sargent and Chris Sims for “their empirical research on causal effects in macroeconomics” highlights the role of the expectations of private agents in economic policy decisions. Because the expectations of businesses and households about inflation and growth affect their decisions on investment, consumption, savings, and wage demands, these are at the heart of the interaction between economic policies and their effects.

Since the 1980s, the main instrument of monetary policy has been the interest rate set by the central bank. Changes in this affect the economy and allow the central bank to arbitrate between economic growth and inflation through [several channels](#), and in particular interest rates, credit, asset prices, exchange rates and, finally, expectations. Indeed, in the course of their daily decision-making, businesses and households base themselves on numerous expectations about consumption, investment, future capacity and future wages and prices, etc. These expectations then play a central role in the determination of economic variables.

Changes in the central bank rate thus send signals about the future state of the economy and future monetary policy, and alter the expectations formed by private agents.

However, the expectations channel is ambiguous, and changes in the base rates can be understood in different ways: private agents may respond to lower rates by consuming and investing more, which may indicate that growth will be stronger in the future, bolstering their confidence and their willingness to consume and invest. In contrast, the same agents may feel that current growth is lower than expected, prompting the central bank to intervene, which reduces their confidence, and hence their willingness to consume and invest... Since the 1990s, the central banks have been complementing interest rates with the [effect of announcements](#) to clarify their future intentions. Communication seems to have become a [tool of monetary policy](#), and two types can be distinguished. Qualitative communication includes interviews and speeches, while quantitative communication consists of the publication of the central bank's forecasts of inflation and growth.

In a [recent working paper](#), we analyze the effect of the forecasts of inflation and growth published quarterly by the central banks of Canada, Sweden, the UK, Japan and Switzerland. With the help of surveys conducted by Consensus Forecasts of professional forecasters from financial and non-financial sectors, we show that the inflation forecasts of the central banks of Sweden, the UK and Japan are a significant factor in the inflation forecasts of private agents. In other words, the publication of the central bank inflation forecasts leads to a revision of the forecasts of private agents. It also appears that the opposite is not true: the central bank forecasts do not respond to the forecasts of private agents.

Two factors could explain the central bank's influence: first, the inflation forecasts of the central bank could be higher quality, making it rational for private agents to be influenced by them so as to improve their own forecasts of

macroeconomic variables. Second, the inflation expectations of the central bank can influence private agents because they transmit signals, either about future decisions on monetary policy, or about the private information available to the central bank. This type of influence is independent of the forecasting performance of the central bank.

To determine the sources of this influence, we evaluated the relative forecasting performance of the central banks and private agents and tested whether the central bank's influence on private expectations depends on the quality of its forecasts. Estimates showed that, in our sample of central banks, only the central bank of Sweden produced significant, regular and robust inflation forecasts that were better than those of private agents. We also found that the degree of influence depends on the quality of the inflation forecasts. In other words, the inflation forecast over a short horizon (1 or 2 quarters), which a historical analysis of forecast performance tells us are of low quality, do not influence private agents, whereas those of higher quality do influence them. Furthermore, the longer-term inflation forecasts of Sweden's central bank managed to influence private expectations even when their quality was low, and the better the quality, the stronger the influence.

While the central banks in the United Kingdom, Japan and Sweden all succeed in influencing private expectations by publishing their macroeconomic forecasts, it appears that the reasons for this influence differ. The first two use the transmission of signals, while the Swedish central bank uses both possible sources for influencing private expectations: its greater forecasting capability and the sending of signals. The consequence of these results is that the publication by the central bank of its macroeconomic forecasts could facilitate and render more effective the establishment of the desired monetary policy by shaping private expectations. This transmission channel, which is faster because it relies only

on the provision of forecasts, could thus allow the central bank to affect the economy without changing its key interest rate, in practice making it an additional policy instrument.

Why the developed countries should renounce their AAA rating

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

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

Since 1945, no developed country has defaulted on its debt. There was no risk on the debt, since the states borrowed in their own currency and could always obtain financing from their central bank. The developed countries enjoyed “monetary sovereignty”. This is still the case today for Japan (which enjoys 10-year loans at 1% despite a debt of 210% of GDP), the United States (which borrows at 2% with a debt of 98% of GDP), and the United Kingdom (which borrows at 2.5% with a debt of 86% of GDP).

Banks and insurance companies cannot function if they do not have risk-free assets and if they have to guard against the failure of their own state, which is of course impossible: the

amounts involved are enormous, and government securities serve to guarantee banking and insurance activities. The banks and insurance companies could not accumulate enough capital to withstand the bankruptcy of their own country or multiple euro zone countries. As we can see today with the sovereign debt crisis in the euro zone, such a requirement would lead to the general paralysis of the banking system.

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

The euro zone countries have lost their "monetary sovereignty": under the Treaty of the European Union, the European Central Bank has no right to finance Member States, and the States are not bound by joint liability. The financial markets noticed this in mid-2009, and suddenly uncontrollable speculation erupted, targeting the most fragile countries in the zone: first Greece, Portugal, and Ireland, which had the fastest growth before the crisis, but will have to change their growth pattern, and then, like dominos, Italy, Spain, and even Belgium. Today, Belgium has to pay an interest rate of 3.8%, Spain 5.2% and Italy 5.6%, compared with 2.6% in France and just 1.8 % for Germany. Greece, Ireland, and Portugal are now in the situation that the developing countries faced yesteryear: their debts have become risky assets subject to high risk premiums, and they are being brought under the yoke of the IMF.

The workings of the financial markets could completely paralyze fiscal policy. When a country enjoys monetary sovereignty, then in a recession the central bank can lower its maximum interest rate and if necessary commit to keeping it low in the long term; the state increases its deficit, but the low interest rates prevent the debt from snowballing; and

it pushes exchange rates lower, which boosts activity. Since the debt is guaranteed by the creation of money, there is no risk of bankruptcy, and thus no reason to have to constantly *reassure* the markets. The central bank, by maintaining long-term rates at low levels in a recession, ensures that fiscal policy is effective. Fiscal policy does not need to worry about the markets. This is still the strategy of the United States today.

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

The euro zone must thus choose between dissolution and a reform that would guarantee the public debt of the Member States, which would re-gain their “monetary sovereignty”. European public debts should become risk-free assets, compensated at low rates but guaranteed in full (by European solidarity and fundamentally by the ECB). This is the only way

to maintain the independence of fiscal policy, which is essential given the disparities in Europe and the loss by each country of its monetary and exchange rate instruments.

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

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

The dual mandate, the Fed and the ECB

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

Since 21 September 2011, the US Federal Reserve has launched [Operation Twist](#) to reallocate its balance sheet to reduce

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

Through Operation Twist, the Federal Reserve will be trading in 400 billion dollars worth of short-term government bonds for long-dated Treasuries. The Fed's strategy of reallocating its balance sheet is aimed at reducing the long-term interest rate. This approach is consistent in spirit with the recent remarks of the President of the Chicago Fed.

The [speech](#) by Charles Evans on 7 September is worthy of our attention for at least two reasons. First, it indicates that today, even though the United States has slipped into crisis, with persistent unemployment and a new recession threatening, attention is being paid too much to inflation and public deficits rather than to the kind of action that would counter the crisis by conducting a policy commensurate with its scale. Using a target-function of the Fed and Okun's law, Charles Evans said that an unemployment rate of 9% of the US workforce would be as worrying as an inflation rate of 5%: the 3-point gap with each of the two targets – a "natural" rate of unemployment of 6% (which he calls a conservative assumption, as the unemployment rate should fall if the United States were to recover the 8 growth points lost during the crisis) or an inflation rate of 2% (again, a conservative assumption) – is very comparable in a country like the United States that does not impose any hierarchy between the targets of inflation and of growth (more precisely, between inflation and maximum employment, see here). Evans noted that the unemployment rate in the United States has actually come to differ by 3 points from its target, but inflation hasn't ... and he then observes:

“So, if 5% inflation would have our hair on fire, so should 9% unemployment.” This led Evans to consider that the inflation target, legitimate in the medium term, is not the priority, and therefore that an expansionary monetary policy should be accentuated by conventional or unconventional means, even at the cost of a short-term boom in prices (which is unlikely in an economy in crisis).

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

(tobacco). Ultimately, in July 2011 the rate of inflation excluding energy and processed food products came to 1.5%. The unemployment rate in the euro zone is, for its part, on the order of 10% of the workforce. To paraphrase Charles Evans, one can say that while 5% inflation would certainly raise the hair on the heads of Europe's central bankers – and fortunately we are far from this – this should also be the case when the unemployment rate reaches 10% of the workforce! The big difference between a Fed official's expansionist drive and the ECB's policy of prudence in comparable economic circumstances (the gaps between the inflation and unemployment rates from their respective targets are more or less the same) also finds a striking parallel in the fiscal policy speeches and actions on either side of the Atlantic. While the European debates almost invariably concern the imposition of additional constraints on the fiscal policies of the euro zone countries (the adoption of "golden rules" in Germany and Spain; the litany of fiscal austerity programs, the latest being in Italy), the need in the euro zone to be able to rely on a strong economic policy instrument comes down solely to the ECB. But this is not necessarily the case in the United States, where the federal government has proposed a new plan to revive the economy in the short term, together with fiscal consolidation over the next 10 years. The speech by Charles Evans should be given by Jean-Claude Trichet, but we are a long way from that. Standing firmly on the impeccable character of the ECB's past actions (see the nuanced critique by [Paul Krugman](#)), the ECB Chairman, when he does talk, does not seem to take the measure of its responsibility for the future performance of its current policies. If the ECB fails to take the lead in boosting activity in a period of low inflation, then the governance of the euro needs to be reviewed. Two critical choices for the future are posed. The euro could disappear, which would not take place without serious difficulties (see the note from Jean Pisani-Ferry about Greece, whose conclusions could be extended to all the euro zone countries, including Germany) and must be firmly

rejected. The status of the system of euro zone central banks could be amended to give equal dignity to the goals of economic growth and inflation, along the lines of the Fed, whose performance has made it possible to minimize the fears of an explosion of inflation.