

## The Fog of Finance by Jean-Paul Fitoussi and Eloi Laurent Project Syndicate November 2007

Eloi Laurent Military leaders talk about the “fog of war” – the condition of fundamental uncertainty that marks combat. The recent credit and liquidity crisis has revealed a similar condition in financial markets, because no one, not even central banks, seems to understand its nature or magnitude.

It is often suggested that what is called the “subprime” crisis was the result of lax monetary policies that led to excess liquidity in financial markets. But there is an obvious paradox here, because how can an excess of liquidity result ultimately in a shortage of liquidity that has to be made up by central banks?

In fact, monetary laxity can be a symptom not of excess liquidity, but of excess saving. This is reflected in increasing income inequality in much of the developed world, and the vertiginous surpluses of oil-producing countries and Asian nations. The emergence of sovereign wealth funds like those of China and the Gulf states to invest the savings of these countries’ budget surpluses is but the tip of the global excess savings iceberg.

Whereas excess liquidity is inflationary and calls for higher interest rates, excess saving is deflationary and calls for lower rates. This brings us to the dilemma faced by central banks. When central bankers cannot avoid a crisis – or when they contribute to create one – their fundamental mission is to do everything in their power to contain its impact.

Their actions, their every word or wink, suddenly assumes immense importance. The central banker is not only a lender of last resort, but also a speaker of last resort. In both respects, the United States Federal Reserve has fared much better than the European Central Bank in this most recent crisis.

If the problem is excess saving, and if uncertainty erodes confidence, a massive injection of liquidity such as the ECB’s in response to the subprime crisis may be necessary but not sufficient. A rate cut also may be required to restore confidence. The Fed has understood that message. Europe needs to know why the ECB has not.

Moreover, the Fed’s efforts were ultimately stabilizing, because it stated its intentions clearly prior to taking action. By contrast, in late August, the ECB’s governor, Jean-Claude Trichet, referred to the monetary-policy decision taken before the crisis to justify the possibility of a rate hike, then left rates on hold. On September 6, Trichet said that the ECB had maintained the status quo, leaving it unclear what he meant. Indeed, whereas the ECB seemed to have implicitly accepted an objective of economic growth, it maintained its hard line against inflation on October 4.

The reason for the ECB’s inertia, obscurity, and rigidity is simple: the ECB is only incidentally in charge of economic growth in the euro area; its primary objective is “price stability.” Yet the current crisis, like others that preceded it, shows that monetary policy governs anticipations, not only of inflation but also of growth, whether central banks like it or not.

So long as the ECB does not acknowledge the doubts now hovering around Europe's economies, there is a risk of a crash. The ECB is convinced that benign neglect is the right exchange rate policy, and that the G7 is the right place to address currency volatility. But the euro is a European affair. Why should a situation in which Europe is bearing the burden of weak currencies in the US and Asia be remedied in a global forum? In the middle of a financial crisis, the only thing worse than doubt is false certainty.

The paradox is that the ECB could have secured its independence by cutting interest rates on September 6, and again on October 4. Now it will be forced to do so. A victim of its backward-looking bias, the ECB chose to wait for the worst instead of preventing it. As a result, the inevitable European rate cut, when it comes, will probably not have the stabilizing effect that it should.