

# The very great recession

*Economic outlook updated for the major developed countries in 2012*

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The growth outlook for the developed countries, in Europe in particular, have deteriorated dramatically in recent weeks. The “voluntary and negotiated” devaluation of Greek sovereign debt securities, which is really nothing but a sovereign default, the wave of budget cuts being announced even as budget bills are still debated, the inability of the European Union to mobilize its forces to deal with the crisis – all these factors render the forecasts made two months ago obsolete. For many European countries, including France, 2012 will be a year of recession.

The growth figures for the second quarter of 2011 in the developed countries, published in August 2011, put the positive signals from early 2011 into perspective. In the third quarter of 2011, the national accounts were better than expected, but the respite was short-lived. The economic indicators for most of the developed countries (see below and a [companion note](#)) heralded a reduction in activity in the fourth quarter of 2011 and [early 2012](#). The euro zone will be stagnant in 2012, with GDP growth of 0.4% and Germany recording the “best” performance in the euro zone (Table 1).

Tableau 1. prévisions pour 2012

		2011				2012				2011	2012
		t1	t2	t3	t4	t1	t2	t3	t4		
Allemagne	PIB	1,3	0,3	0,5	-0,1	0,1	0,1	0,1	0,1	3,0	0,4
	Taux de chômage	6,1	5,9	5,7	5,7	5,7	5,7	5,7	5,7	5,8	5,7
	Solde public*									-1,2	-1,4
France	PIB	0,9	-0,1	0,4	-0,2	-0,1	0,0	0,0	0,0	1,6	-0,2
	Taux de chômage	9,2	9,1	9,3	9,6	9,9	10,2	10,5	10,7	9,3	10,3
	Solde public*									-5,8	-5,3
Italie	PIB	0,1	0,3	0,1	-0,2	-0,4	-0,4	-0,3	-0,3	0,7	-0,9
	Taux de chômage	8,2	8,1	8,2	8,4	8,6	8,8	8,9	9,0	8,2	8,8
	Solde public*									-3,9	-2,3
Espagne	PIB	0,4	0,1	0,0	-0,1	0,0	0,0	0,0	0,0	0,7	0,0
	Taux de chômage	20,6	21	22,2	22,6	22,8	23	23	23	21,6	23,0
	Solde public*									-7,4	-5,4
Zone euro	PIB	0,8	0,2	0,2	-0,1	-0,1	0,0	0,0	0,0	1,6	0,0
	Taux de chômage	10,0	10,0	10,6	10,8	10,9	11,0	11,1	11,2	10,3	11,1
	Solde public*									-3,5	-2,9
Royaume-Uni	PIB	0,4	0,1	0,5	-0,1	0,0	0,2	0,2	0,2	0,9	0,5
	Taux de chômage	7,7	7,9	8,3	8,5	8,6	8,7	8,8	8,8	8,1	8,7
	Solde public*									-9,1	-8,5
États-Unis	PIB	0,1	0,3	0,6	0,4	0,4	0,1	0,2	0,3	1,7	1,4
	Taux de chômage	8,9	9,1	9,1	8,7	8,7	8,7	8,7	8,7	9,0	8,7
	Solde public*									-9,2	-9,2
Japon	PIB	-0,7	-0,3	1,5	0,7	0,6	0,6	0,4	0,4	-0,1	2,4
	Taux de chômage	4,7	4,6	4,4	4,5	4,5	4,6	4,7	4,7	4,5	4,6
	Solde public*									-8,8	-9,4

\* En points de PIB.

Sources : Comptes nationaux, prévisions OCDE décembre 2011.

The first phase of the great recession, in 2008-2009, led to the swelling of public debt (about 16 points in the euro zone, more than 30 points in the US and UK, see Table 2). Phase II will be determined by how the public debt caused by the crisis has been digested: either low interest rates will make it possible to postpone the adjustment of public deficits and the economies can bounce back, thus easing the necessary adjustment, or the adjustment will be immediate, amplified by higher public interest rates and the persistence of under-employment (Table 3). Grippled by the fear of default, Europe is transforming the *great* recession that began in 2008 into a *very great* recession.

Tableau 2. Besoins de financement, dettes publiques et caractéristiques de ces dettes

	All	Fra	Ita	Esp	RU	USA	PIB	ZE 4
<b>Besoins de financement sur les marchés en 2012</b>								
En milliards	251 M€	295 M€	391 M€	175 M€	257 M€	3151 M€	228 M€	3156 M€
En point de PIB	9,8	14,1	24,4	15,8	16,5	19,8	47,4	35,3
<b>dont déficit public financé par appel au marché en 2012</b>								
En milliards	30 M€	78 M€	11 M€	37 M€	114 M€	910 M€	52 M€	186 M€
En point de PIB	0,8	5,7	3,9	3,1	8,6	9,7	6,7	2,3
<b>dont dette arrivant à maturité financée par appel au marché en 2012</b>								
En milliards	215 M€	217 M€	368 M€	118 M€	122 M€	2261 M€	194 M€	930 M€
En point de PIB	9,8	16,4	22,5	16,6	7,8	14,1	40,7	32,6
<b>Dettes publiques totales - 2011</b>								
En milliards d'euros	2 062	1 895	1 884	368	1 181	11 064	9 516	6 207
En milliards de dollars	2 795	2 264	2 553	730	1 671	14 994	12 896	8 412
En milliards d'euros PPA 2010	2 051	1 825	1 869	360	1 281	10 210	11 544	6 219
En dollars par tête	34 183	35 298	42 109	16 495	29 932	46 530	101 736	35 177
En point de PIB	80,3	83,7	118,7	32,4	78,3	98,5	273,4	83,3
Variation par rapport à 2007	15,4	19,9	15,1	16,5	14,0	35,3	46,5	16,6
<b>Dettes publiques de marché estimées au 31 décembre 2011</b>								
En milliards d'euros	1 108	1 315	1 571	598	1 526	7 297	6 727	4 933
En milliards de dollars	1 302	1 782	2 129	756	1 797	9 890	9 016	6 368
En milliards d'euros PPA 2010	1 102	1 416	1 538	490	1 809	9 890	11 568	6 538
En point de PIB	45,1	45,0	99,0	15,4	75,4	64,8	160,8	42,7
En dollars par tête	18 568	27 385	35 156	16 572	28 786	56 678	71 505	24 322
<b>Caractéristiques de la dette de marché</b>								
Taux d'encours moyen sur la dette en 2011	nd	3,1	nd	4,0	2,7	5,3	5,9	nd
Taux d'encours moyen sur les émissions en 2011	nd	nd	3,5	nd	2,8	nd	6,5	nd
Taux d'encours moyen sur les émissions en 2012	0,9	1,5	4,3	5,0	2,0	5,4	6,5	2,9
Taux d'encours sur les émissions à 10 ans en 2012	2,8	3,2	6,5	5,5	2,5	2,2	5,1	4,3

Note : la PPA est calculée par rapport à la zone euro, et tient compte des différences de niveaux de prix entre pays de la zone euro.  
Sources : calculs OCDE décembre 2011, Statist, Agence de trésor nationale.

Tableau 3. Évolution de la situation des chômeurs entre 2007 et 2010

En points de population active					
Évolution entre 2007 et 2010	Allemagne	Espagne	France	Italie	RU
chômage	-1,6	11,9	1,3	2,4	2,6
chômage de longue durée	-1,5	5,7	0,5	1,2	1,3
chômage non indemnisé	-0,3	5,7	0,5	2,0	4,3

Source : Eurostat.

After the “voluntary” Greek default, the euro zone countries have inflicted on themselves not only an adjustment that was even more brutal than that required by the Stability and Growth Pact, but also contagion and a general collapse in sovereign debt. The measures proposed by the European Union, from the EFSF to the adoption of the “golden rule”, have not been persuasive of its ability to solve the public finance problems of the euro zone members either in the short or long term, especially as Europe seems to have forgotten that growth and the restoration of full employment are fundamental to the sustainability of public debt and to the European project more generally.

Faced with the risk of insolvency on sovereign debt, creditors are demanding higher risk premiums to continue to fund both new debt and the renewal of the fraction of old debt that is expiring. The hardening of financing conditions, even as business prospects are deteriorating as a result of budget cuts, is nipping attempts at fiscal consolidation in the bud. The result: a downward spiral. The rising cost of debt adds to interest charges, which undercuts deficit reduction and leads to additional fiscal discipline to reassure donors. The added restrictions weigh on activity and wind up augmenting the cyclical deficits – at which point the governments, panicked at the stubborn resistance of the deficits and the prospect of a downgrade in their sovereign rating, respond with even greater rigor.

Because the economies of the European countries are so closely intertwined, the simultaneous implementation of restrictive fiscal policies leads to magnifying the global economic slowdown by undercutting foreign trade (we developed this point in our [previous forecasting exercise](#)). Restrictive

policies hit domestic demand in whichever countries implement them and thus reduce their output, but also their imports. This dynamic decreases the exports of their trading partners, and therefore their activity, regardless of their own fiscal policies. If these partners also implement a restrictive policy, then an external impact has to be added to the internal restriction (an indirect effect). The magnitude of these effects depends on several factors. The direct effects are mainly linked to negative impulses within each country. The indirect effect is more difficult to measure, since it depends on the degree of openness of each country, the geographical distribution of its exports and the elasticity of imports to GDP of the countries that are tightening their policy. Thus, a very open country for which the majority of exports are going to a country undertaking severe budget cuts will suffer a strong indirect effect. In this respect, the highly integrated countries of the euro zone will suffer more from the restrictive policies of their partners than will the United States or Japan. Their growth will be seriously curtailed, pushing back deficit reduction. In many countries, the coming recession is the result of the increasingly restrictive measures being taken to try to stabilize their debt / GDP ratio as soon as possible in an increasingly unfavourable economic environment.

The race to tighten up to try to bring public deficits below 3% of GDP and to stabilize debt ratios is aimed as much at meeting the requirements of European agreements as it is at reassuring the rating agencies and financial markets. The latter, among them the European banks, hold at least 50% of the public debt of the developed countries in the form of securities issued by the national debt agencies. This percentage varies from 77% of the public debt held by financial institutions in France to 97% for Spain.

In the euro zone, between 9 and 23 percentage points of GDP of public debt, depending on the country, needs to be renewed in

2012 (see Table 2). Outside of Japan, it is Italy, which combines a high debt with a large proportion of short-dated securities, which will have the largest financing requirement. If requirements related to the financing of the public deficit in 2012 are added to this, then the potential for total issues in the euro zone ranges between 10% of GDP in Germany to 24% in Italy.

These high levels are posing problems for countries that have lost the confidence of the markets. If the interest rates at which these countries are financed in 2012 remain at their average levels for the last quarter of 2011, Spain would borrow at 5% and Italy at 4.3%. France and Germany, however, would continue to benefit from low interest rates (1.5% and 0.9% respectively). The issue rates in December 2011 for these two countries have up to now been little affected by the threats to downgrade the sovereign debt of the euro zone countries. Even though the financing need from the markets was greater in 2012 for the United Kingdom, the United States and Japan than for the euro zone, their rates have remained low. Paradoxically, the downgrading of the US sovereign rating in August 2011 was accompanied by a decrease in 10-year rates and short-term rates in the United States. Within this context of a flight to safety, the programs of massive purchases of government securities on the secondary market that were implemented by the Federal Reserve (FED), the Bank of England (BoE) and the Bank of Japan have been keeping public long-term rates low. Monetary policy is also affecting short-term interest rates as well as long-term rates. The role of lender of last resort being adopted by these central banks is thus reassuring the markets and avoiding higher interest rates during Treasury auctions. In contrast, the ECB's mandate and the strict supervision of Europe's legal scaffolding limit ECB action. The relatively low amounts of government bonds purchased since 2010 (2.3% of euro zone GDP compared with 11% of US GDP for the Fed and 13% of UK GDP for the BoE) and tension between euro zone countries concerning the role of the

central bank is fueling demands by investors to protect their risks by raising premiums.

To stop the collapse of European sovereign debt, we must rule out any possibility of a sovereign default, public interest rates must be reduced to the maximum by all means possible, and a European strategy for stabilizing the public debt needs to be implemented, first by dealing with under-employment, thereby renewing growth, followed by an adjustment of public finances.

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## Post-Durban: For a Sino-European axis

By [Eloi Laurent](#)

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

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

influence and leadership will spur the ambitions of other countries too.

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

For France, this means achieving its climate targets (the division of its emissions by four by 2050, called the “factor 4” approach) by introducing a price signal to contain emissions from diffuse greenhouse gas emissions (*i.e.* from housing and transport) that are not included in the European carbon market. To be clear, it will be necessary to introduce a carbon tax that spells out how it will be integrated into the French tax system. [A recent study by the OFCE](#) shows that this may well generate a dual dividend, both social and environmental. The [Perthuis report](#) is quite clear on this point: with the support of a price signal, the French climate transition will generate jobs. This transition should not, however, neglect issues of social justice, starting with the urgent problem of fuel poverty.

The European Union must also speed up the reform of its carbon markets, whose price signal is now almost inoperative (a tonne of CO<sub>2</sub> has fallen to 7 euros). These markets could be significantly affected by the outcome of the Durban conference, as was the case after the summit in Copenhagen. Various options exist, such as to establish a Europe-wide central carbon bank.

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

There are, ultimately, three fundamental reasons why the EU

needs to confirm and reinforce its climate goals at Durban and especially “post-Durban”:

1. The first concerns the human security of Europeans: the EU needs to reduce its emissions of greenhouse gases because, as is shown by a recent report by the IPCC, these are at the origin of the proliferation of extreme weather events on our planet, and this will be even more the case in the future. The European Union has experienced nearly 350 of these events during the Noughties alone, almost four times more than in the 1980s. The heat wave of summer 2003, alone, cost the lives of 70,000 Europeans.
2. The second reason relates to the economic prosperity of Europeans. The EU needs to strengthen its comparative environmental advantage and free itself as soon as possible from the fossil fuel trap. Europe's dependence on carbon has only increased over the past two decades. The rate of energy dependence of the EU member countries rose by an average of about 10 percentage points over the last fifteen years, to 53% in 2007, including 82% for oil and 60% for natural gas, which between them account for 60% of all energy consumed in the EU. Conversely, the short-term economic cost (not including the longer-term benefits) of switching from a 20% target for the reduction of emissions to a 30% reduction by 2020 is minimal, on the order of about 0.6% of the EU's GDP per year (estimated by the European Commission).
3. The third reason, and perhaps the most fundamental, concerns the need today for the political cohesion of the European Union. What is necessary now is nothing less than rebuilding the European Union, which has been devastated economically and politically by the global crisis. The prospect of the coordinated economic depression currently being proposed to European citizens



by their governments will signal the breakup of the euro zone but also in turn, it can be feared, a halt to the construction of Europe and even its unraveling. The ecological transition may indeed “save the climate”, but it can also save Europe by giving it a future once again.

The best hope for what is already being called “post-Durban” may well lie in the establishment of a Sino-European axis on the climate: China is becoming aware that its impact on climate change is matched only by the impact of climate change on it (the world’s largest emitter, it will in turn be the first victim of its emissions). As a result of the desertion by the US, Europe can confirm its role as global leader on the climate.

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

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## **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.

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# 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<sup>[1]</sup>. 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.

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[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](#)".