The ECB is still worried about the weakness of inflation

By Christophe Blot, Jérôme Creel and Paul Hubert

The President of the European Central Bank, Mario Draghi, recently announced that the increase in the ECB's key interest rate would come "well past" the end of the massive purchases of bonds (scheduled for September 2018), mainly issued by the euro zone countries, and at a "measured pace". The increase in the key rate could therefore occur in mid-2019, a few weeks before the transfer of power between Mario Draghi and his successor.

In his quarterly hearing with MEPs, Mario Draghi proved to be cautious about the intensity and sustainability of the economic recovery [1]. Listening to him, the euro zone has not necessarily closed its output gap (actual GDP would have remained below its potential) despite the recovery in recent quarters. This is not the time to change the direction of monetary policy at the risk of weakening the recovery. It is also undeniable that the effects of the recovery are only materializing slowly and gradually in wage increases, which partly explains why the euro zone inflation rate remains below its mid-term target.

The ECB President has also been confident that companies are gradually anchoring their price (and wage) expectations on the ECB's inflation target of 2% per year. Mario Draghi also appeared very confident in the effectiveness of monetary policy. He announced that the measures undertaken since 2014 would contribute to a (cumulative) increase of 2 percentage points, respectively in real growth and inflation between 2016 and 2019.

If the ECB's forecast of inflation back to its target in 2019 is contradicted by Hasenzagl et al. (2018), we find these same determinants of European inflation. In a recent study, we also show that the two main determinants of inflation in the euro area are inflation expectations and wage growth. Without anchoring the former on the medium-term target of the ECB and without a second-round effect of monetary policy on wages, inflation will not return to its target in the short term. Structural reforms may have increased potential GDP, as argued by Mario Draghi, but they have so far more certainly weighed on wage and price developments.

[1] Once a quarter, a monetary dialogue is organized between the President of the ECB and the members of the Monetary Affairs Committee of the European Parliament. This dialogue allows the President of the ECB to explain the direction of monetary policy in the euro area and to express his point of view on topics defined upstream. Une fois par trimestre un dialogue monétaire est organisé entre le Président de la BCE et les membres de la Commission des Affaires monétaires du Parlement européen. Ce dialogue permet au Président de la BCE d'expliquer l'orientation de la politique monétaire dans la zone euro et d'exprimer son point de vue sur des sujets définis en amont.

Missing deflation – unique to

America?

By Paul Hubert, Mathilde Le Moigne

Was the way inflation unfolded after the 2007-2009 crisis atypical? According to Paul Krugman: “If inflation [note: in the United States] had responded to the Great Recession and aftermath in the same way it did in previous big slumps, we would be deep in deflation by now; we aren’t.” Indeed, after 2009, inflation in the United States remained surprisingly stable given actual economic developments. Has this phenomenon, which has been described as “missing deflation”, been observed in the euro zone?

Despite the deepest recession since the 1929 crisis, the inflation rate remained stable at around 1.5% on average between 2008 and 2011 in the United States, and 1% in the euro zone. Does this mean that the Phillips curve, which links inflation to real activity, has lost its empirical validity? In a note in 2016, Olivier Blanchard recalls on the contrary that the Phillips curve, in its simplest original version, remains a valid instrument for understanding the links between inflation and unemployment, despite this “missing disinflation”. Blanchard notes, however, that the link between the two variables has weakened because inflation is increasingly dependent on expectations of inflation, which are themselves anchored in the US Federal Reserve’s inflation target. In their 2015 article, Coibion and Gorodnichenko explain the missing deflation in the United States by the fact that inflation expectations tend to be influenced by the most visible price changes, such as changes in the price of a barrel of oil. Since 2015, we have seen a drop in inflation expectations concomitant with the decline in oil prices.

The difficulty in accounting for recent changes in inflation by using the Phillips curve led us in a recent article to evaluate its potential determinants and to consider whether the euro zone has also experienced a phenomenon of "missing deflation". Based on a standard Phillips curve, we did not find the conclusions of Coibion and Gorodnichenko when we consider the euro zone as a whole. In other words, real activity and inflation expectations give a good description of the way inflation is behaving.

This result seems to come, however, from a bias in aggregation between national inflation behaviours in the euro zone. In particular, we find a notable divergence between the countries of northern Europe (Germany, France), which show a general tendency towards *missing inflation*, and the more peripheral countries (Spain, Italy, Greece), which are exhibiting periods of *missing deflation*. This divergence nevertheless shows up from the *beginning* of our sample, that is to say, in the first years when the euro zone was created, and seems to be absorbed from 2006, without undergoing any notable change during the 2008-2009 crisis.

In contrast to what happened in the United States, it seems that the euro zone did not experience missing deflation as a result of the 2008-2009 economic and financial crisis. On the contrary, it seems that divergences in inflation in Europe predate the crisis and tended to be absorbed by the crisis.

How can Europe be saved? How can the paradigm be changed?

By Xavier Ragot

There are new inflections in the debate over the construction

of Europe. New options from a variety of economic and political perspectives have seen the light of day in several key conferences and workshops, though without the visibility of public statements. The debate is livelier in Germany than in France. This is due probably to the caricature of a debate that took place during France's presidential elections, which took the form of "for or against the single currency", while the debate needed was over how to orient the euro area's institutions to serve growth and deal with inequalities.
Two conferences were held in Berlin one week apart that considered opposing options. The first tackled the consequences of a country leaving the euro area; the second examined an alternative paradigm for reducing inequalities in Europe. In other words, the two conferences covered almost the entire spectrum of conceivable economic policies.

Sowing fear: the end of the euro area?

The first question: What would happen if one or more countries left the euro area? Should we hope for this, or how could we prevent it? A conference held on March 14 under the title "Is the euro sustainable – and what if it isn't?" brought together the heads of influential institutes like Clemens Fuest, one of the five German "wise men", Christoph Schmidt, and economists frequently seen in the German media like Hans-Werner Sinn, as well as economists like Jeromin Zettelmeyer. The presence of the OFCE, which I represented, hopefully helped to serve as a reminder of some simple but useful points.

This first conference sometimes played with the ambiguity of the issue, with some contributions seeming to wish for an end to the euro area while others were more analytical in order to show the risks. The voice of Hans-Werner Sinn stood out during this discussion for its radical stance. Without going so far as to wish that Germany left the euro area, Sinn insisted in a systematic (and skewed) way that Germany was suffering under Europe's monetary policy. He insisted in particular on the role of Germany's hidden exposure to the debt of other countries through the European Central Bank and TARGET2, which books the surpluses and deficits of the national central banks vis-à-vis the ECB. The TARGET2 balance shows that the southern European countries are running a deficit, while Germany has a substantial surplus of almost 900 billion euros, which represents 30% of German GDP. These amounts are very significant, but do not in any way represent a cost for Germany.

In the most extreme case of a national central bank's failure to pay (i.e. an exit from the euro area), the loss would be shared by all the other states independently of the surpluses. The TARGET2 balances are part of Europe's monetary policy, which is aimed at achieving a goal that was agreed on: an average inflation level of 2%. This target has not been hit for many years. Moreover, this policy has led to low interest rates that benefit Germans who pay low interest charges on their public debt, as Jeromin Zettlemeyer pointed out. Finally, Germany's large trade surplus shows that the lack of an exchange rate mechanism in the euro area has benefited Germany significantly. Recall that the volume of Germany's exports exceeded China's in 2016, according to the German institute Ifo!

My presentation was based on the OFCE's numerous studies of the European crisis. The OFCE has published an analytical note on the effects of an exit from the euro area, showing all the related costs. The studies by Durand and Villemot provide the analytical basis for providing orders of magnitude. How much would Germans' wealth decline if the euro area were to collapse? The result is, in the end, not very surprising. The Germans would be the greatest losers, with a loss of wealth on the order of 15% of GDP. These figures are of course very tentative and need to be interpreted with the utmost care. The collapse of the euro area would plunge us into unexplored territory, which could surprise us with unexpected sources of instability.

After these preliminary elements, the heart of my presentation was then focused on a simple point. The real challenge facing us is to build coherent labor markets within the euro area, while reducing inequalities. Following on the common monetary policy, the coordination of fiscal policy that was carried out so painfully after 2014 and the aberrations associated with the recessionary fiscal policy (austerity), the main question facing Europe over the next ten years is to develop coherent labor markets. Indeed, Germany's wage moderation, the result of the difficulties with reunification in the early 1990s, has been a powerful destabilizing force in Europe, as was shown in an article by Mathilde Le Moigne. What is called the supply problem in France is in fact the result of divergences within Europe on the labor market in the wake of Germany's wage moderation. I proposed that the European Parliament initiate a Europe-wide discussion of national wage dynamics in order to bring about the convergence of wages in a non-deflationary way while avoiding high unemployment in southern Europe. This co-ordination of economic policy on the labor market is designated by the English term "wage stance". Co-ordination of changes in minimum wages and in regulated wages, which orients the direction of wage changes in labour negotiations, are tools for the co-ordination of labor markets.

A second tool is of course the establishment of a European system of unemployment insurance, which would be much less complex than one might think. A European unemployment insurance would aim to be complementary to national unemployment insurance, and not a replacement. National unemployment insurance systems are actually heterogeneous because, on the one hand, the labour markets are distinct, and on the other hand national preferences differ. Unemployment insurance systems are for the most part the result of historical social compromises.

How should this relatively radical German stance against Europe be interpreted today? Perhaps it represents the discontent of economists who are losing influence in Germany. It might seem paradoxical, but many German economists and observers are adjusting to recognize the necessity of building a different Europe, one not based on rules, but leaving room for political choices within strong institutions – i.e. for agile, well respected institutions rather than rules. This position is associated with France in the European debate: choices rather than rules. The German coalition agreement that paved the way for an SPD/CDU government has placed the issue of Europe at the center of the agreement, but with a great deal of vagueness about the content. Certain developments will test the relevance of this hypothesis, in particular the issue of a euro area minister and the nature of the decision-making rules within the key crisis-resolution mechanism, the European stability mechanism.

Europe: Changing the software / model / paradigm / narrative

A second, more confidential conference proved to be even more exciting, with the presence of the European Climate Foundation on the climate issue, the INET institute on developments in economic thought, and the OFCE on European imbalances. The aim of the conference was to reflect on a shift in the paradigm, or narrative, and come up with a new articulation between politics and economics, the state and the market, in order to think sustainable growth in terms of both the climate and society. A narrative is a vision of the world conveyed by simple language. Thus the "neoliberal" narrative is built on positive words like "competition", "markets" and "freedom" as well as negative words like "profit", "interventionism" and "egalitarianism", which allowed the creation of a language. Donald Trump produces an equally effective narrative: "giving power back to the people", "America first"; this narrative marks the return of politics to a mode that assumes an underlying nationalism.
How could another narrative be built that has a central focus on the evidence for the fight against global warming and the

aggravation of inequality and financial instability?

For one day economists who are renowned in Europe spoke about artificial intelligence, global warming, current forms of economic and industrial policies, the dynamics of credit and financial bubbles, and more. Empirical work at the forefront of current research as well as reflections about the possibility of a coherent storyline were combined in the promise of an alternative narrative. It was just the start. The possibility of a renewal of thought that transcended political divisions and spoke about what was essential came to light: how could the economy be placed at the service of a political project that aims not to rebuild borders to exclude but to imagine our common humanity?

These two conferences show the vitality of the European debate, which is presented from an overly technical perspective in France. The *raison d’être* of the euro is a common project. It is at this level that we need to conduct the discussion leading into the 2019 European elections.