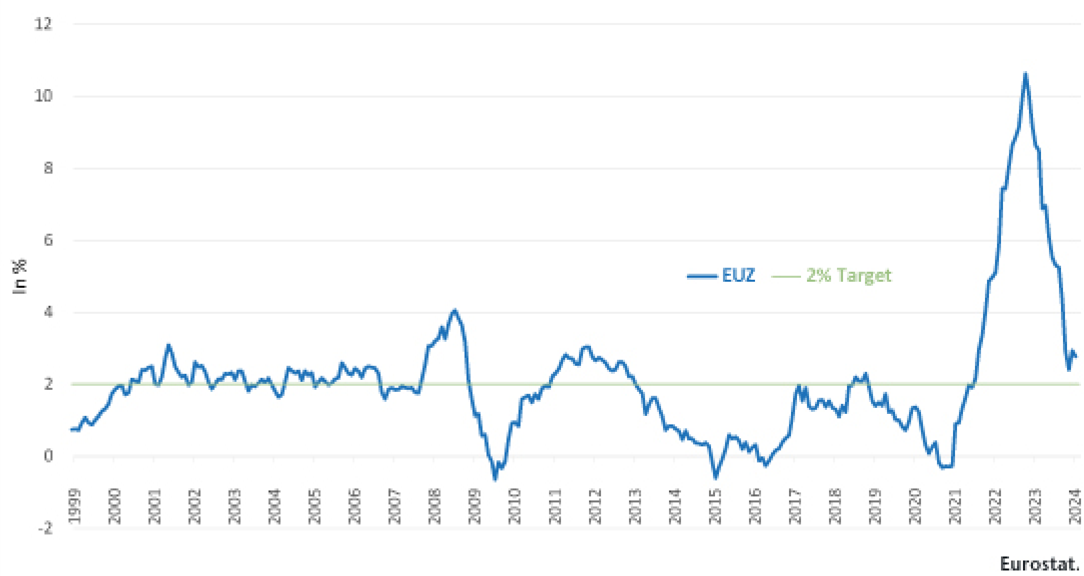
Should the ECB Revise its inflation target?

Christophe Blot and Francesco Saraceno

The inflation rate in the Eurozone continues to decline. In February, it dropped to 2.6%, more than two percentage points lower than the August figure (See Figure). The inflation rate is still above the ECB 2% inflation target despite the monetary policy tightening implemented since Summer 2022. Since then, the deposit facility rate has increased from -0,5 % to 4 %. Over the past year, the reduction in inflation has been largely due to the disappearance of the factors that had fueled the inflationary spike in the first place (bottlenecks, energy, post-pandemic recovery), which no longer have a significant impact today. There is indeed a broad consensus among economists that monetary policies take several quarters to influence demand, growth, and price dynamics[1]. Therefore, the tightening started to be felt only in 2023, and the peak is still to be reached. Rising interest rates are starting to weigh on consumption, investment, and public spending, contributing to the decline in inflation through a cooling of aggregate demand. It may be noticed that the current situation contrasts with the pre-Covid period where inflation remained below the target for a sustained period despite the expansionary measures – and notably unconventional ones – introduced by the ECB. Such difficulty in reaching the inflation target raises the issue of the appropriate numerical value for the target. Is the current 2% figure too high or too low?

Figure. Eurozone inflation rate and ECB target



According to the latest forecasts of the Eurosystem staff, inflation would still remain above the 2% target in 2024 (2.7%) and would not be in line with the target before 2025 The slow convergence to the target and the economic slowdown would lead the ECB to stop tightening monetary policy but no interest rate cuts have been contemplated so far (even if markets expect one in the next few months)[2]. Nevertheless, in spite of the high uncertainty surrounding economic activity and inflation, the overall consensus of forecasters is that the inflation episode is largely behind us. Therefore, it is time to start drawing lessons not only from the recent increase in prices but also from the previous long period, between the Global Financial Crisis of 2008 and 2019 when the ECB faced the opposite problem, unsuccessfully trying to raise an inflation rate that remained stubbornly close to deflation.

A meaningful discussion on the central banks' objectives would have been unwarranted while inflation was not under control. They would have been accused of shifting the goalposts. However, once their credibility is preserved by demonstrating that they have been able whatever it takes to bring inflation back to close to 2%, central banks should take stock of the recent experiences with inflation and with deflation and proceed with a review of their objectives.

Drawing lessons from multiple crises

Some economists, including Nobel laureate Paul Krugman and former IMF Chief Economist Olivier Blanchard, argue that the central banks of advanced economies should reconsider the inflation target, raising it from 2% to 3%[3]. It is worth noting that the 2% inflation target, introduced in New Zealand in 1980 and subsequently adopted by nearly all major central banks (and notably the Federal Reserve, the Bank of England and the Bank of Japan), has no particular basis; it was simply believed, when adopted, to be low enough to reassure the markets about price stability and minimize the economic cost of inflation, while allowing for some margin for adjustment: in the event of negative shocks, inflation could fall without going into negative territory and triggering dangerous deflationary spirals.

There are essentially two arguments in favor of increasing the desired inflation target. The first is contingent: while inflation has dropped relatively painlessly from double-digit levels a year ago to values close to the target today, bringing it from the current level to 2% may prove much more difficult. We could remain stuck with inflation rates fluctuating between 2% and 3%, or even slightly higher. These levels do not create significant instability problems (in terms of de-anchoring expectations, for example), so it may not be worth paying the price in terms of growth and unemployment of forcing inflation to return to 2%.

The second reason for a revision of the desired inflation rate is more structural. The 2% target may have seemed reasonable during the long period of the Great Moderation when stable (though not stellar) GDP growth was accompanied by limited fluctuations in the inflation rate. However, that period of apparent macroeconomic stability concealed growing imbalances, such as a chronic tendency toward excess savings and, consequently, increasingly lower equilibrium (“neutral”) real interest rates[4].

Since 2008, we have entered a new phase where imbalances have come to light, and macroeconomic shocks have become more severe. In a context of greater instability, central banks may find themselves in need of significantly reducing interest rates. If these rates are initially moderate, the risk of hitting what economists call the effective lower bound (interest rates that cannot be lowered below zero or slightly negative values) increases. This is the situation in which the Fed and the ECB have found themselves for the whole decade of the 2010s, having to resort to unconventional policies such as asset purchases to stimulate the economy. A higher inflation target would allow for higher interest rates under normal conditions and more room to lower them when necessary. This additional margin could prove valuable in the likely event that the coming years bring increased macroeconomic and geopolitical instabilities. Andrade et al. (2021) for instance show that while a 1.4% inflation target was consistent with a pre-crisis estimation of the short-term interest rate that would prevail when the inflation rate is stable and the economy at full employment (r-star) of 2.8%, a one-point decrease of r-star should lead the central bank to revise upward its inflation target by 0.8 point[5]. According to the revised estimates of Holston, Laubach and Williams (2023), the current r-star in the Eurozone would be negative (-0.7%) entailing an optimal target at 2.8%.

Furthermore, structural factors such as the ecological transition could lead to structurally higher inflation rates in the coming years, e.g., due to higher costs associated with fossil fuels (notice though, that some argue instead that secular stagnation might not be over). Insisting on aiming for 2% inflation could require long periods of monetary tightening, hindering investment in renewables and paradoxically perpetuating the inflationary tensions related to the transition.

To these reasonable arguments in favor of a higher inflation target, those against revising it oppose equally reasonable ones. The most significant one is that, in a world like that of central banks, where credibility is everything, changing the inflation target in the process of bringing inflation down could be devastating, essentially a confession of impotence: shifting the goalposts during the game. Moreover, how credible can a central bank be that announces a 3% inflation target when, between 2008 and 2020, it was unable to move from 1% to 2%? Another argument, recently made by Martin Wolf concerning the UK, is that central banks have an implicit bias, being more reluctant to tighten when inflation increases than to loosen when it drops. This leads to an overall level of inflation somewhat higher than the target and makes calls for higher targets dangerous. This argument hardly seems to apply to the current situation. If anything, the experience of the 25 years of existence of the euro points to a deflationary bias.

The solution, therefore, seems to be only one. For this round of the merry-go-round, unfortunately, there is little to be done, and we must resign ourselves to paying the costs of central banks' ill-advised commitment to an inflation target of 2% through a monetary restriction, instead of resorting to a more multitool policy mix. Governments and fiscal policies should be prepared to mitigate these costs with income policies and fiscal redistribution to protect the most vulnerable economic agents.

Do central banks control inflation precisely?

This discussion should not overlook the question of the ability of the ECB to control inflation. The recent surge of inflation and the difficult task for central banks to bring it back to 2% echoes the already mentioned difficulties of the same central banks to increase inflation to 2% when it was persistently low during the last decade. Many have argued from the outset of the current inflationary episode that addressing inflation with monetary tightening was the wrong approach (here, or there); other, more targeted, microeconomic tools would have been more effective (among other things because monetary policy is characterized by long lags) and less painful for addressing a structural inflation resulting from sectoral imbalances rather than from generalized overheating. However, whether due to the inertia of governments, as usual happy to delegate unpopular decisions to the ECB, or to the old monetarist reflexes, which, although minoritarian in academia unfortunately remain influential in public debate ("inflation is always caused by too much money chasing too few goods"), central banks have been the main characters in the fight against inflation.

Said it differently, demand and supply, micro and macro elements interact, in determining an average inflation rate that has multiple causes. Inflation and deflation are complex phenomena that are better tackled with a plurality of instruments and monetary policy alone may not be powerful enough. This may have two implications. First, coordination of monetary and fiscal policies may help to better achieve the target. Second, if the central is not all-powerful in fighting a phenomenon that depends on other causes, it may be more reasonable not to target a point of inflation but a target zone.

Announcing a range is certainly more realistic as central banks cannot reach the 2% with complete precision. There are always many sources of uncertainty related to the effectiveness of monetary policy, its transmission delays, future shocks, the relation between activity and prices (the slope of the Phillips curve). Furthermore, the measure of inflation relies on some ad-hoc indicators and is inevitably subject to measurement errors, which may stem from the breakdown of quality and price effects, the inclusion of all the dimensions of the cost of life, which are not accounted for by a point target.

These uncertainties affect inflation and may eventually challenge the central bank’s credibility. Finally, a range would also provide the ECB with more leeway to handle tradeoffs between its objectives. Of course, a criticism against a target range is that it is less precise, which could undermine its credibility[6]. But the credibility argument can be used in the other direction. How credible is a central bank that systematically misses its very specific target?

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[1] See OFCE Blog for a brief review.

[2] In the press conference, following the 25 January Governing Council, Christine Lagarde stated that “it was premature to discuss rate cuts”.

[3] It is useful to remind that the 2% target for the inflation rate has been adopted by several of central banks and notably the Federal Reserve, the Bank of England and the Bank of Japan.

[4] See Chapter 2 from the April 2023 IMF World economic outlook.

[5] See Andrade, P., Galí, J., Le Bihan, H., & Matheron, J. (2021). Should the ECB adjust its strategy in the face of a lower r★?. *Journal of Economic Dynamics and Control*, 132, 104207.

[6] Ehrmann (2021) shows that inflation anchoring is not reduced in countries which have target zones but conversely that credibility is improved. See “Point targets, tolerance bands or target ranges? Inflation target types and the

anchoring of inflation expectations." *Journal of International Economics*, 132, 103514.

Where does the European Union stand?

By Robert Boyer, Director of Studies at EHESS and the Institut des Amériques

Speech at the "European Political Economy and European Democracy" seminar on June 23, 2023, at Sciences Po Paris, as part of the 'Théorie et Economie Politique de l'Europe' seminar, organized by Cevipof and OFCE.

The aim of the first study day of the Theory and Political Economy of Europe seminar is to collectively engage in a work of overall theoretical reflection, following on from the thematic sessions of 2022, by continuing the multidisciplinary spirit of the seminar. The aim is to begin outlining the contours of the two major blocks of European political economy and European democracy and to identify the points of articulation between them. And to prepare for multidisciplinary writing with several hands.

An apparent paradox

During the various and rich interventions pointing out the shortcomings, dilemmas, and contradictions that characterize the processes of European integration, a central question seems to emerge:

“How has a politico-economic regime in permanent disequilibrium, which has become very complex, been able, until now, to overcome a large number of crises, some of which threatened its very existence?”

A brief review of the current situation is enlightening and makes it more necessary to seek out the factors likely to explain this resilience, which never ceases to surprise researchers and specialists, foremost among them many economists. In the face of a succession and accumulation of poly-crises and rising uncertainties, is it reasonable to anticipate that the European Union (EU) will continue its current course, protected by the mobilization of the processes that have ensured its survival, not least thanks to the responsiveness demonstrated by both the European Central Bank (ECB) and the European Commission since 2011?

Baroque architecture full of inconsistencies

The various speakers highlighted many of them:

- The European Parliament is a curiosity: it is an assembly with no fiscal powers. Would giving it this power be enough to restore the image of democracy on a European scale?
- The EU issues a common debt even though it has no direct power of taxation: isn’t this a call for an embryonic federal state? Is there a political consensus on this path?
- This debt corresponds to the financing of the Next Generation EU plan, which recognizes the need for solidarity with the most fragile countries, in response to a common “shock” that does not lend itself to the moral hazard so feared by the frugal countries of the North. Yet it is the result of an ambiguous compromise, with two opposing interpretations: an exception that must not be repeated for the North, and a founding, Hamiltonian moment for the South.

- It is not very functional or democratic for the European Parliament to vote on Community expenditure, but for national parliaments to vote on revenue.
- Does it make sense to have a multiannual program adopted by an outgoing assembly of the European Parliament, which will then be binding on the next one?
- The ceiling set for the European budget limits the financing of European public goods, which should compensate for and go beyond the limitation on the supply of national public goods in the application of the criteria governing national public deficits and debts.
- At the European level, the quest for more democracy tends to focus on the question of political control over the Commission and the ECB, whereas social democracy has in the past been a critical component in the legitimacy of governments at the national level.
- The same applies to the question of corporate governance in Europe, a forgotten issue on the European agenda that is regaining a certain interest in the face of the transformations brought about by digital technology and the environment.
- Competition policy is often perceived by economists as one of the Commission’s key instruments since it is an integral part of the construction of the single market. Yet legal analysis shows that competition is not a categorical imperative, defined finally, but a functional concept that evolves over time. So much so, that the Commission can declare that today it is at the service of the environment.
- The Commission is usually criticized for its role as a defender of the acquis, its taste for excessive regulation, its technocratic approach, and its inertia. And yet, since 2011, it has continued to innovate in response to successive crises, to the point of having relaunched European integration.
- The ECB was founded as the embodiment of an independent,

typically conservative central bank, with a monetarist conception of inflation. And yet, without changing European treaties, the ECB has been able to innovate and effectively defend the Euro.

- The EU Court of Justice and national constitutional courts do not have the same interests and legal conceptions, but so far, no head-on conflict has produced a blockage in European integration. Is this sustainable?
- Is the distribution of competencies, fixed by the treaties and de facto adjusted as problems and crises arise, satisfactory and up to the challenges of the industry, the environment, public health, and solidarity in a dangerous and uncertain international environment?
- The "European Constitution" is not a constitution, because integration has proceeded via a series of international treaties. How can we explain the fact that these treaties have been imposed when member countries could have coordinated through the OECD, EFTA, the IMF, or ad hoc agreements (European Space Agency, Airbus, Schengen) with no overall architecture?

Reasons for surprising resilience

We need to identify the factors that can account for the perseverance that lies at the heart of continental integration and ask ourselves whether they are sufficiently powerful to overcome the current multi-crises.

- From the outset, the project was a political one, aimed at halting Europe's decline in the wake of the two world wars. But in the absence of political agreement on a common defense, the coordination of economic reconstruction was seen as a means to this end. In this respect, Russia's invasion of Ukraine has strengthened ties between governments, even if it means inverting the hierarchy between geopolitics and economics and bringing back to the forefront the possibility of Europe as a power.

- Conflicts of interest between nation-states are at the root of a succession of crises, which are overcome by ad hoc compromises that never cease to create further imbalances and inconsistencies, which in turn lead to another crisis. In a way, the perception of incoherence and incompleteness is a recurring feature of European construction. However, the configuration can become so complex and difficult to understand that it can overwhelm the inventiveness of the collectives that are the various EU entities and their ability to coordinate. By way of example, a genuine EU macroeconomic theory has yet to be invented, and this is a major obstacle to the progress of integration.
- European time is not homogeneous. Periods when new procedures are put in place after a breakthrough give the impression of bureaucratic, technocratic management at a distance from what citizens are experiencing. By contrast, open crises forbid the status quo, as the very existence of institutional construction is at stake, with the stratification of a large number of projects and their incorporation into European law. This experience of trial and error is the breeding ground that enables the Commission, for example, to devise solutions to emerging problems. As a result, the equivalent of an organic intellectual seems to have emerged from this collective learning over an extended period. This is one interpretation of the paradoxes mentioned above.
- European Councils, the Court of Justice, the ECB, and the European Parliament all play their part in this movement, but it is undoubtedly the European Commission that in a sense represents the European, if not the general, interest. The fact that it has the power to initiate regulations and manage procedures gives it an advantage over other bodies. Indeed, many governments would be satisfied with inter-state negotiations, with

no common ground to build on, and would go it alone. Failure to find a compromise solution would mean the simple disappearance of the EU. Similarly, without the "whatever it takes" approach, the ECB would have disappeared with the Euro. The major crises offer a strong incentive to move beyond dogmatic posturing in favor of a re-hierarchization of objectives and the invention of new instruments.

- Finally, there are two sides to the proliferation of regulations, procedures, and European agencies attached to the Commission. On the one hand, they give rise to the diagnosis of poorly controlled management and the harsh judgments of defenders of national sovereignty. On the other hand, they are also factors in the reduction of uncertainty and the creation of regularities that coordinate expectations in a context where financial logic generates bubbles and macroeconomic instability.
  In a way, a certain redundancy in a myriad of interventions is a guarantee of resilience. The European Stability Mechanism (ESM), for example, was a way of circumventing the ECB's delay in recognizing the need for vigorous intervention. So the complexity of the EU can also mean redundancy and resilience.
- Political power plays a crucial role in the development of European institutions. It intervenes in the framework of councils and summits. So far, in the national political arena, governments favoring further integration have prevailed: this is sometimes one of the only markers of their policy that survives the various periods. As a result, a collapse of the EU could mean the loss of their credibility. It would be dramatic for a government to be held responsible for the failure of a project that has been built up over decades. This is perhaps a hidden source of the permanence of European institutions. What is more, "Brexit" far from marking the end of the EU has rather closed ranks, especially as the expected benefits for the UK have not manifested

themselves. Beware, however, that the polarization and division of societies between the winners and losers of trans nationalization has favored the breakthrough of parties defending strong national sovereignty, i.e. a countertrend that forbids prolonging the hypothesis of a lasting hegemony of pro-European parties.

- Finally, the succession of financial crises, the return of pandemics, the harshness of the confrontation – not only economic – between the United States and China, the growing awareness of the environmental emergency, and the installation of a new inflation generated by recurring scarcities, which risks being aggravated by the transition to a war economy, are all factors in a dual awareness. On the one hand, common interests tend to outweigh disagreements between member countries. On the other hand, each of them carries little weight in the confrontation with the United States, which has become openly protectionist, and China, with its dynamism in emerging productive paradigms. The EU needs to be a geo-economic and political player in its own right. This explains the Commission's activism since Covid-19. Citizens have benefited from this new impetus, with a common strategy on vaccines, for example. For their part, the governments of the most fragile economies have benefited from European solidarity, which has counterbalanced the principle of regional competition.

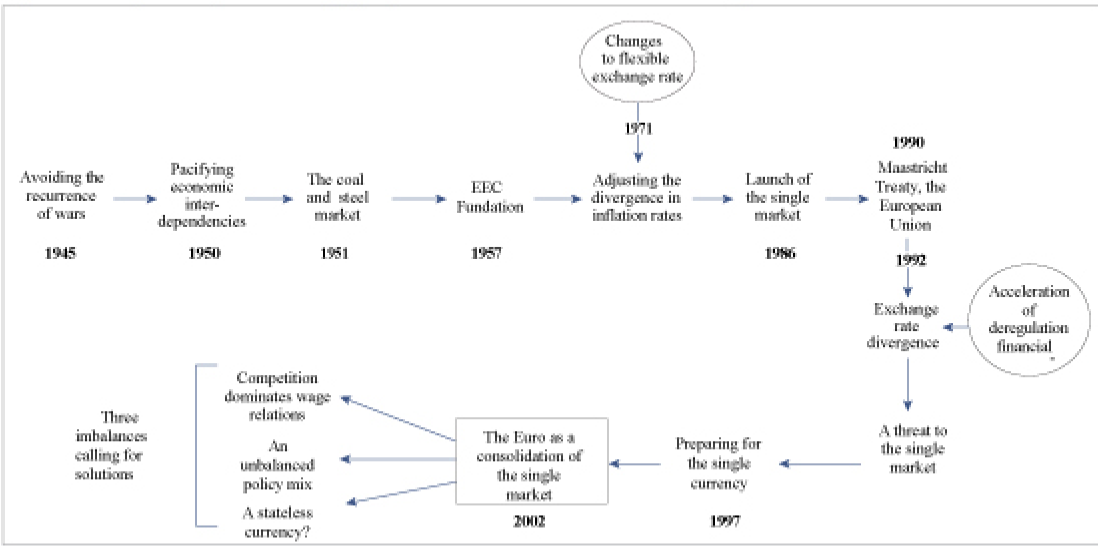
Historical bifurcation, polycentric governance, or nationalist withdrawal?

The processes described above can recombine to form a wide variety of trajectories. Prediction is not possible, as it is the strategic interactions between collective actors that will determine how to overcome the EU's various crises. It is possible to imagine three more or less coherent scenarios.

- *Towards an original federalism disguised by a myriad of* *technical coordination procedures*

This first scenario is based on three central assumptions. Firstly, it marks the end of reliance on neo-functionalism, whereby governments must be the servants of the necessities imposed by economic interdependence between nation-states (figure 1). The sphere of politics pursues its objectives, even if governments must contend with economic logic. Secondly, it draws the consequences of technological, geopolitical, health, and environmental transformations that threaten the stability of societies and the viability of their socio-economic regimes. Pooling resources increases the chances of success for all participants in European programs. Finally, this first scenario extends the trends already observed since the outbreak of the pandemic.

Figure 1: **Building the European market step by step: the virtues and limits of the functionalist approach 1945-2002**



As far as the word federalism has a repulsive effect on public opinion, which is influenced by populist nationalism, the practice of enhanced cooperation does not have to be accompanied by an appeal to the federalist ideal. Instead, skillful rhetoric must convince citizens that the EU ensures their protection and opens new common goods. These advances in no way subtract from the social, economic, and political rights guaranteed at the national level. Charismatic politicians must be able to resist anti-EU rhetoric that feeds on the relative powerlessness of national authorities overwhelmed by transnational forces beyond their control.

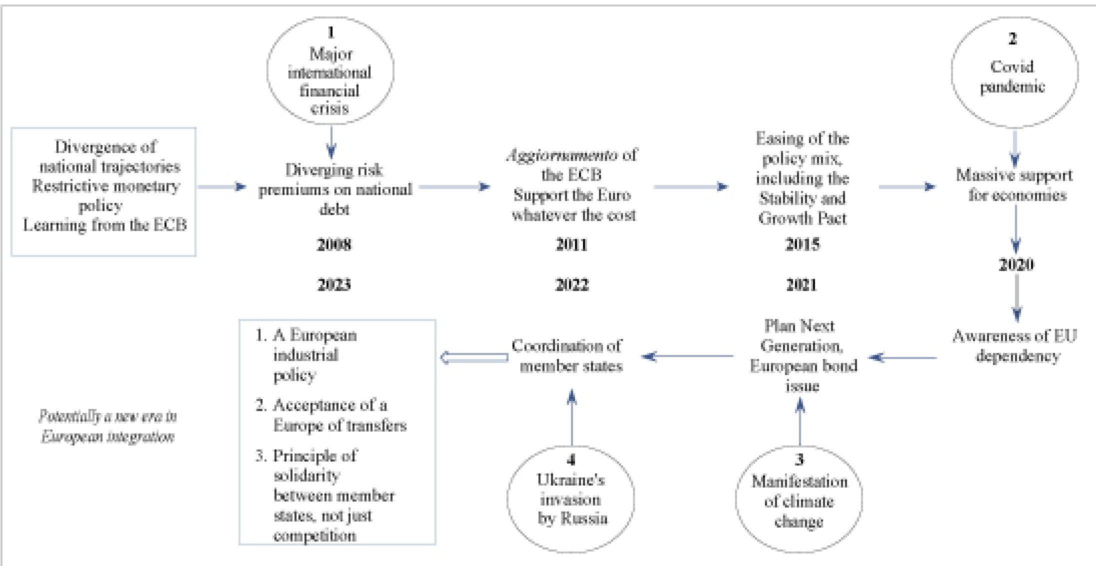
- *Adapting polycentric governance at the margins, far from a Europe of power*

This second scenario, on the other hand, assumes that the current period will be one of continuity with the long-term trajectory of European integration. The polycentrism of EU entities is a vector of pragmatic adaptability to emerging issues, without the need to centralize power in Brussels, as suggested by the diversity of European agency locations. Trial and error, the multiplication of ad hoc procedures, and the possible use of enhanced cooperation on issues involving a fraction of member countries are all sources of adaptation in the face of the repetition of events potentially unfavorable to the EU.

This considers the fact that negotiating new European treaties seems a perilous mission, that public opinion judges the EU on the basis of its contribution to the well-being of its populations rather than the transparency and coherence of its governance, and that an imperial conception is illusory. One might be tempted to invoke a form of catallaxy applied not to the economy and the market, but to the political sphere: the interaction of highly varied processes, without central authority, eventually leads to a roughly and provisionally viable configuration. The English expression “muddling through” aptly captures this pragmatism, marked by the renunciation by public decision-makers of the need to spell out an objective and a goal, if only to persevere in being.

Success is not guaranteed. Firstly, past successes are no guarantee of their continuation into the future. Secondly, there is no guarantee that a pragmatic solution will be found in the face of an avalanche of unfavorable events since the affirmation of an objective may prove to be a necessary condition for lifting the prevailing uncertainty as to the outcome of both institutional and economic crises. Last but not least, how can we politically legitimize an order whose logic and nature elude decision-makers? Isn’t this powerlessness the breeding ground for populist voluntarism?

Figure 2. **Transformations in the global economy affect all countries and stimulate unprecedented institutional advances (2008-2023)**



- *National and European elections: a nationalist majority redesigns a different Europe*

This third scenario is based on an analysis of changes in the objectives of government following recent elections in Europe. Both in the South (Italy) and in the Scandinavian countries (Finland, Sweden, Denmark), coalitions have come to power dominated by parties opposed to immigration, defenders of national identity, and, in short, reluctant to delegate new powers to the EU. In this, they join the authoritarian, nationalist governments of Central Europe (Hungary, Poland). In the European Parliament elections of 2024, could this movement result in the loss of a majority in favor of the EU's current policies, to the benefit of a new majority bringing together nationalist parties that are very diverse, but share the same obsession: to block the extension of EU competences and repatriate as many of them as possible to the national level?

Russia's war against Ukraine has brought the imperative of defense to the fore, an area in which the EU has made little progress. Does not this mean that NATO is becoming central to the political organization of the old continent, to the detriment of the economic objectives pursued by European integration?

These hypotheses, derived from the 23 June 2023 CEVIPOF and OFCE meeting? call for a follow-up, as the questions to be clarified are so many and quite difficult indeed. Cross-disciplinary analysis is more necessary than ever.

Will the US labour market withstand monetary tightening?

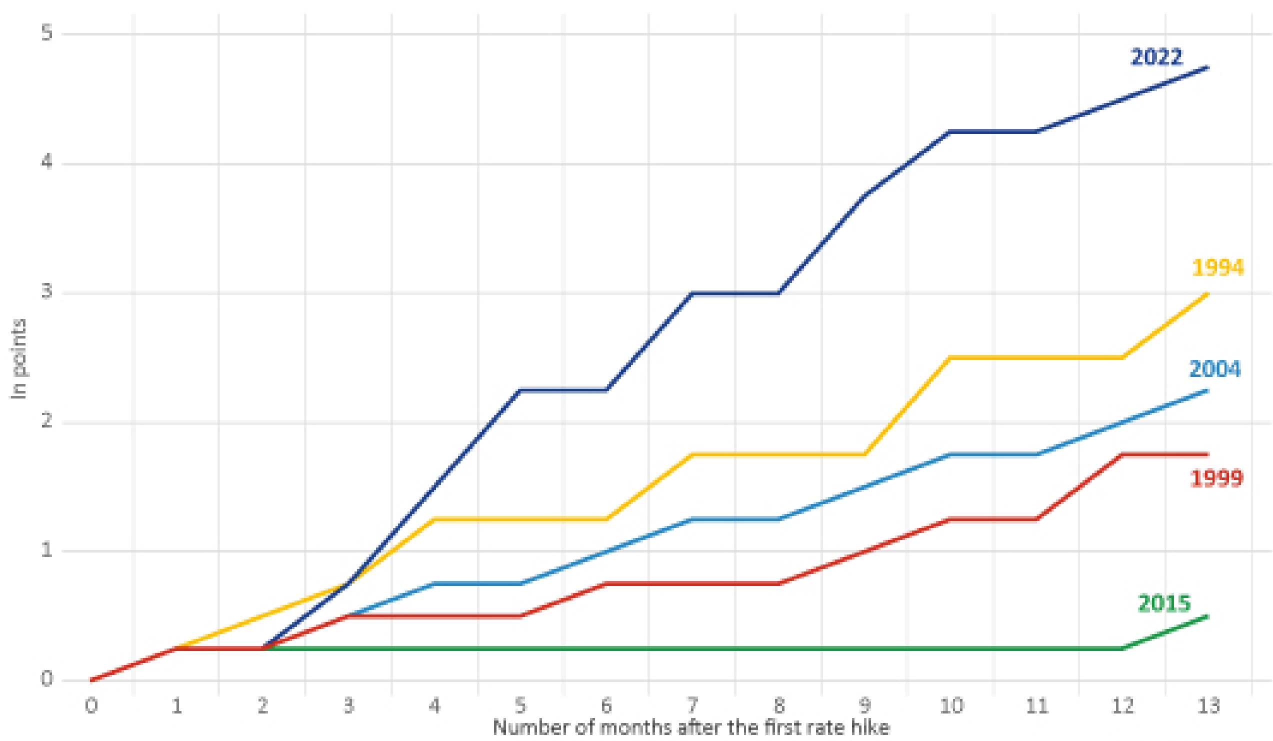
By **Christophe Blot**

In March 2022, the US central bank began tightening monetary policy in response to rapidly rising inflation. Since then, the target rate for monetary policy has been increased at each meeting of the Federal Open Market Committee (FOMC), and now stands at 5%. The aim of these decisions is to bring inflation back towards the Federal Reserve’s 2% target. After peaking in the summer of 2022, inflation has fallen in line with the fall in energy prices. Thus far, economic activity has been resilient, and the unemployment rate has remained stable despite the tighter monetary and financial conditions. Will inflation continue to fall, and, more importantly, can it converge on the target without pushing up unemployment?

Inflation under control?

The Federal Reserve had been cautious throughout 2021, under the view that the increase in prices would be transitory. It was not until March 2022 that it began tightening, just over a year after inflation began to rise above the 2% target, when it had reached 6.8%[1]. The rise in prices has in fact proved to be more prolonged than FOMC members had anticipated and has spread to all components of the index. Finally, the central bank also feared the risk of a disconnection in inflation expectations, which would have sustained an inflationary spiral. Once it began to act, rate hikes occurred in rapid succession, with the target rate for federal funds rising from 0.25% to 5% in one year, i.e. a much faster pace of tightening than that observed in previous cycles (**Figure 1**), and in particular during the course of 2015, when the Federal Reserve had raised rates only twice in one year, and each time by only 0.25 points.

Figure 1. **The tightening of monetary policy in 2022 compared with precedents**



Source: Federal Reserve.

Inflation peaked just a few months after the tightening started. From 7% year-on-year in June 2022, it gradually fell to 5% in February 2023. However, this decline was not due to the Federal Reserve, but mainly reflected changes in the energy component, which is itself directly linked to the fall in oil prices and, to a lesser extent, in the price of American gas[2]. In February 2023, the energy component of the consumption deflator fell by 0.9% year-on-year, whereas it had risen by 60.8% in June 2022. Although the food price index remains dynamic, its rise is also stalling.

Looking beyond the energy factor, is the decline in inflation sustainable? Assuming that oil and gas prices remain stable, the contribution of energy prices will indeed push US inflation down further in coming months. However, the end of the inflationary episode will depend mainly on trends in core inflation, which of course includes a diffusion effect of energy prices but whose dynamics depend mainly on supply and demand factors[3].

Is a rise in unemployment inevitable?

Excluding energy and food prices, so-called core inflation also shows signs of slowing down. In February 2023, it rose by 4.6% year-on-year, compared with 5.2% in September 2022. This dynamic can be explained in part by the evolution of durable goods prices, which were hit during 2022 by supply difficulties[4]. The indicator measuring the pressure on production lines has fallen sharply and, since the beginning of 2023, has returned below its long-term average value[5]. The impact of monetary policy will mainly be transmitted via demand. Indeed, the increase in the target rate for monetary policy has been passed on to all public and private rates, market rates and bank rates. The consequent tightening of monetary and financial conditions should result in a tapering of credit activity and a slowdown in domestic demand: consumption and investment.

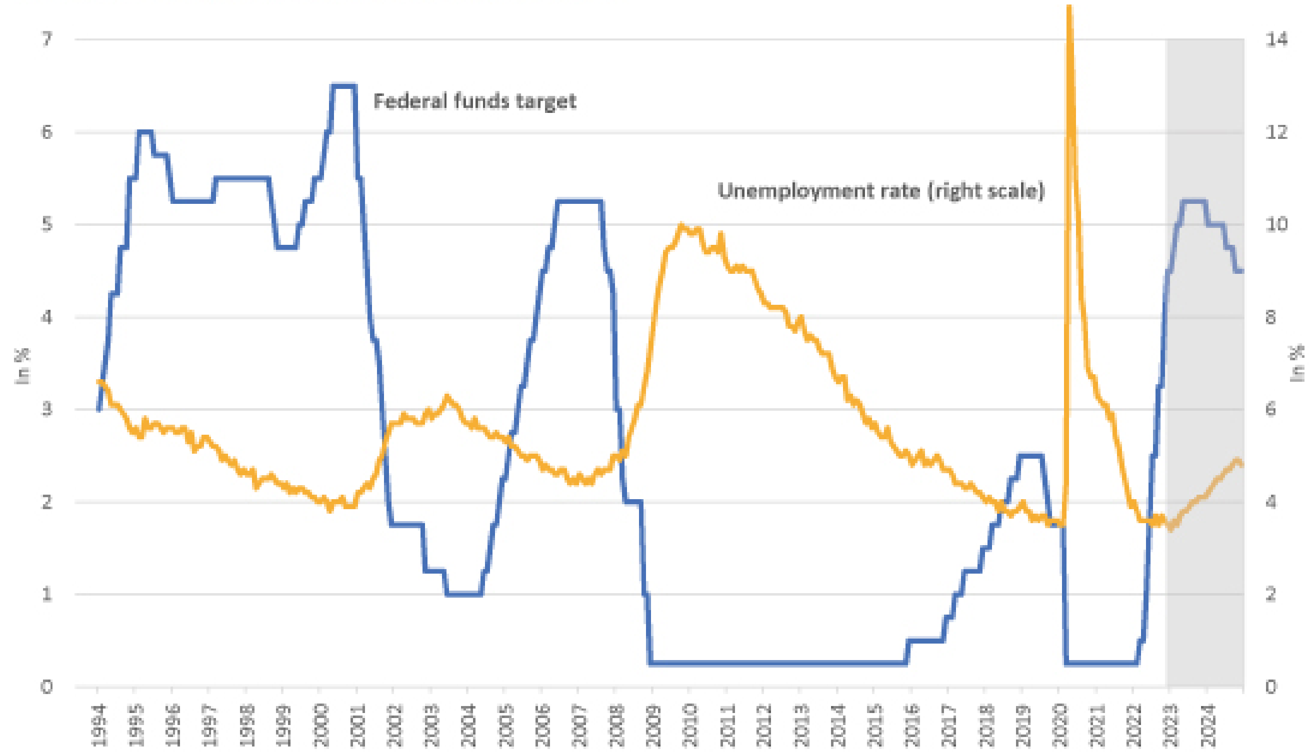


Figure 2. Federal Reserve rate and unemployment rate

Sources: Federal Reserve and Bureau of Labor Statistics.

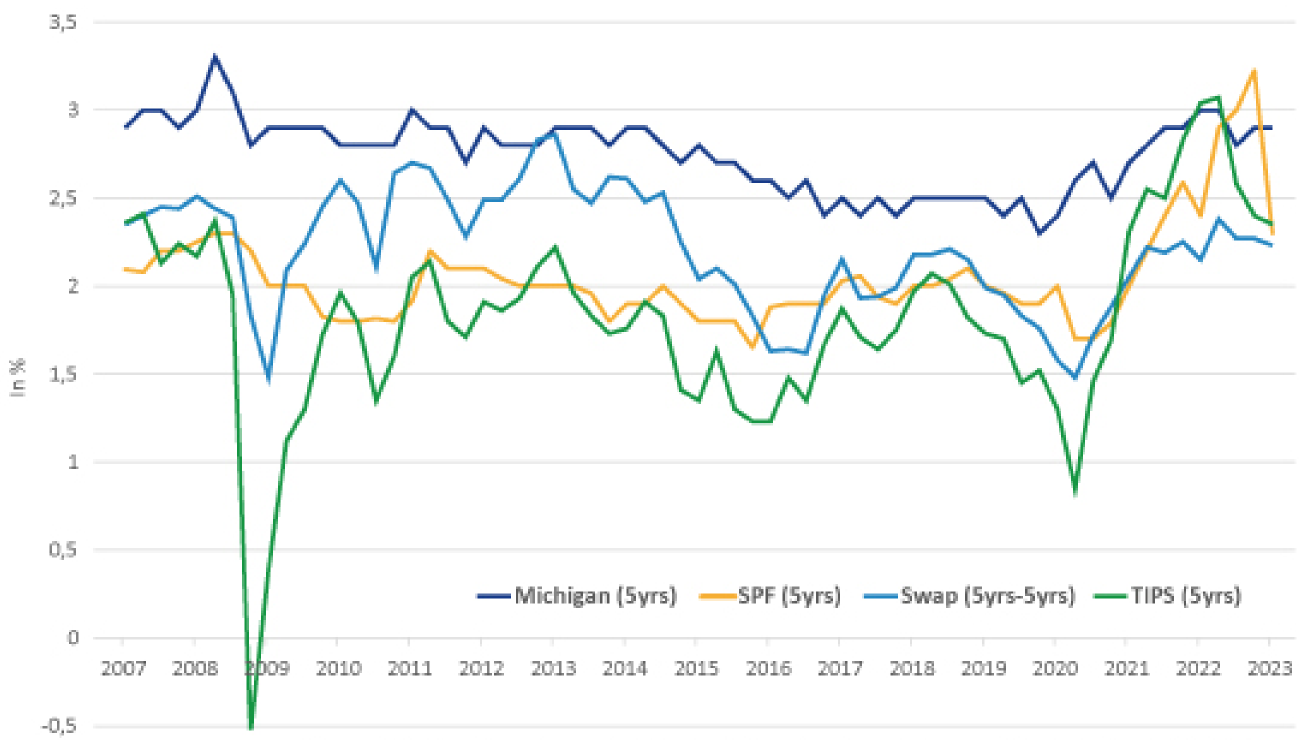
However, after GDP fell in two quarters at the beginning of 2022, it recovered in the second half of the year. Most importantly, the unemployment rate remains at a historically low level: 3.5%, according to the Bureau of Labor Statistics (BLS) for the month of March 2023. Is this situation – falling inflation without rising unemployment – sustainable? If so, the Federal Reserve would succeed in achieving its price target while avoiding recession or at least rising unemployment. **Olivier Blanchard** seemed to doubt this optimistic scenario. Indeed, most macroeconomic analyses suggest that a restrictive monetary policy pushes up unemployment. For example, the variant of the **FRB-US** model suggests that a one-point interest rate hike results in a 0.1 point rise in unemployment in the first year and then peaks at 0.2 points in the second and third years. Recent analysis by Miranda-Agrippino and Ricco (2021) suggests a similar order of magnitude, with a peak of around 0.2 points for a one-point increase in the policy rate, but faster transmission[6]. Given the magnitude of the monetary tightening and all else being equal, we expect the unemployment rate to rise by 0.3

percentage points in 2023, which in our scenario would bring it to 3.9% from 3.6% on average over 2022. Indeed, given the lags in the transmission of monetary policy, the tightening over 2022 is likely to have only a small impact, which could explain why the unemployment rate has not yet risen. Previous episodes of monetary tightening have also been characterised by a more or less significant lag between the tightening phase of monetary policy and an increase in unemployment (**Figure 2**). For example, the Federal Reserve's moves to tighten monetary policy in the summer of 2004 did not have a rapid impact on the unemployment rate, which continued to fall until the spring of 2007, before rising sharply thereafter, reaching a peak of almost 10% in early 2010 in the context of the global financial crisis. The same inertia was evident after 2016, with unemployment not rising until 2020 during the lockdowns.

Finally, the capacity of monetary policy to reduce inflation depends not only on the relationship between unemployment and inflation but also on the reaction of inflation expectations. In this regard, the various indicators of long-term expectations suggest either stability or a slight decrease. For example, the Michigan Household Survey indicates a 5-year inflation expectation of 2.8% in February 2023, compared with 3.1% in June 2022. According to market indicators, 5-year 5-year forward inflation expectations fluctuate around 2.5%. These levels are certainly higher than the target set by the Federal Reserve, but they do not reflect a significant and lasting shift away from what was observed before 2021 (**Figure 3**). As for the inflation-unemployment link, it is clear that there is greater uncertainty. In the FRB-US model, the increase in unemployment induced by monetary tightening has very little effect on the inflation rate, although the estimates of Miranda-Agrippinon and Ricco (2021) suggest a greater impact. In our scenario, US inflation would continue to fall in 2023 not only because of the energy component but also because of a fall in core inflation. In our scenario, we assume that by the end of 2023, the deflator would rise by

3.6% year-on-year, with core inflation at 3.7%.

Figure 3. Indicators of long-term inflation expectations



Sources: Michigan Survey, Survey of Professional Forecasters (Federal Reserve of Philadelphia) and Refinitiv Eikon.

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[1] This is inflation measured by the consumer price deflator, which is the index monitored by the Federal Reserve. In comparison, inflation measured by the consumer price index (CPI) is on average higher, whether we consider the overall indicator or the index excluding food and energy prices.

[2] The price of gas on the US market has not reached the highs seen in Europe. However, the price almost tripled between the spring of 2021 and the end of summer 2022 before returning to the low point observed in April 2020.

[3] The contribution of food has already fallen since the start of the year, and we anticipate that this will continue.

[4] This is the case for semiconductors, used in particular by the automotive sector. These shortages have contributed to the rise in the prices of cars, both new and especially used, which rose by more than 40% year-on-year at the beginning of

2022.

[5] See the **Global Supply Chain Pressure Index** (GSCPI), which is calculated by economists at the New York Federal Reserve.

[6] See Miranda-Agrippino S. & Ricco G. (2021), "The transmission of monetary policy shocks", *American Economic Journal: Macroeconomics*, 13(3), 74-107. Other estimates indicate effects that are sometimes greater, depending on the estimation strategy. See the simulations reported by Coibion O. (2012), "Are the effects of monetary policy shocks big or small?", *American Economic Journal: Macroeconomics*, 4(2), 1-32.

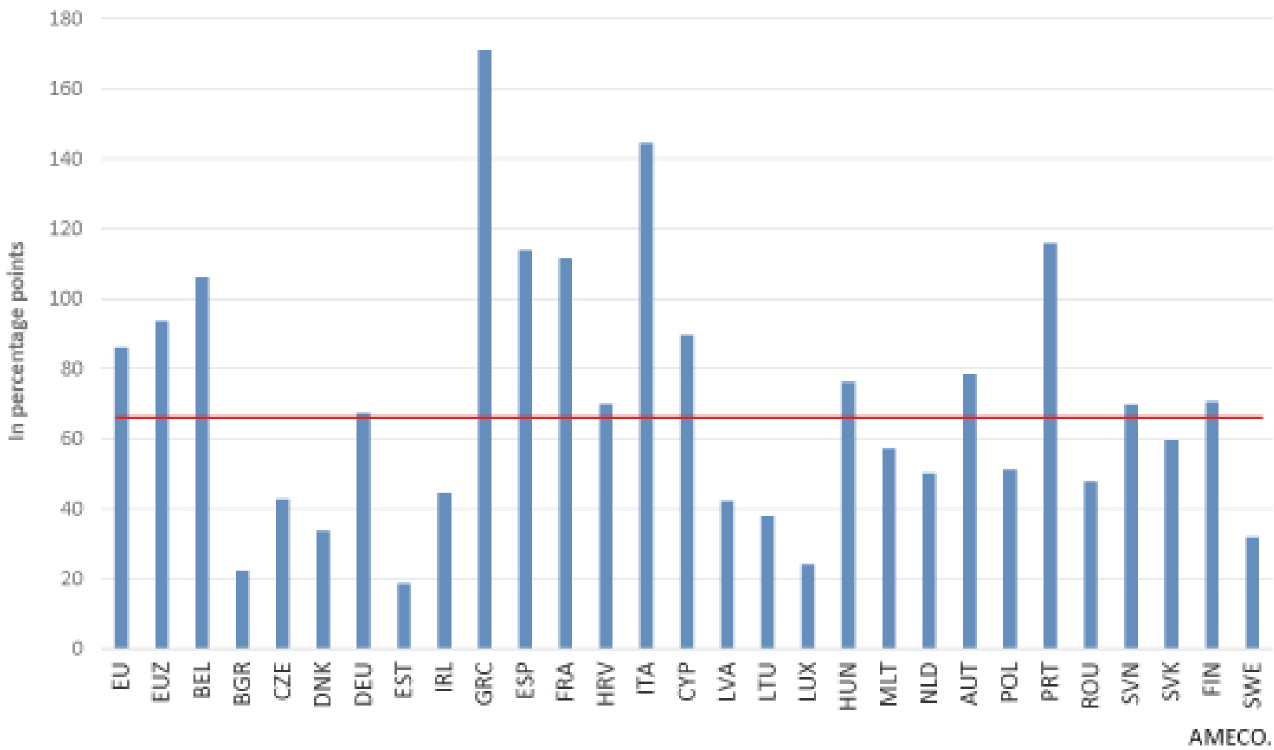
Reforming the Growth and Stability Pact: The Commission has fallen on the debt

By Jérôme Creel

In its communication of 9 November 2022, the European Commission outlined the contours of the new European fiscal framework that should, in its words, be simplified and adapted to Member States' specific needs in order to ensure that they remain solvent and to allow for necessary reforms and investments. The new framework should also take better account of economic imbalances, including those relating to trade, and, finally, it should be better applied. A vast programme!

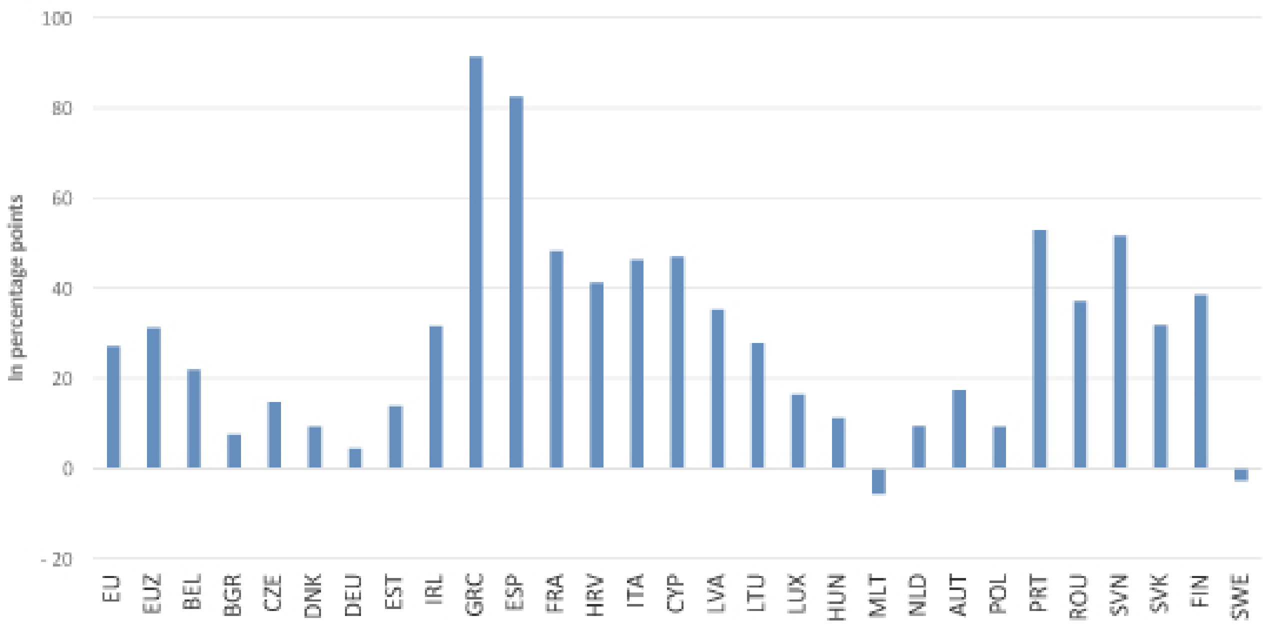
The goal of ensuring the Member States’ solvency, which is reiterated by the Commission, reflects that a significant number of Member States have excessively high public debt-to-GDP ratios within the current European fiscal framework: 12 Member States out of the 27 will have a public debt-to-GDP ratio that exceeds the 60% threshold at end 2022 (Figure 1).

Figure 1. **Ratio of public debt / GDP forecast for end 2022**



These high levels of public debt are the consequence of the series of economic, financial and geopolitical crises that have hit Europe since 2007. Between end 2007 and end 2021, public debt rose by almost 30 percentage points of GDP on average, with a dispersion of around 23 points. As Figure 2 shows, some EU Member States (recall that the Stability and Growth Pact that the Commission is planning to reform applies to all of them, not just those in the euro zone) have experienced debt increases of almost 50 points (France, Italy, Cyprus, Portugal) or even much higher (Greece, Spain). Others, like Germany, have seen their debts increase only slightly, or even decrease (Malta, Sweden). In this context, it would be difficult if not impossible to apply fiscal rules in a homogeneous or undifferentiated way, as this would require major efforts from Member States that are gradually emerging from the pandemic and are continuing to suffer from the energy crisis that is severely hurting public finances[1].

Figure 2. Variation in the ratio of public debt / GDP between end 2007 and end 2021



AMECO, Author's calculations.

The Stability and Growth Pact, which has been in force since the creation of the euro zone in 1999, aims to ensure fiscal discipline among EU countries by preventing excessive government deficits and debts or by correcting them through fiscal policies that limit spending and boost tax revenues. As the Pact is not applied mechanically, its application depends on how the States and the Commission interpret what is meant by the "excessive" nature of deficits and debts. Although numerical criteria have been appended in a Protocol to the Treaty on the Functioning of the European Union – the well-known criteria of 3% of GDP for the deficit and 60% of GDP for the debt – there are exceptional circumstances that allow for temporary exemptions. So when a serious crisis occurs, as was the case in 2020 with the pandemic, the derogation clause relating to the suspension of the preventive arm of the Pact can be activated. As a result, the Pact will have been put on hold from 2020 to the end of 2023. In the Commission's view, what should happen after that?

The Pact’s two numerical criteria would be retained, but the main tool for meeting the criteria would be changed. Fiscal sustainability[2], i.e. the reduction of public debt, would now be assessed on the basis of a single indicator: primary expenditure, i.e. public spending net of discretionary income, excluding interest charges on the debt and expenditure on unemployment benefits. The reference in the current fiscal framework to the annual reduction in the debt (one-twentieth of the difference between the current debt and the 60% of GDP target) would be dropped, as would the reference to a minimum reduction in the cyclically adjusted government deficit. The one new indicator would replace two, and hence in the Commission’s view constitute a simplification.

The primary expenditure target should ensure a plausible path for reducing the public debt towards the 60% of GDP target over 10 years. This does not imply that the debt will necessarily have reached its target after 10 years, but rather that it will be on a trend towards that at a pace deemed satisfactory.

Member States are to present the Commission with a “national medium-term fiscal and structural plan” consistent with their commitment to fiscal discipline. The primary expenditure target established in close coordination between the Member State and the Commission should therefore be consistent with the expenditure deemed necessary by both parties to ensure structural reforms and investments. The precise nature of these is not specified. The primary expenditure target could therefore differ from one country to another, in accordance with likely differences in their needs for reform and investment.

Primary expenditure in line with this fiscal discipline would be planned over a period of 3 to 4 years, engaging the State’s responsibility during this period. If unforeseen economic circumstances prevented the public debt from falling at the desired pace (the State’s commitment is accompanied by a growth scenario over the same horizon) or if the reforms and investments fail to produce the anticipated results, mainly economic growth, the adjustment in primary expenditure could be extended by up to 3 more years: the State would then have a maximum of 7 years to reduce its public debt towards the 60% of GDP target at a satisfactory pace. This would tend to greatly expand the notion of the medium term in the current version of the Stability and Growth Pact.

Since 2011, the European Union has equipped itself with instruments for monitoring macroeconomic imbalances (the overheating of wages, trade imbalances, excessive private debt, etc.), which have so far not been connected to the European fiscal framework. The Commission is proposing to integrate these into the framework. By better monitoring these imbalances, the Commission would adjust its recommendations for reforms and investments to ensure that the Member States enjoy sustainable growth and gradually reduce their debt.

Finally, the Commission is giving serious emphasis to the need for Member States to respect their commitments – the application of the Stability and Growth Pact has not always been very scrupulous – and for national bodies to more closely control these (in France, the High Council for Public Finances, the HCFP). These bodies would be responsible for organising a national debate on the relevance of the multiannual public finance assumptions made by governments.

So this is the reform project. What do we think of it?

First of all, the reform project, if adopted, would give the States greater manoeuvring room than in the current rules: reducing the debt more slowly, maintaining spending on unemployment benefits, and taking investments into account. There would be no immediate fiscal austerity.

However, adjusting primary expenditure over several years to ensure debt sustainability while taking account of the reforms and investments deemed necessary does not really seem much different from the situation prevailing today. Flexibility would be enshrined in the new draft whereas it is more a matter of improvisation in the current framework. But in practice how much does this really change? The States are by now used to modifying their fiscal policies to finance reforms and investments while ensuring their solvency. The hearings before France's High Council on Public Finance are already supposed to stimulate the national debate on the short and medium-term orientation of public finances. On this point, too, it is rather difficult to see how the Commission's proposal is innovative.

The *a priori* coherence between a potentially more flexible target for primary expenditure and the continuing need to meet the public deficit criterion is not self-evident. How much manoeuvring room will States with deficits in excess of 3% of GDP really have? They will definitely need to find new resources to reduce their deficit and maintain their primary expenditure capacity in order to finance reforms and investments. This is a major challenge, especially if macroeconomic conditionality is applied for the availability of EU funds (cohesion policy, funds from the Recovery and Resilience Facility of the Next Generation EU programme) when the public deficit is deemed excessive: the granting of EU funds may be suspended.

The major role played by the Commission in the proposed fiscal process is another significant factor. The Commission imposes the path for adjusting expenditure, and if the States fail to implement their fiscal plans and reforms on time, it may magnanimously grant them a little extra time to do so. And, in what is considered an intelligent proposal for sanctions[3], it plans to systematically require the finance ministers of countries that have not met their commitments to explain this before the European Parliament. In this fiscal process, should the role of Europe's only democratic assembly really be limited to systematically humiliating those at fault? This provision does of course already exist, but it is not applied systematically. There are undoubtedly other ways of involving the European Parliament in the new fiscal framework.[4] But it is true that the Commission has a strong penchant for technocratic bodies, such as fiscal committees or high councils for public finance.

As for better integrating the tools for monitoring macroeconomic imbalances, the intention to ensure the overall coherence of the Commission's recommendations is laudable. It remains to be seen however whether countries that exceed the maximum threshold for their trade surplus – which is likely to happen again once energy costs have fallen – will actually implement the recommendations. Germany's governments have thus far never taken these into account.

Finally, there is something very mechanical in the vision of fiscal policy that this reform project conveys. Over a three- to four-year horizon, ministry officials will continue to do what they have been doing since the Stability and Growth Pact was first put into place, i.e. to calculate expenditure trajectories compatible with reducing the public debt. And, contrary to what the proposal tries to imply, the controversial notion of the output gap, i.e. the gap between unmeasurable potential GDP and actual GDP, has not disappeared from the European fiscal framework. It will remain crucial to separate the cyclically-adjusted deficit from the cyclical deficit, and the primary structural balance (the cyclically-adjusted government balance excluding interest charges) remains the benchmark for analysing debt sustainability.[5] Given the series of economic crises that we have been going through for the last 15 years and the rising debt they have generated, it is not clear that these exercises have been very useful.

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[1] See the forecast for the world economy [in French] recently conducted by the OFCE's Analysis and Forecasting Department.

[2] On the sustainability of the debt, see the special issue of the *Revue d'économie financière* from last month.

[3] The characterization as intelligent appears in column 3 of Figure 2 of the Commission Communication.

[4] This is the subject of my contribution to the aforementioned special issue of the *Revue d'économie financière*.

[5] See pp. 11-12 and p. 22 of the Commission Communication.

Can the US Federal Reserve bring inflation back to 2%?

by Christophe Blot

At the monetary policy meeting on 16 March 2022, the Federal Reserve raised its interest rate by a quarter point to 0.5%[1]. With the strong increase in inflation observed in the United States since the spring of 2021, there is little doubt that this movement will continue. Indeed, Jerome Powel recently confirmed this and envisaged a half point increase at the meeting on 4 May. Beyond that, expectations from futures contracts on the federal funds rate suggest that the interest rate will rise to at least 3% by year's end. Will the US central bank succeed in bringing inflation back to its target? Put another way, can the nature of the imbalances that are pushing up prices be corrected by monetary policy? And how high should interest rates rise to curb the current inflationary surge?

After settling at 1.2% in 2020, inflation, measured by the consumer price deflator, reached 3.9% in 2021 on an annual average, i.e. a level well above the Federal Reserve's 2% target[2]. Furthermore, contrary to the expectations formulated by the members of the Federal Open Market Committee (FOMC) in mid-2021,[3] inflation picked up steam and by February 2022 exceeded 6%, the highest level since 1982[4]. As Jean-Luc Gaffard and Francesco Saraceno point out, inflation is necessarily the result of sectoral market imbalances, which have their source in either insufficient supply or excess demand. The appropriate policy response must therefore be based on as complete a diagnosis as possible of the causes of the inflation, which results in social costs[5]. However, given the Fed's mandate, tightening monetary policy seems unavoidable[6]. In the case of the United States, this is a dual mandate since, according to the Federal Reserve Act, the aim of US central bank policy is to promote both price stability and maximum employment. With the unemployment rate at 3.6% in March 2022, the Fed logically considers that it is further from its price stability objective than from its full employment objective. Besides the unemployment rate, other indicators such as the resignation rate or the ratio between the number of unemployed and job openings also confirm the existence of tensions on the labour market[7].

The main question is therefore how much tightening is needed to bring inflation back to target. The answer to this question depends in particular on the transmission of monetary policy to prices. How does inflation react when the central bank decides to raise its interest rate? Remember that the central bank only sets a very particular rate, a very short-term money market rate. Changes in this rate are then transmitted to market and bank rates, and on to financial and property prices. Monetary policy therefore influences the totality of financing conditions and, through this, household consumption and household and business investment[8]. When the central bank tightens its monetary policy, demand is reduced and unemployment rises, which has an impact on prices, i.e. the prices of goods and services and wages. The impact of monetary policy on inflation can be quantified by estimating the effect of higher interest rates on unemployment and the link between inflation and unemployment.

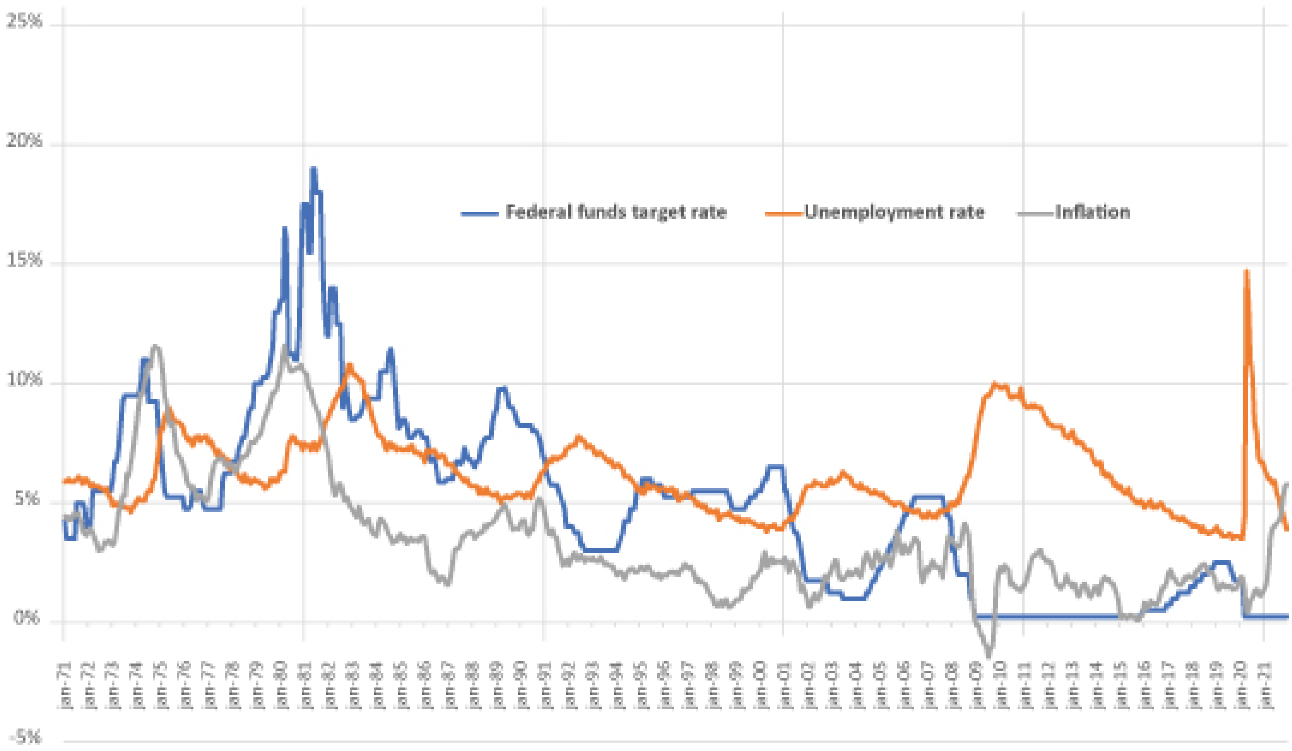
A recent analysis by Silvia Miranda-Agrippino and Giovanni Ricco (2021) suggests that a one percentage point hike in the interest rate set by the central bank pushes up the unemployment rate by 0.3 percentage points after 12 months.[9] All else being equal, Ball and Mazumder (2011) suggest that, using a standard Phillips curve estimate, an additional 1 percentage point of unemployment would reduce inflation by 0.5 percentage points. So raising the rate from 0.25% to 3% by the end of 2022 would result in a 0.4 percentage point reduction in inflation. The tightening scenario envisaged for monetary policy therefore seems largely insufficient to bring inflation back to its 2% target. In other words, the only way the Fed could hope to reduce inflation would be by raising the interest rate even further. This is not, however, a reasonable prospect.

First, reducing inflation by 4 points – from 6% to 2% – implies such a steep rate hike that it would push the US economy into a violent recession and a brutal rise in unemployment. This was the path chosen by Paul Volcker, Fed Chairman between 1979 and 1987, who pursued a highly restrictive monetary policy at the beginning of his term in order to reduce US inflation, which exceeded 10% at the end of 1979 (Figure 1). The result was a sharp rise in the unemployment rate, to its highest level since 1951[11]. There are, however, important differences with the current inflationary situation. Inflation today is partly the result of supply factors that, according to Reifschneider and Wilcox (2022), are temporary[12]. Monetary policy would not be effective in countering a shock to energy prices or global supply constraints, since these do not really depend much on the US macroeconomic situation. The point is to focus action on the contribution to inflation arising from domestic factors, and in particular tensions on the labour market, which have been fuelled in part by the fiscal stimuli of Donald Trump in 2020 and then of Joe Biden in 2021[13]. However, it is clear that, like many other forecasters, the Fed was off in its belief that this inflationary episode would not last long and that supply factors would ease relatively quickly. Since then the war in Ukraine has put further pressure on energy prices and hence on inflation.

At the same time, it seems apparent that inflation expectations are probably better anchored around the Federal Reserve's inflation target than they were in the late 1970s. According to the Michigan Household Survey, long-term inflation expectations – five years ahead – have risen but appear to have stabilised around 3% since May 2021. In particular, they are lower than they were in the late 1970s and early 1980s (Figure 2). And these inflation expectations do play a role in the dynamics of inflation. Indeed, the more households or companies anticipate a high level of inflation, the more they will ask for wage increases or set their prices at a higher level, which will result in a spiral in which inflation expectations feed inflation, which in turn pushes expectations a little higher. It is therefore also in order to avoid this type of runaway so-called second-round effects that the Fed is deciding to accelerate its monetary tightening. The aim is to maintain this anchorage. Recent work has shown that this channel for transmitting monetary policy onto expectations is significant[14].

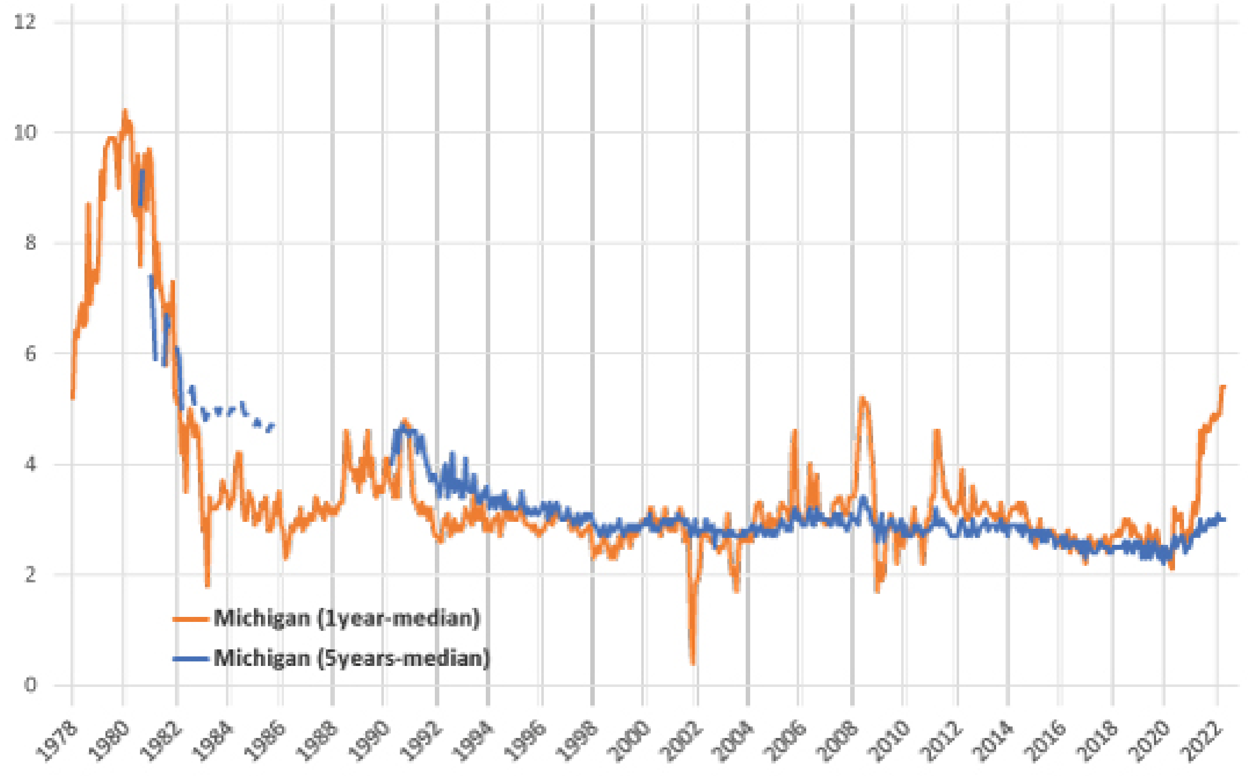
It therefore seems that the current situation justifies monetary tightening in the US. The difficulty facing the central bank is to distinguish between supply and demand factors. The objective of the tightening initiated by the Fed must be mainly to limit the tensions observed on the labour market and to influence agents' expectations so that these expectations don't take off. It should at the same time be relatively moderate so as not only to avoid pushing the economy into recession but also to avoid a sharp rise in long-term interest rates, which would lead to destabilising pressures from the weight of the public debt. While the supply factors driving inflation are temporary, the Fed's response will allow inflation to gradually converge towards its target. In this respect, it is worth noting that the average inflation targeting strategy gives the Fed greater manoeuvring room, as it can in fact tolerate inflation above 2%. Since 2008, inflation has mostly been below 2%, so even with 5% inflation in 2022, the path of the price index would still be lower than the shadow path that would have been observed if inflation had risen by 2% per year since 2009 (Figure 3). Finally, if the supply factors prove to be long-term, the appropriate economic policy will not be to curb demand through an overly restrictive economic policy but rather to stimulate supply through an investment policy that can raise production capacity to the appropriate level.

Figure 1. **Inflation, unemployment and monetary policy**



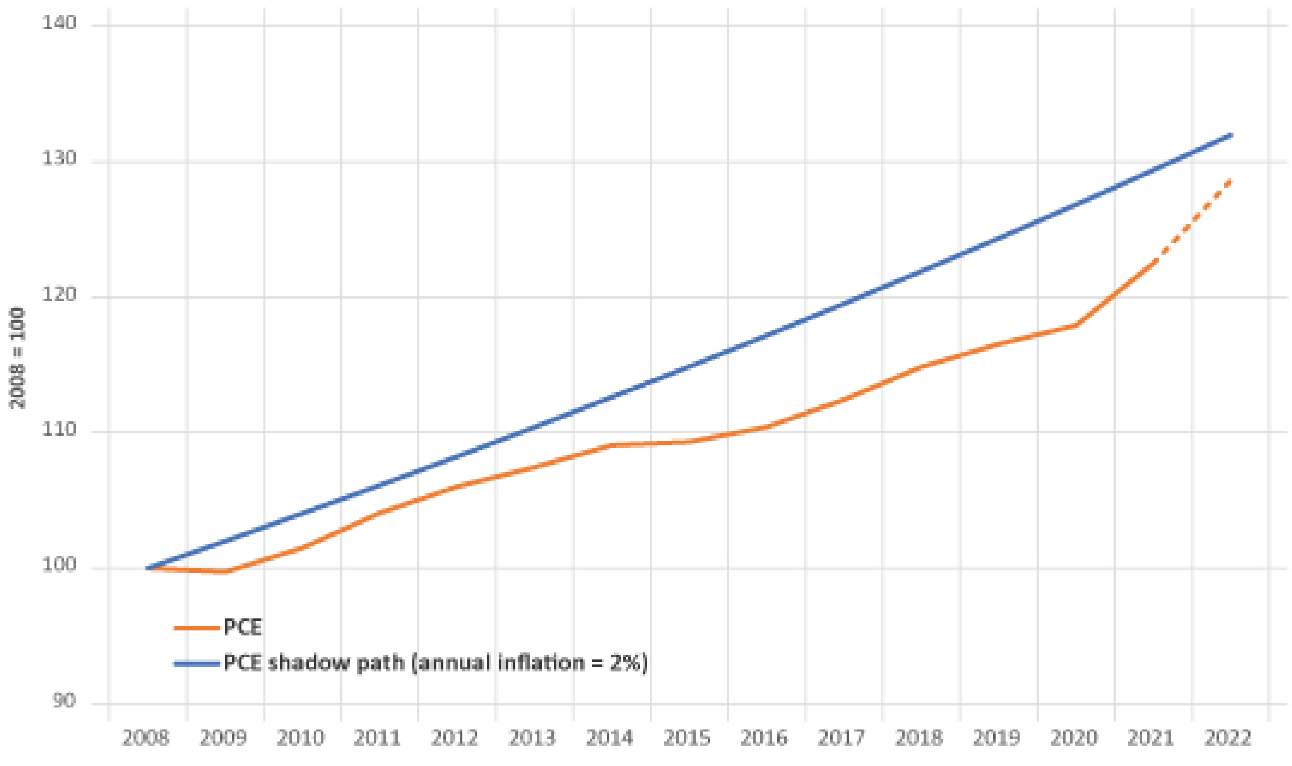
Federal Reserve, Bureau of Economic Analysis, Bureau of Labour Force.

Figure 2. **Inflation expectations of American households**



University of Michigan.

Figure 3. Trajectory of the consumer price deflator



The trajectory for 2022 is calculated for a forecast of an average annual inflation rate of 5%.
Bureau of Economic Analysis.

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[1] In the United States, the Federal Reserve's policy rate corresponds to the target for the rate at which commercial banks exchange federal funds, which are the deposits they hold with the local Federal Reserve.

[2] See Blot, Bozou and Hubert (2021) for a discussion of central bank inflation targets and the reformulation proposed by the Fed in August 2020.

[3] Projections by FOMC members in June 2021 suggested inflation of between 1.9% and 2.3% at the end of 2022, with a median of 2.1%: see here.

[4] Inflation measured by the consumer price index even exceeded 8.5% in March 2022. Note that the inflation indicator used by the Federal Reserve is the consumer price deflator.

[5] Even if wages are growing faster in the US, they are not currently compensating for inflation, which is resulting in a

loss of purchasing power for US households.

[6] Basically, the central bank's mandate does not specify that its monetary policy response should be differentiated according to the causes of inflation, which implicitly suggests that long-term inflation can only be a monetary phenomenon.

[7] See this analysis or this one.

[8] Monetary policy also influences foreign trade through its effect on the exchange rate.

[9] See Miranda-Agrippino S., & Ricco G. (2021). The transmission of monetary policy shocks. *American Economic Journal: Macroeconomics*, 13(3), 74-107. The effect on unemployment is obtained by considering a monetary policy shock such that the one-year interest rate rises by one percentage point. Although the Federal Reserve does not directly control this rate, it is nevertheless influenced by the central bank's decisions.

[10] See Ball L. M. & Mazumder S. (2011). Inflation dynamics and the great recession. *Brookings Papers on Economic Activity*, Spring, 337-381.

[11] This record of 10.8% in November 1982 was only exceeded in April-May 2020 during the pandemic. In 2009, the peak for the unemployment rate rose to 10%.

[12] See https://www.piie.com/sites/default/files/documents/pb22-3.pdf. Their optimism is, however, debatable.

here: https://www.piie.com/blogs/realtime-economic-issues-watch/what-needed-tame-us-inflation

[13] See Aurissergues, Blot and Bozou (2021), "Les États-Unis vers la surchauffe? [Is the US overheating?] Policy Brief of

the OFCE no. 97

[14] See Diegel M. & Nautz D. (2021), "Long-term inflation expectations and the transmission of monetary policy shocks: Evidence from a SVAR analysis", *Journal of Economic Dynamics and Control*, 130, 104192.

Is the war in Ukraine influencing central bank monetary policy?

by Christophe Blot

The end of 2021 was marked by growing concern among central banks about inflation[1]. As pressure on prices intensified with Russia's invasion of Ukraine, could this change the terms of the discussion and influence future monetary policy decisions? Indeed, in February, the inflation rate reached 5.9% in the euro area and 7.9% in the US[2], well above the 2% target of the ECB and Federal Reserve. The January policy meetings suggested that a rate increase was imminent in the US and likely by the end of the year in the euro area[3]. So what is the situation today? The war between Russia and Ukraine has not only shaken up the geopolitical situation but is expected to affect the global economy, accentuating inflationary pressure, reducing household purchasing power and fuelling uncertainty. Finally, the risk of a sovereign default by Russia could also rekindle financial tensions, in particular viaa risk of contagion in the emerging countries. In this new context, one could expect greater caution and a more wait-and-see approach, as suggested in a post by Xavier Ragot. However, neither the ECB at its meeting on 10 March nor the Federal

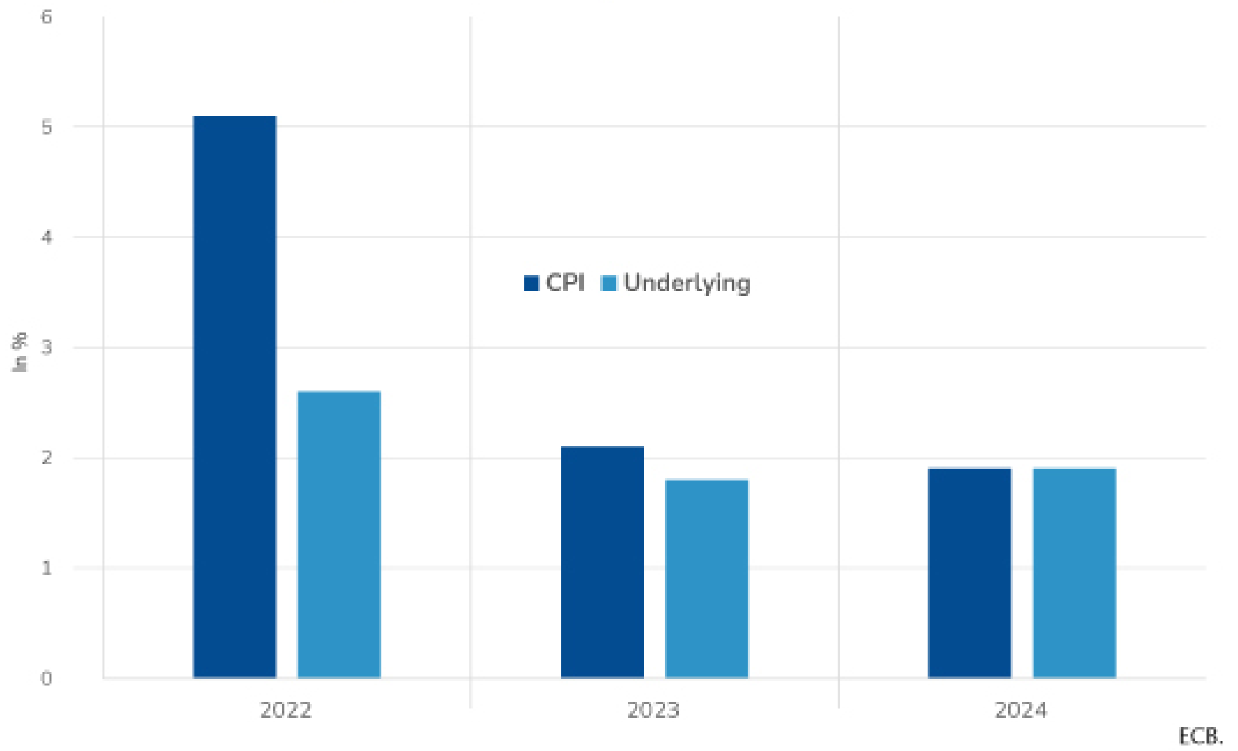
Reserve on 16 March have changed their tune. The banks remain focused on inflation.

As stated in the introductory statement of the ECB press conference on March 10, Christine Lagarde acknowledged the many uncertainties linked to the conflict's economic repercussions. But she also stressed the strength of the economic recovery, with growth in the euro area expected to reach 3.7% in 2022 and 2.8% in 2023, according to the Eurosystem. These forecasts have been revised downwards since December 2021 by 0.5 and 0.1 points respectively. However, the ECB has decided to end its asset purchase programme (APP) more quickly, with it gradually decreasing in net terms to 10 billion euros in June. Beyond that, "the calibration of net purchases for the third quarter will be data-dependent and reflect our evolving assessment of the outlook". In other words, net purchases should cease unless inflation and inflation expectations fall sharply[4]. 4] Recall that in December 2021, it was envisaged that purchases under the APP would continue until the third quarter of 2022. Indeed, in the short term, the shock of Russia's invasion of Ukraine will undoubtedly translate into higher inflation, fuelled in particular by rising prices for energy and certain foodstuffs. Thus, the ECB's inflation expectations have been revised upwards: 5.1% on average over 2022 compared to a forecast of 3.2% in December 2021. Does this mean that the ECB is planning to raise rates soon? The press release issued at its previous meeting on 3 February stated: "The Governing Council expects net purchases to end shortly before it starts raising key ECB interest rates". Assuming that asset purchases are now scheduled to wind up in June, the likelihood of a rate hike becomes greater. A qualification is needed, however, as its 10 March press release states that, "Any adjustments to the key ECB interest rates will take place some time after the end of our net purchases under the APP and will be gradual". So the end of purchases is definitely put forward, but now the rate hike would take place not "soon after" but "some time after". This is still widely considered possible, although it cannot be said that it is more likely today than at the end of the 3 February meeting. Moreover, to a journalist who explicitly asked whether "some time after" ruled out the possibility of a rate hike this year, Christine Lagarde replied that no action had been ruled out and that the ECB's communication was intended to give itself as many options as possible.

However, the ECB does seem to be focusing on inflation. Beyond the short-term inflationary shock, the ECB is looking closely at inflation one or two years hence, since this is the horizon at which a monetary policy decision affects prices. So what's most important for the rate scenario are inflation expectations for 2023 and 2024, and not for 2022. If long-term inflation converges to or exceeds the 2% target, the ECB will surely raise rates as the need for monetary support fades[6]. According to the latest forecasts, the ECB expects inflation to reach 2.1% in 2023 and 1.9% in 2024, which are close to the target (Figure 1).

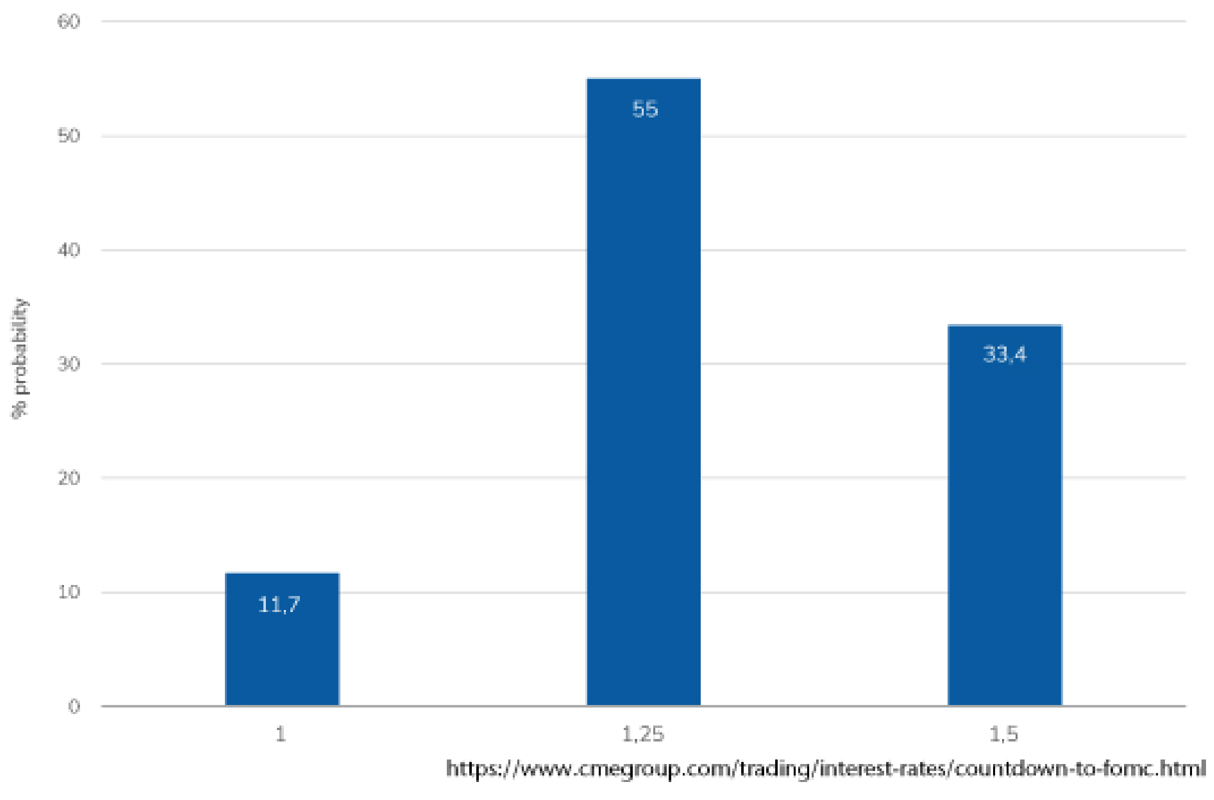
With inflation close to target, growth robust and unemployment falling, the prospect that monetary policy will be normalized may seem fitting. However, note that higher inflation is being driven largely by food and energy prices. Apart from these two components, the ECB expects inflation to be 1.8% in 2023 and 1.9% in 2024[7]. Under these conditions, the ECB is in a dilemma, with a shock that is resulting in higher inflation but also slower growth, which could delay the return of growth to its potential[8]. If inflation remains essentially driven by energy and food prices, then a rate hike would not be effective in reducing it but would accentuate the negative shock on the economy. So while the ECB's primary objective remains inflation, tightening monetary policy is worthwhile only if it helps to achieve this objective. In the current context, the ECB will have to find the right mix between on the one hand fighting against a risk of runaway inflation that is linked to possible second-round effects and on the other risking undermining the recovery.

Figure 1. Inflation expectations of the ECB



From this point of view, the situation of the US is different even if, as in the euro area, the FOMC members have revised the US growth forecast for 2023 downwards and the inflation forecast upwards. The US economy is probably less exposed to the shock of the war. The main difference with the euro area, however, is the level and nature of the inflation. Indeed, the change in inflation is not only a consequence of pressure on energy prices, as the year-on-year increase in the underlying consumer price index was 6.4% in February, compared to 2.7% in the euro area. Moreover, wages also seem to be taking off, reflecting tensions in the US labour market and thus a much higher risk of overheating than in the euro area, which would justify faster and probably stronger action by the Federal Reserve[9]. It is therefore not surprising that the FOMC members were broadly in favour of a quarter-point increase in the federal funds rate at the meeting held on 16 March. This hike in the monetary policy rate had been announced implicitly at the previous meeting and was widely anticipated. This trend could even pick up pace since, at the end of the FOMC meeting scheduled for 15 June, according to the *FED watchers,* there is a 55% probability that the rate will reach 1.25% and a 33% probability that it could hit 1.5% (Figure 2)[11]. However, even if higher rates seem more justified in the United States, the Fed will also have to take into account the impact of interest rates on medium-term debt dynamics. Given the level of public debt (130% in 2021 versus 109% in 2019), close coordination of monetary and fiscal policies is likely necessary to reconcile the objectives of fighting inflation, maintaining growth and gradually reducing public debt. As Gilles Dufrénot reminds us, debt reduction after the Second World War was accompanied by a low real interest rate strategy[12].

Figure 2. **Expectations of US monetary policy rates as of 15 June 2022**



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[1] See the OFCE post of 20 January 2022.

[2] The consumption deflator, an indicator monitored by the Federal Reserve, was rising by 6.1% year-on-year in January 2022.

[3] Note that in the UK, January inflation was 5.5% and the Bank of England had already raised its key interest rate twice.

[4] The flow of asset purchases by the ECB under the APP leads to increasing the size of its balance sheet. Terminating the programme does not imply a cessation of purchases but rather the end of increases in the size of its balance sheet. Thus, the ECB will replace maturing assets with purchases that stabilize the balance sheet.

[5] In December 2021, the ECB envisaged net purchases of 30 billion euros in the third quarter of 2022.

[6] It is indeed conceivable that, given the current level of interest rates, a small hike would not contribute to slowing down activity but would reflect less support.

[7] Recall that since July 2021 the ECB has communicated a new inflation target of 2%, as opposed to its previous “close to but below 2%”. However, the measure of inflation remains the HICP, an indicator that includes energy and food prices. See Blot, Bozou and Hubert (2021) for more detail [in French].

[8] Indeed, central banks generally react to the gap between actual inflation and the target and the gap between the level of activity and potential GDP. Thus, rapid growth does not indicate that activity is exceeding its potential. Indeed, according to the OECD, this growth gap should still be negative in 2023 (-0.3%). However, this estimate does not take into account the impact of the economic shock linked to the war in Ukraine.

[9] See Domash and Summers (2022) for a more in-depth analysis of the tensions in the US labour market. Although the

unemployment rate has not yet returned to its early 2020 level, other indicators such as the employee resignation rate and the job vacancy rate point to greater pressure.

[10] All but one member voted in favour of this increase, with the dissenting voice in favour of a half-point increase.

[11] A meeting is also scheduled for 4 May, at which there is a 58% probability of a rate hike of 0.25 points and a 42% probability of 0.5 points.

[12] See Reinhart and Sbrancia (2015) for a more detailed analysis of public debt reduction after 1945 in the industrialized countries.

What direction for monetary policy in 2022?

By Christophe Blot

With the return of inflation in 2021, the focus is now
on the central banks and their mandate for price stability. Between 15 and 17
December 2021, the Federal Reserve, the Bank of England (BoE), the European
Central Bank (ECB) and the Bank of Japan (BoJ) all held their final monetary
policy meetings of 2021. What do these meetings tell us about their approaches
to asset purchases and monetary policy in 2022? Is a rapid rise in interest
rates on the cards? Despite remaining uncertainty about the future course of

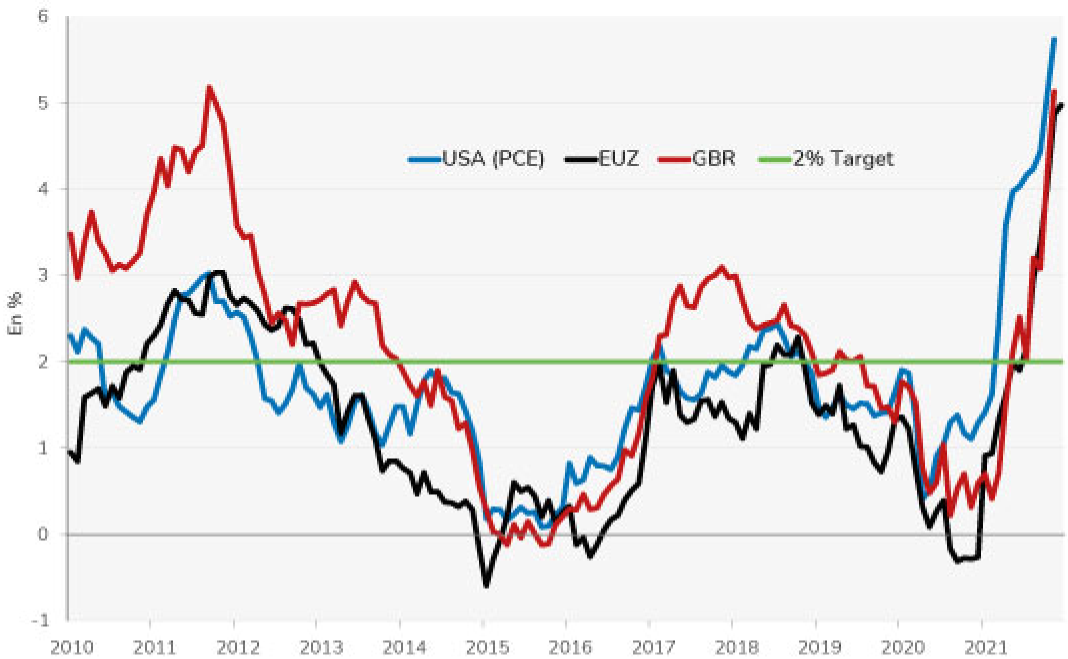
the pandemic and its consequences for activity in the first half of 2022, the central banks have gradually revised their assessment of the situation with regard to rising inflation. They now think that the inflationary shock will continue into 2022. Based on this, the British were the first to act as the BoE announced an increase in its key rate. The Federal Reserve is likely to follow in 2022, presaging future normalization. As for the ECB, despite winding down its asset purchase programme linked to the health crisis, it is not yet envisaging the normalization of monetary policy. In any event, its latest meeting did not suggest a rate hike in 2022 in the euro zone.

Central banks raise inflation expectations

The recent surge in prices in all the industrialized and emerging countries is largely due to the rebound in energy and many other commodity prices in connection with the effects of the health crisis on the global economic situation in 2020 and 2021.[1] This follows a long period of low inflation, which led central banks to set their interest rates at a very low level and to implement unconventional monetary policies such as asset purchase programmes. These policies, which resulted in sharp increases in their balance sheets, were aimed at holding down long-term rates.[2] Yet price stability is a key element of the

central banks’ mandate. It is therefore natural that the recent inflationary
pressures raise the question of how they will react and whether they might tighten
their monetary policy stance, since inflation is well above the 2% target
generally used by central banks to judge price stability.[3] Indeed, in December 2021, the year-on-year change
in the consumer price index rose to 5% in the euro zone and, in November, 5.1%
in the UK (Figure 1). In the United States, the consumer price deflator –
an indicator monitored by the Federal Reserve – rose by 5.7%, the highest level
since the early 1980s.[4] Beyond the impact on energy prices, the underlying
indices also rose. In the euro zone, the year-on-year change climbed from 0.4%
in December 2020 to 2.7% a year later, while in the US the underlying
consumption deflator reached 4.7% in November.[5]

Figure 1. Dynamics of inflation

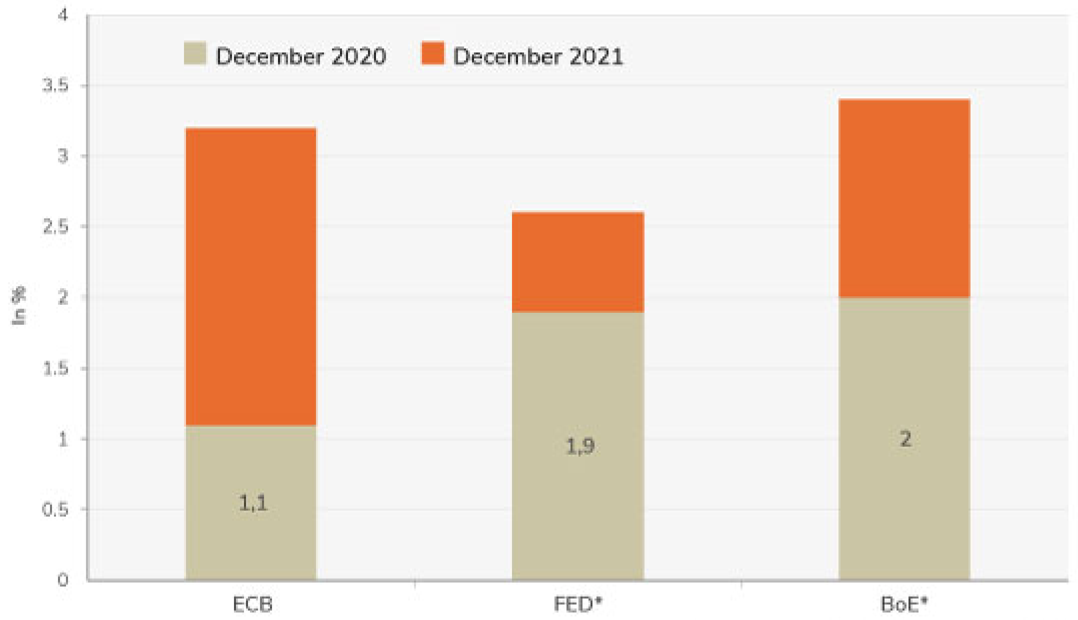


National accounts.

While initially the central banks were not all that concerned about the phenomenon, considering it temporary, it is clear that they have gradually revised their view, resulting in upward revisions of their inflation expectations for 2022 (Figure 2). Thus, the inflation projection that was communicated by the Federal Open Market Committee (FOMC) in December 2020 for the end of 2022 was 1.9%. One year later, the inflation forecast for the fourth quarter of 2022 was 2.6%. The ECB has also issued a significant revision, with inflation expectations rising from 1.1% in December 2020 to 3.2% – for the year as a whole – according to the latest projections of December 2021.[6] Inflationary pressure is still considered temporary, as all three central banks foresee inflation in 2023 closer to the target.[7] Nevertheless, in the context of a recovery but also of uncertainty about the effects of the new Omicron variant, the central banks are facing a dilemma. Should they counter these inflationary pressures by tightening monetary policy? Even if the rebound in inflation is temporary, inflation would be well above target for some months, which could lead to second-round effects. Moreover, the accumulation of household savings could boost growth in 2022 and keep inflation high.[8]

Conversely, could tightening prematurely undermine the recovery and slow the fall in the unemployment rate? In this respect, the unexpected return of inflation could also provide an opportunity to see how the ECB and the Federal Reserve might adjust their monetary policy after the announcement of their inflation target revisions. Indeed, in July 2020, the US central bank announced that it wished to wait for an inflation target of 2% on average, indicating that after being under target, as was the case in recent years, it would tolerate inflation above 2%. The rebound in inflation might have suggested that the Federal Reserve would be less reactive to rising inflation. However, the acceleration of prices has been significant in the US, and the recent change in tone suggests that even if the Fed tolerates inflation above 2%, the current level is probably too high.[9] Paradoxically, the ECB has not announced average inflation targeting (AIT) but has made it clear that the target is 2% and that it should be interpreted *symmetrically*. The ECB therefore considers that inflation below or above 2% is not compatible with its objective of price stability. Nevertheless, this is a medium-term target and takes into account lags in the transmission of monetary policy. So even though the ECB has not indicated that it will tolerate inflation above 2%, it will not automatically tighten monetary policy when observed inflation exceeds the target but it will condition its action on its inflation expectations over a 12 to 24-month horizon. Its expectation for 2023 therefore indicates that current inflation is temporary and that beyond 2022 inflation should again be below 2%.

Figure 2. Inflation expected for 2022 by the ECB, the Federal Reserve and the Bank of England



** Inflation expected for the fourth quarter 2022.*
ECB, Federal Reserve (FOMC), BoE (Inflation report).

The Bank of England and Federal Reserve consider normalization

The communications from the central banks' monetary policy meetings held between 15 and 17 December 2021 were expected to focus on two points: the continuation of their asset purchase programmes and the level of the key interest rates.

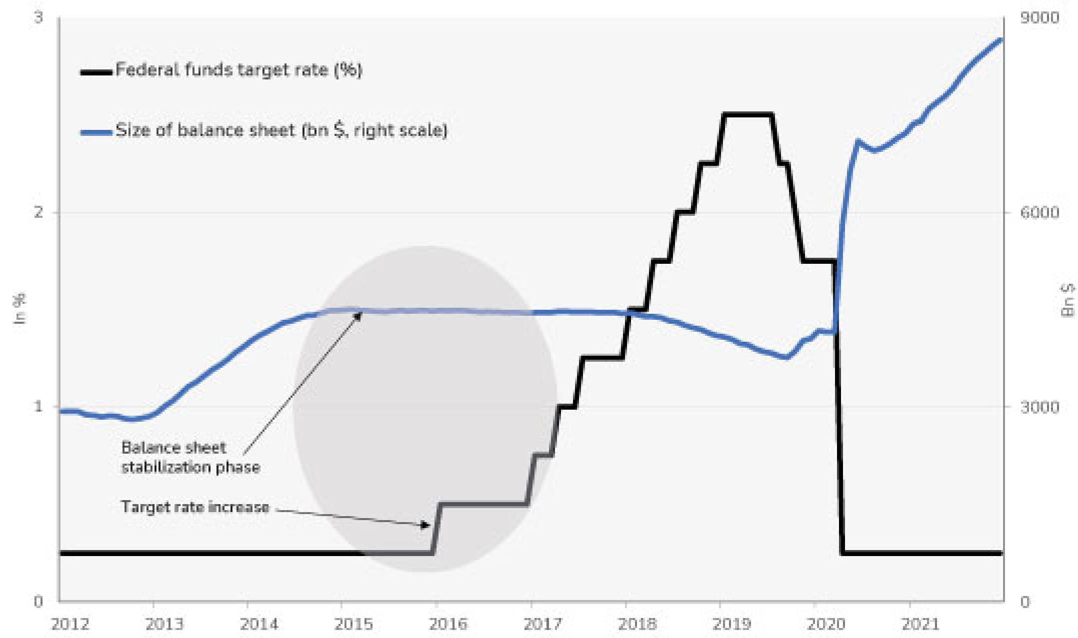
The BoE was the quickest to react by raising its key rate by 0.15 percentage points, from 0.1% to 0.25%. As stated in its 16 December press release: "The MPC's remit is clear that the inflation target applies at all times, reflecting the primacy of price stability in the UK monetary policy framework." Furthermore, it was decided to maintain the stock of securities acquired by the BoE. A key element of this decision is the way in which the BoE has implemented its asset

purchase policy.
Unlike the Federal Reserve and the ECB, which announce purchase flows on a monthly basis, the BoE proceeds in stages, announcing a target for the stock of assets – revised if necessary – and making purchases quickly in order to reach the target.[10] Moreover, the BoE has not made its rate decisions conditional on its asset purchase policy, whereas ECB communiqués have always stated that it would only consider rate hikes once asset purchases have stopped.

In the United States, a rate hike is to be preceded by a so-called taperingphase during which the Federal Reserve gradually reduces monthly purchases. The strategy implemented by the US central bank therefore consists first of all of communicating this path for asset purchases. This first step was launched in November. At the meeting of 15 December 2021, the FOMC announced that the pace of tapering down was being accelerated: from January 2022, monthly purchases will be USD 60 billion (40 bn for Treasuriesand 20 bn for Mortgage-backed Securities) compared with USD 120 billion per month before November 2021. There will be further reductions in the following months. The Federal Reserve is acting in a sequenced manner, as it did during the previous phase of normalization that began in January 2014 (Figure 3). Purchases stopped at the end of 2014, and the policy rate was raised in December 2015. Finally, the reduction in the size of the balance sheet – in billions of dollars – had been announced in June 2017 and implemented from October 2017.[11] However, the timetable is likely to be accelerated, as information from the 15 December meeting suggests that there could be three rate hikes in 2022. The time between the end of asset purchases and a rate hike would be shortened, and rates would rise more quickly than in this previous phase of normalization, when there was only one hike in 2015 and another one a year later. The FOMC members in fact anticipate a target rate for federal funds of 0.9% at the end of 2022, compared to the current range of 0-0.25%.[12]

It should also be noted that, in accordance with its mandate, the FOMC is focusing on the situation in the labour market, since the Federal Reserve must not only ensure price stability but also achieve maximum employment. In this regard, while the unemployment rate fell to 4.2% in December, employment remains 1.8% (or 2.8 million jobs) below the December 2019 level, also reflecting withdrawals from the labour force. The prospects of stabilizing the size of the balance sheet – in value terms – in early 2022 and of several rate hikes therefore indicate that the Federal Reserve sees labour market conditions as gradually converging towards the maximum level of employment.

Figure 3. Interest rates in the United States and size of Federal Reserve balance sheet



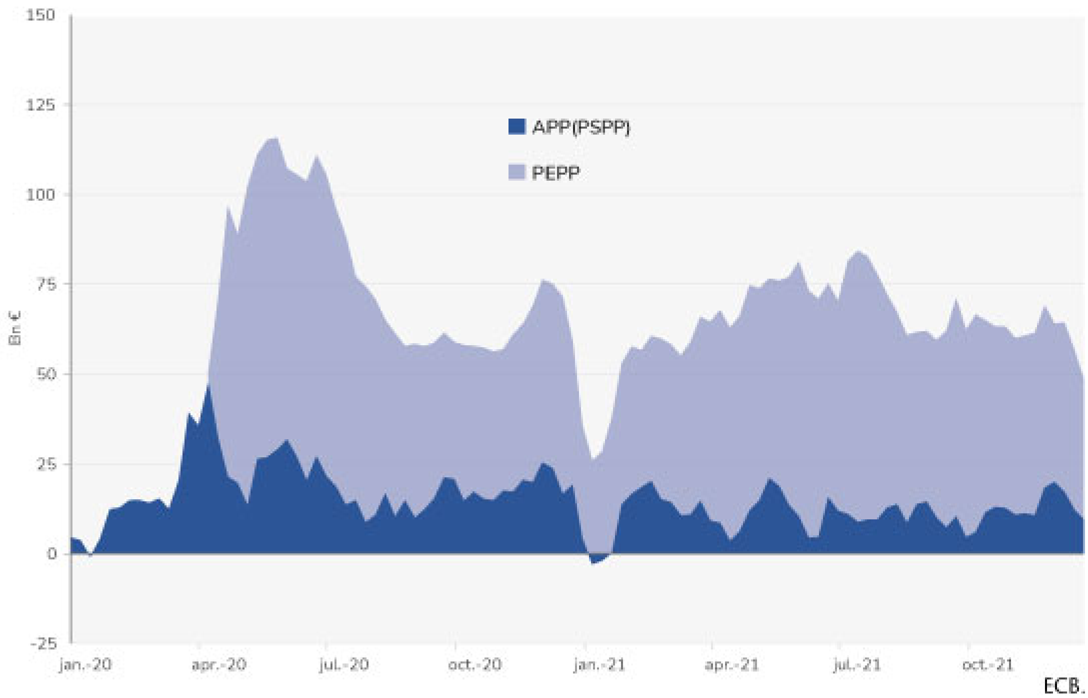
Federal Reserve.

The ECB takes a more cautious approach

In the euro zone, inflationary pressures have increased even as the economic recovery remains more fragile. In the third quarter of 2021, GDP was still 0.3% below its level at the end of 2019, whereas for the United States it was 1.4% above. There is nevertheless improvement in terms of the unemployment rate, which in November 2021 stood at 7.3%, lower than the level observed prior to the outbreak of the pandemic. However, in her press release at the 16 November press conference, Christine Lagarde considered that monetary policy must remain accommodating in order to bring inflation down towards its medium-term target. Thus, beyond the current inflationary pressure, the ECB still considers that inflation will remain below target in 2023, which therefore argues for a slower normalization of monetary policy in the euro area.

Nevertheless, the Governing Council announced the end of the Pandemic Emergency Purchase Programme (PEPP) in 2022.
The PEPP had been put in place in March 2020, in the context of the pandemic,
to combat sovereign risk.[13] Note that purchases had already slowed in line
with the announcements made since September 2021 (Figure 4). However, this reduction in purchases under
the PEPP would be partly offset by an increase in purchases throughthe Public Sector Purchase Programme
(PSPP). In the second quarter of 2022, purchases are to increase from 20
to 40 billion euros per month. They would then adjust to 20 billion euros in
October 2022, after a plateau of 30 billion euros in the third quarter. At this
stage, the ECB is not indicating a complete halt to asset purchases. The size
of its balance sheet would therefore continue to grow, postponing for the time
being the prospect of a rate hike, probably beyond 2022.[14]

Figure 4. **Cumulative monthly flows of ECB purchases of sovereign bonds**



ECB.

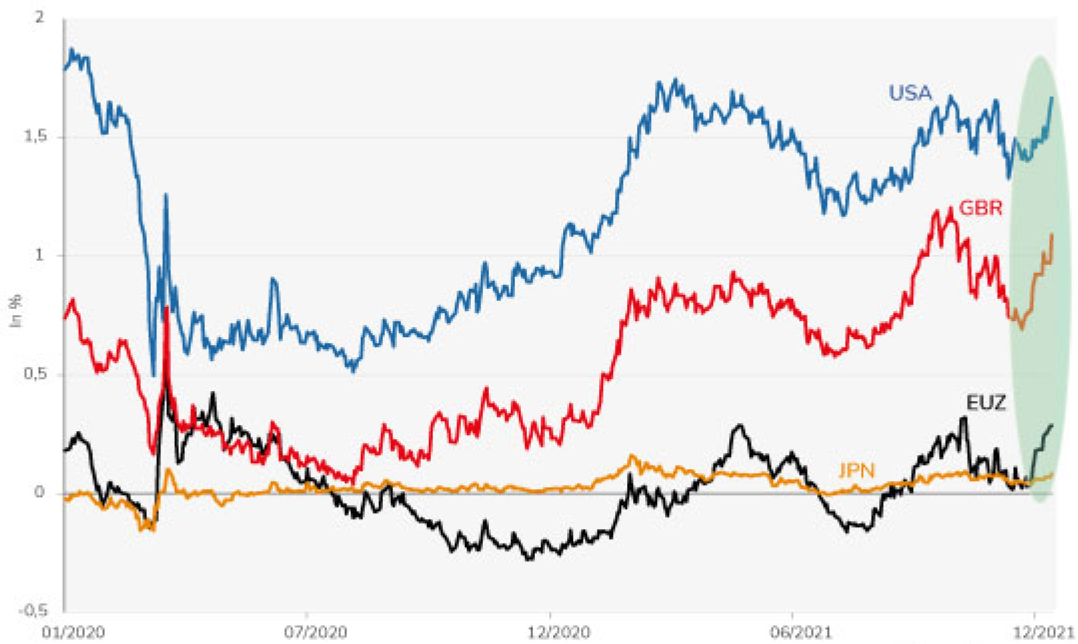
Although there has been talk of normalizing monetary policy, the central banks remain cautious about the recent inflationary surge, considering it a temporary episode. The same caution seems to prevail in most other industrialized countries. In Japan, although inflation is rising (to 0.6% in December 2021), it remains well below the BoJ’s target. The BoJ has therefore not changed its communications. Quantitative easing continues, and it is sticking to the goal of keeping the short-term rate at -0.1% and the government bond rate at 0%. Earlier this month, the Bank of Canada and the Australian central bank also maintained their rate targets. The target rose, however, in Norway.

How did the markets react to these policy announcements?

Since 15 December, long-term rates have risen in the euro zone, the United States and the United Kingdom, approaching the levels seen before the outbreak of the pandemic (Figure 5). The trend in Japan is much more modest. The average rate on government bonds issued in the euro zone rose by 24 basis points, with a slightly larger increase in Italy and Spain than in Germany and France. In the United States, the increase is comparable: 24 basis points between 14 December 2021 and 4 January 2022; but the rate is still below its pre-crisis level. In the UK, it’s risen over 35 basis points. The markets have therefore incorporated a moderate tightening of monetary

policy by 2022.
Should inflation remain at the level observed at the end of 2021, the central banks could accelerate the pace of monetary policy normalization, either byraising policy rates further or by reducing the size of their balance sheets, which would probably result in a further rise in long-term rates.

Figure 5. Changes in long-term rates



Eikon (Datastream).

The year 2022 should therefore be characterized by a rise in short-term rates and probably also in long-term rates in the UK and the US. It is clear that the inflationary surge observed since mid-2021 will lead the central banks, in particular the BoE and the Federal Reserve, to accelerate the normalization process. Normalization is also important to give central banks room to manoeuvre in case of new negative shocks. There is, nevertheless, economic uncertainty due to the arrival of the Omicron variant.

Even if agents have partly adapted to the health restrictions, a slowdown in growth without a reduction in inflationary pressures would create a more delicate trade-off for the central banks between their price stability objective and the need to support the economy.

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[1] See the OFCE post of 17 December 2021 [in French] on this point and the more detailed analysis of Le Bayon and Péléraux (2021).

[2] The policy rate set by the central banks represents a target for very short-term market rates. Changes in this rate are then intended to influence bank rates and all market rates along the term structure.

[3] The Federal Reserve and the ECB have recently reaffirmed the symmetry of this objective by revising their inflation targets.

[4] Inflation measured by the consumer price index rose by 7.1% in December.

[5] In December 2021, the consumer price index adjusted for food and energy prices rose by 5.5%.

[6] The way that inflation expectations are determined differs between the central banks. In the case of the Federal Reserve, expectations are formulated by the members of the FOMC, while for the ECB they are formulated by its own economists.

[7] Respectively, 2.3% and 2.2% at the end of the year in the US and UK, and 1.8% for the year as a whole in the euro zone.

[8] See our October 2021 economic forecasts published in *Policy Brief* no. 94: Le prix de la reprise [The Price of the Recovery].

[9] See the OFCE post of 4 January 2022 on inflation targets and expectations [in French] and the detailed analysis of Blot, Bozou and Hubert (2021).

[10] See Gagnon and Sack (2018) for a comparison of these two strategies.

[11] Measured in GDP points, the size of the balance sheet fell slightly earlier, from 26.4% in Q1 2015 to 18.8% in Q2 2019. Prior to the implementation of unconventional measures, the Federal Reserve's balance sheet was between 6% and 7% of GDP.

[12] This is the scenario that emerges from the *Minutes*. The Federal Reserve publishes a detailed report of the FOMC meeting three weeks following the meeting.

[13] See Blot, Bozou, Creel and Hubert (2021) for a more in-depth discussion of the objectives and effects of the ECB's sovereign asset purchase programmes.

[14] The 16 December press release does indeed state that: "We expect net purchases to end shortly before we start raising the key ECB interest rates."

Should the Eurozone rely on the US?

by Christophe Blot, Caroline Bozou and Jérôme Creel

The Covid-19 pandemic has led governments and central banks around the world to implement expansionary fiscal and monetary policies. The United States stands out for its substantial fiscal support, which is much greater than that in the euro area. In a recent paper prepared for the Monetary Dialogue between the European Parliament and the European Central Bank, we review these measures and discuss their international implications. Given the size of the US stimulus packages and the weight of its economy, we can indeed expect significant spillover effects on the euro area. However, the impact will depend not only on the orientation of economic policy but also on the precise nature of the measures adopted (transfers, spending and the articulation between monetary and fiscal policy).

Expansionary monetary policy is generally perceived as a policy based on self-interest, since a fall in the US interest rate should lead to a depreciation of the US dollar that is unfavourable to America’s trading partners. However, the literature shows that the exchange rate channel can be dominated by a financial channel and by increased demand from the US economy, both of which generate positive spillovers (see Degasperi, Hong and Ricco, 2021).

The international spillover from US fiscal policy should also be positive, once again *via* demand effects, and also due to an expected appreciation of the dollar (see Ferrara, Metelli, Natoli and Siena, 2020) as well as from expectations of a return to balanced public finances à la Corsetti, Meier and Müller (2010). The favourable impact on the rest of the world might also be attenuated if the US fiscal expansion were to lead to a rise in the global interest rate. Ultimately, the magnitude of the international spillover effects of US fiscal policy will depend on the response of the exchange rate and the interest rate. Faccini, Mumtaz and Surico (2016) confirm the importance of financial effects but nevertheless show that the real interest rate could fall after a US expansionary shock.

In this paper, simulations conducted using a macroeconomic model and empirical analysis confirm the positive effects of US expansionary monetary policy on euro area GDP. There is, however, uncertainty about the timing and duration of these positive effects.

As regards fiscal policy, empirical analysis suggests that the spillover from the US measures implemented since the outbreak of the Covid-19 crisis will be positive, at least in the short term (in the first two years). Given the size of the fiscal impulse, the impact would not be negligible.

The global spillover from US macroeconomic policies is therefore expected to be positive, but there is some uncertainty beyond 2022.

However, it should be borne in mind that the euro area's growth will depend primarily on the path taken by its own policy mix. The euro area should not therefore rely only on US policy to consolidate and accelerate its recovery. The contrasting fiscal impulses in 2020 and 2021 between the US and the euro area already indicate a risk of increasing divergence between the two regions.

We also briefly discuss that the main repercussions from the US may come not from macroeconomic policies but from financial risks. Asset prices have risen sharply in 2020, sparking fears of a financial bubble, at least in the US. This risk could have a significant impact on the euro area in the medium to long term.

The “modern theory of money” – is it useful?

by Xavier Ragot

A heated debate is currently taking place in macroeconomics. The change in US economic policy following the election of Joe Biden has sparked debate over what to expect from “Bidenomics”. The debate has seen radical Keynesian proposals being promoted by the “modern theory of money” (MMT). This movement advocates massive stimulus packages and the monetization of public debt. This post discusses the MMT proposals through a review of two recent books that have recently appeared in French: **Stephanie Kelton, *The deficit myth* (**John Murray, 2020**)** and **Pavlina Tcherneva, The case for a job guarantee** (Polity, 2020).

Before criticizing MMT, we should briefly summarize its proposals: the first key idea is the promotion of monetary policy in the service of fiscal policy. MMT supports the systematic purchase of public debt by central banks, the so-called *fiscal dominance* of monetary policy, in order to allow for an increase in public spending. For economists, fiscal dominance is opposed to *monetary dominance*, which defends the idea that the primary role of monetary policy should be to control inflation and leave the financing of public expenditure and debt to taxation.

The second proposal is the promotion of the state as the employer of last resort. The state should be in charge of providing jobs that are useful to the public to all unemployed people, i.e. a public employment service to avoid falling into poverty.

The rather benign criticism of the modern theory of money offered here can be summarized as follows: it is difficult to see anything really new. MMT is not really a theory of money, nor is it modern, though it does stimulate debate!

Should public debts be financed by money?

First of all, let's not deny ourselves the pleasure of acknowledging that Stephanie Kelton's book is a good mainstream economics book, and a lively and controversial introduction to macroeconomics. The book is of course not perfect, but prior to any criticism, let's first note that it is a pleasure to read. Stephanie Kelton's thesis is that money creation is carried out on behalf of states, for countries such as the United States or Great Britain that do not belong to monetary unions. In these countries, the state can ask the central bank to buy up as much public debt as it wants by creating money: it is the state that sets the statutes of its national central bank.
This monetary sovereignty allows the state to finance policies, with the only

constraint being inflation. For MMT, monetary policy should serve fiscal
policy, which should manage inflationary risks by stabilizing aggregate demand.
This approach is interesting because it evokes certain economic truths, or simply
accounting truths. Let's consider a couple of these before offering some criticism.

The first is that public debt is held by someone: a
state's debt is someone else's wealth. Consequently, it makes no sense to write
that "we" are indebted because the state is indebted. On the contrary, we are enriched
by the public debt we hold on the state. The impact on our wealth depends not
on the debt itself, but on how the financing of the debt interest is
distributed. This way of thinking leads to restoring the accounts of agents.
When the state issues debt, other actors hold it, and will receive the interest
on the debt and the eventual repayment of the principal. Public debt therefore
contributes to the formation of other actors' wealth.

The value of Stephanie Kelton's book is that it
presents these accounting relationships in a lively and polemical manner,
directly attacking politicians in the US who do not understand these
macroeconomic realities. Indeed, it should not be assumed that there is a broad
understanding of these macroeconomic features. In France, there are still
people who believe that the public debt represents "indebtedness to future

generations", which makes little sense, as has been discussed elsewhere. Stephanie Kelton's fight on behalf of macroeconomics is therefore salutary, and much remains to be done.

The second accounting truth is more interesting for the public debate. In our economies, central banks belong to states that have a monopoly on issuing central bank money, such as the banknotes, coins and currency held by banks. By force of law, this money cannot be withheld from transactions. The existence of cryptocurrencies will not significantly challenge this monopoly in the near future. Furthermore, we can expect a vigorous response from the states aimed at ensuring their central bank's control over the issuance of money. This public monopoly holds in the euro area as well, even though the European Central Bank "belongs" to different states. However, overall money creation is for the benefit of the states. So how does a macroeconomist think about all this? At an abstract level, the state can finance itself either by issuing public debt or by issuing money. The latter possibility is called "seigniorage" in the economic literature, because it stems from the monetary sovereign's monopoly on issuance. This general view is taken for granted in monetary economics. For example, the standard textbook on monetary economics devotes an entire chapter to it (see chapter 4 in Carl Walsh, *Monetary Theory and Policy*, MIT Press). The fact that government debt is held by non-residents does not change the logic, as they are paid in the national currency. As long as inflation is low and not very volatile (and that is the point!), the national currency is accepted in the exchange. The problem with monetary financing is that it can create destabilizing effects and generate inflation, which reduces household purchasing power, with complex effects on inequality. Predictable inflation is nowadays said to be a public good, because it allows people to avoid unpredictable fluctuations in their income.

So there are really no new theories in MMT. In my opinion, the importance of this "theory" is rather different, and does not involve convincing the macroeconomist or the monetary theorist. The point is to promote an alternative economic policy, stimulating activity through higher public debt and the eventual monetization of public debt, while accepting a higher inflationary risk. The book defends the historic post-WW2 economic orientation, so-called traditional Keynesian policy, which involved drawing on fiscal tools to achieve full employment, even if this leads to moderate inflation. In doing this Stephanie Kelton rehabilitates Abba Lerner who, from the 1940s onwards, promoted policies that would later be described as Keynesian, and which he called *functional finance*. Abba Lerner emphasized that his contribution was to show the coherence of Keynesian thought: the aim of economic policy is full employment, the means are public debt and money creation, and, because of the possibility of issuing money, the risk is inflation and not the unsustainability of public debts. In 1943, he presented his conception in fourteen pages written in a very accessible form. The history of inflation in the 1970s showed that the use of these policies to revive economies with production constraints (linked to oil at the time) could lead to high and volatile inflation. Clearly identifying a demand shock is necessary to control inflation.

Again, there is nothing radically new here in the United States, where the central bank's mandate is to ensure low inflation and maximum employment. It is in the euro area that this statement implies a profound change, as the ECB's sole mandate is price stability, not economic activity. Making changes to the ECB's mandate is an old topic that is mentioned in passing, and dealt with at greater length here in the wake of the 2008 financial crisis.

Let us turn now to a critique of the book. The limit on debt monetization or monetary financing of public expenditure is inflation, as the author reminds us. However, nothing precise is said about the link between economic policy and inflation. Yet this link is essential to properly calibrate the amount and the format of the stimulus package in the US, and which we need to develop in Europe. The ECB holds around 23% of France’s public debt. How far can we go? What are the economic and social costs of higher inflation? How can we ensure that inflation expectations do not rise dangerously?

This subject has been studied extensively from various angles: the relationship between economic activity and inflation, the famous Phillips curve, for example, covered in a recent article here. The relationship between the quantity of money and inflation has also been analysed extensively, for example here. To understand the effects of inflation, it is necessary to study in detail who holds money and why, which we do here.

The work of Stephanie Kelton and the MMT economists carefully avoids citing the work of other approaches in order to foster the appearance of a new school of economic thought. At this point, however, that is not the case. Stephanie Kelton’s book is a good introduction for those who want to learn about the macroeconomic policy debate through topical issues from a polemical angle. But MMT has to be criticized for its relative macroeconomic naivety and empirical weakness.

The second revendication of the MMT authors is the promotion of a job guarantee for all employees. This second aspect is independent of the macroeconomic management of aggregate demand and the financing of the public deficit. It concerns the residual part of underemployment that exists in the business cycle. The proposal set forth by Pvalina Tcherneva is simple: it consists of proposing an additional tool, an offer of public jobs paid at least at the minimum wage (which Pvalina Tcherneva wants to increase to $15 for the United States). These jobs would not be compulsory, but would constitute a universal right for the whole population. They would be linked to training, accreditations and apprenticeships, with the goal being that when those employed in these jobs leave they should be suited to find a job in the private sector. According to the author, these jobs are not intended to compete either with public employment with identified objectives or with private employment, which responds to a solvent demand.

The French reader will find these jobs familiar: they could be subsidized jobs in the non-market sector, which we know can boost the returns on employment, when the qualification achieved is effective, as is shown in evaluations. The proposal is to make the number of such jobs endogenous through the demand of workers over the cycle. While a deep-going reform of the training and apprenticeship system is necessary, the proposal of a counter-cyclical use of this type of job is interesting and already in partial use.

Paradoxically, perhaps, the interest is in thinking not an opposition to the market economy, but a policy of

stabilization, which
gives rise to radical criticism of MMT! The cyclical employment deficit
is compensated for either by vigorous and potentially inflationary management
of aggregate demand or by a policy of generating public jobs. These Keynesian
policies are developed within the so-called post-Keynesian approach, which is one of 50 shades of Keynesianism
(neo-Keynesian, historical Keynesian, post-Keynesian, circuitist, etc.).

MMT, post-Keynesianism, and Joe Biden's new economic policy

We are witnessing a profound change in US economic
policy with plans for investment stimulus packages, higher taxes on
corporations and wealthier households, and a plan to increase the federal
minimum wage, all with an accommodating central bank that seems to have little
concern about short-term inflationary pressures. These developments are in line
with the MMT recommendations (without taking up all the recommendations). One legitimate
question is to identify the role of this school of thought in these
developments. This can only be answered imperfectly, as the mysteries of
economic policy are so obscure, sometimes for the decision-makers themselves.
The MMT proposals were first taken up by Bernie Sanders, who leads the left
wing of the Democratic Party and whose economic adviser for the 2016 campaign
was Stephanie Kelton. As a result, the proposals have become

part of the
American economic debate.

However, one can trace a completely different
intellectual genealogy of the change in US economic policy, from either the
neo-Keynesian or Keynesian stream, and this seems to me to be more realistic.
The work of Paul Krugman on the liquidity trap in Japan, of Lawrence Summers on secular stagnation, and of Olivier Blanchard on the role of multipliers (among many others) have for several years now led to developments within the IMF and the OECD in a much
more Keynesian direction. These developments are independent of MMT, which
presents fewer empirical proposals than some of the work cited here. Thus,
Biden's economic turn seems to me to be much more imbued with the pragmatic
experience of the real world than with a new "alternative" body of theory. What
is described as pragmatism is in fact above all an empirical approach to
economic mechanisms, in a context of low interest rates that give states a new capacity for debt.

European lessons?

To conclude, what are the lessons for Europe of MMT
(and the Keynesian turn in US policy)? The expansionary use of fiscal policy
and the monetary financing of public deficits can of course take place only at
the level of the euro area, as it is the central banks of the Eurosystem that
have the monopoly on issuing money. The problem therefore is not so much
economic as political. The different economic situations in

the euro area are
giving rise to different requirements for a recovery. Germany's economy is
stimulated by strong external demand due to a favourable internal exchange
rate. Germany's public debt is expected to be around 65% in the coming
quarters. The Italian economy is experiencing weak growth and a public debt of
160%. More than any theoretical debate, it is this economic and political
divergence that is paralysing Europe. The judicious use of European recovery packages
can bring about re-convergence and job creation, but that is another matter.

Monetary Policy During the Pandemic: Fit for Purpose?

Christophe Blot, Caroline Bozou and Jérôme Creel

In a recent Monetary
Dialogue Paper for the European Parliament, we review
and assess the different policy measures introduced by the ECB since the
inception of the COVID-19 crisis in Europe, mainly the extension of Asset
Purchase Programme (APP) measures and the development of Pandemic Emergency
Purchase Programme (PEPP) measures.

APP and PEPP have had *distinct*

objectives in comparison with former policies. APP has been oriented towards price stability while PEPP has been oriented towards the mitigation of financial fragmentation.

To this end, we start by analysing the effects of APP announcements (including asset purchase flows) on inflation expectations via an event-study approach. We show that they have helped steer expectations upward.

Then, we analyse the impact of PEPP on sovereign spreads and show that PEPP has had heterogeneous effects that have alleviated fragmentation risk: PEPP has had an impact on the sovereign spreads of the most fragile economies during the pandemic (e.g. Italy) and no impact on the least fragile (e.g. the Netherlands). However, sovereign spreads have not completely vanished, making monetary policy transmission not fully homogeneous across countries.

On a broader perspective, we also show that overall macroeconomic effects have been in line with expected outcomes since the mid-2000s: ECB monetary policy measures have had real effects on euro area unemployment rates, nominal effects on inflation rates and financial effects on banking stability. These results are in line with recent estimates at Banque de France (Lhuissier and Nguyen, 2021).

As a conclusion, an increase in the size of the PEPP program,

as
recently decided by the ECB, will be useful if financial risks re-emerge.
Meanwhile, we argue that an ECB decision to cap the sovereign spreads during
the COVID-19 crisis would alleviate the crisis burden on the most fragile
economies in the euro area, where sovereign spreads remain the highest.