

PANELISTS DEBATE

Jean PISANI-FERRY

I would like to go back to three topics. You just added a fourth one, fiscal policy, but let us start with these three. The first is this issue of competitiveness and wage price adjustment. You all agree on the diagnosis, that this part of the functioning of the Euro area is not satisfactory.

Jean-Claude TRICHET

It was not.

Jean PISANI-FERRY

Yes. Some adjustment took place, perhaps faster than some would have expected. Ireland has adjusted extremely well, and Greece is adjusting. Portugal is adjusting. Therefore, it is taking place, but slowly and in a partial way. This is something that was not sufficiently present at the start and not sufficiently addressed in the reforms. You mentioned the excessive imbalance procedure. It has not been implemented.

Jean-Claude TRICHET

It is asymmetrically implemented.

Jean PISANI-FERRY

It is supposed to be implemented. It was supposed to be symmetrical. The procedure was never activated, so the macro side remains neglected. That is one point. One of Olivier's recommendations is that we can do better by having a higher inflation rate, so achieving 2%, really, and that means, in this current situation, taking the risk of being a little above 2%. However, the risk of too-low inflation is very detrimental to the Euro area. Secondly, that means a much more institutional approach to wage price setting and the social partners. Can I have some reaction from you on this topic?

Ashoka MODY

Yes, I can give you very quick reactions. Firstly, inflation is stuck at 1%; in Italy it is about 0.6%. Talking about higher inflation in Germany, the ECB has essentially lost credibility as an inflation-fighting machine, and therefore there is a disengagement between price-setting behaviour and monetary policy. This is like the Bank of Japan – essentially, you have the same problem here – which keeps trying to introduce some stimulatory monetary policy and inflation does not budge, because there is no connection between how people set prices and what monetary policy does.

Regarding adjustment through wages, the main problem here is social. I tell a story in my book about a woman who is a worker in a factory in Ivrea, and her income has gone down from EUR 1 000 to EUR 600 a month, and she says that if it is cut any more, she will not be able to pay her mortgage. The social cost, the social discontent that is created through this process, is enormous; that is why people have floating exchange rates. The rest of the world has floating exchange rates for a very good reason – because it creates an easy adjustment process. Adjustment through wages is almost never possible.

Coming back to a statement that Olivier made, that a floating exchange rate was a non-starter, it is a non-starter today, I understand that, but I do not buy that it was a non-starter. I simply do not buy that. Jean-Claude will remember that from the time of the breakdown of the ERM to the time of the introduction of the Euro was a period of seven years, and exchange rates were effectively floating. He was making sure that the exchange rates remained close to what it was for Germany, but that was a policy choice, there was no commitment. That is the crucial point – there was no commitment to a fixed exchange rate, which allows the possibility of an adjustment through the exchange rate if there is a crisis. That possibility was essentially removed, and if that is removed, adjustment through wages will never happen.

**Jean PISANI-FERRY**

Jean-Claude, can you address this issue of the inflationary machine and the possibility of generating inflation on target?

Jean-Claude TRICHET

It is a problem for all major central banks of the advanced economies. First of all, I would like to go to the point made by Olivier. It is absolutely clear that rules were not respected. My first speech, having just been appointed President of the ECB, was to tell Germany and France under the presidency of Italy, in the European Parliament, that it was a pity to refuse the normal implementation of the rules of the Stability and Growth Pact to Germany and France. Jacques Chirac and Chancellor Schröder were on the same line, and they were backed by Italy. It has been a pity, not particularly for Germany but probably for France, and of course for Greece, Portugal and Spain in some respects, that the Stability and Growth Pact was not to be respected with the full support of the biggest countries.

A second experience I could mention was that since 2005, looking at the persistent national divergences we were observed in cost competitiveness and external imbalances, I was circulating, every month, to all ministers of finance of the Euro area, the evidence of those divergences that were going on since the start of the Euro until 2009, namely just before the financial crisis. The only event that triggered the arrest of that phenomenon, objectively, had been the financial crisis. Governments were all aware of that; they were all aware of the fact that it was possible in this currency area to have wages and salaries in the Greek public sector to grow by 117% from the start of the euro to the end of 2009, when it was 110% in Ireland, 70% in Portugal, 36% on average in the EU area, and 20% in Germany!

Jean PISANI-FERRY

Are you not lending support to Ashoka?

Jean-Claude TRICHET

It was clear since 2005 that we needed very strong governance at the centre in order to do what Olivier was calling for, and what was done in the heat of the crisis, with the obligation for a number of countries to go back to sounder macro-policies. All highly imbalanced countries at the time of the sovereign risk crisis, by the way, are now in current account surplus. It was obvious that taking into account the dimension of the imbalances, the adjustment would be very painful.

That being said, we are now supposed to be in a different world, and I fully agree with Olivier that the macroeconomic imbalance procedure has to be applied symmetrically. Maybe a number of observers were too optimistic in thinking that Germany, in an overheating situation, would go back to the average yearly inflation it had displayed in the past? Germany had yearly average inflation of 2.9% during the 40 years before the Euro. That is clearly what we need now, for a while: we want the 2% to be respected in the Euro area as a whole, we need a number of countries – the cases in point are clearly Germany and the Netherlands, and perhaps Austria, over the average of 2%, along with others below the average – for them to catch up with their loss of cost-competitiveness inside the setup of the Euro area.

Let us not forget that the Macro-economic Imbalance Procedure (MIP) has been created. My criticism would be that it is not applied as it should be, and I fully agree with Olivier on that point. But let us not say that we did nothing in the circumstances. I was myself calling for that since the first observation that there was no spontaneous correction of this persistent divergence.

Olivier BLANCHARD

Ashoka said something unfair, and Jean-Claude was too polite to contradict him. He said that the ECB has lost all credibility because inflation is less than 2%. We understand the problems of central banks. The ECB is not the only central bank to have been unable to increase demand sufficiently to achieve inflation. It has done more or less everything it could; it was just not enough. The same has been true in the US – it has taken a long time to get back to 2%. I am happy to say this because I have criticised the ECB enough in the past to have credibility, but you should not say things like that.

**Ashoka MODY**

There is a huge difference between the Fed and the ECB.

Jean-Claude TRICHET

I appreciate very much what you said. Since the very beginning, by the way, we delivered 1.75% - for a central bank that said at the very beginning that it would be less than 2% but close to 2%, it is not that bad overall!

Ashoka MODY

I am not speaking of your phase, Jean-Claude, I am speaking of today. Today the inflation rate is stuck at 1%, the Fed is at 2% and rising, the ECB is stuck at 1% and not rising.

Jean-Claude TRICHET

Ashoka, there is some kind of consensus now, including at the IMF, that the ECB is not absurd in projecting 1.7% for next year and 1.7% for the year afterwards.

Ashoka MODY

It has been predicted for the last five years.

Jean-Claude TRICHET

Yes, but we were in the worst crisis since World War Two, and it started in Wall Street, so to put the blame on the Euro area is a little overdone.

Jean PISANI-FERRY

Olivier, you recently published a piece on Italy, giving your assessment of the fiscal policy of the current coalition, so that would be a good point to start with.

Olivier BLANCHARD

I will make two points, the first regarding this piece you referred to which came out yesterday.

It argues that the fiscal expansion Italy is embarking on may actually not affect growth positively. The reason is that, when you have a fiscal expansion, you typically will get an increase in interest rates; in countries in which the central bank controls monetary policy, the central bank may want to increase rates to avoid overheating. But, in a country which is part of a common currency area, and in which foreign and domestic investors are on edge, you get a sovereign spread. The increase in the spread, due to anticipations of loose fiscal policy, confirmed in the budget which just came out, about 250%, probably offsets the positive direct effects of the fiscal expansion. My sense is that the growth forecasts for Italy are wrong, and this has implications, because if they do not deliver on growth and they have a larger deficit in the end, things will look bad.

The other point I want to make is more fundamental. If you have a government in any member country which is perceived as being potentially fiscally irresponsible, or makes noises about euro exit, this is a recipe for foreign investors and domestic investors to take their money and move out. Euro exit can happen, even if this was not the intention of the government. Leave aside Italy. If populism continues to grow, I worry that, in the next 10 years, we see this scenario happen somewhere. The Euro is incompatible with at least some forms of populism.

Jean PISANI-FERRY

I would add one caveat to what you said, because it can be understood as saying that we have no instrument. There is an instrument, the OMT of the ECB, but it supposes that there is a policy programme agreed upon between the ESM and the government, which is obviously the solution to that political equation.

Olivier BLANCHARD

Should somebody change their mind and see that the writing on the wall, a crisis can indeed be avoided, but if a government insists on keeping the same line and, right or wrong, that line worries investors sufficiently, there is no OMT, there is no program, and things go bad.

Jean-Claude TRICHET

Any time we have a problem, we are back to the existential problem of the Euro and the Euro area. This is wrong, and we proved over the last 20 years that this permanent assumption that we are on the verge of catastrophe is not right. We had a real dramatic stress test and we passed it. The situation in Italy today is much better, obviously, than that of Greece in the crisis. As a matter of fact in Greece the people did not want to leave. The Italian people do not want to leave, and the President of the Council of Ministers in Italy and the leaders of the other two parties said publicly that they did not want to leave the Euro or the EU.

There is a triangle between the market itself, namely investors and savers the world over, the national government and the promise they made, and the Commission and the European Institutions. My bet, the result of which I am very confident about, is that a solution would be found. I experienced that in August 2011, and it was so dramatic that we intervened in the market overnight, massively, through the SMP programme. We did not let the speculation explode. I wrote a letter to Berlusconi and explained to him, over the double signature of the president of the ECB and the national governor Mario Draghi, that the situation was so dramatic that the Government had to give a number of new signals to the investors and savers in Italy, in Europe and the world over. It was done, and there were many changes in the macroeconomic policy.

I am confident that we will surmount the difficulties. I fully agree that the political difficulty is extremely worrying, not only for Italy but for others, because when the extreme left and extreme right are uniting, it is the worst possible political situation you can have. We had the experience of the 1930s between the two world wars, so I take the political aspect extremely seriously. But I would not say it is plain wrong to conclude that the Euro area will explode.

Olivier BLANCHARD

I am not saying it will happen. I would indeed bet against it if I had to take a bet, but the probability is sufficiently high that we have to think about it.