JEFFRY FRIEDEN

Professor of Government at Harvard University

Jean-Claude Trichet, Vice Chairman of the Académie des sciences morales et politiques, former Chairman of the European Central Bank, Honorary Governor of the Bank of France

Now I turn to Jeffry Frieden, who we know even if he was not here last year.

Jeffry Frieden

I was teaching, sometimes we have to teach.

Jean-Claude Trichet

He teaches very brilliantly as Professor of Government and if I am not wrong, he is Chair of the Harvard Department of Government and of course, one of the most important and well-known professors in our domain. You have the floor, and we are very keen to hear what you have to say.

Jeffry Frieden

Thank you, Jean-Claude and I take the opportunity to take into account your questions and the expectations we can answer them all in five minutes. I am going to avoid that by invoking my own comparative advantage, which is political economy, the intersection of politics and economics. I want to focus on a couple of issues I think are central. I absolutely agree with the previous speaker about the importance of what is happening in West Africa and the developing world more generally, but again, given my comparative advantage I am going to focus on some of the problems that face us in in the OECD and especially the US.

The end of cheap money has very broad and deep implications, as Jean-Claude has indicated. The most direct is that it creates a whole series of new or renewed sources of financial instability as markets re-equilibrate. We saw bubbles in market after market over the course of the last 15 or 20 years, with very low or even negative real interest rates. That era is coming to an end, and I think it will lead to a series of financial difficulties as rebalancing takes place. As Jean-Claude has indicated, it is not surprising that many of these problems will surface in the non-bank sector and the non-bank financial institutions. In the regulatory literature there is a concept of a regulatory dialectic, which is that the markets innovate while regulators run behind the markets trying to figure out how to strike a balance between innovative activity on the one hand and safety on the other. Of course, the regulators are usually running after the markets rather than the other way around. They eventually catch up -- usually in times of crisis when the riskier financial institutions have collapsed -- and impose a whole new series of regulations. Then in the next round, the private sector tries to find its way around them. That is what is happening in this instance as well, so I think we face the unfortunate prospect of a new round of zombie financial institutions and zombie firms that have the threat of exercising a serious drag on economic growth. The first problem is not just where the financial instability is going to come from and what the policy response will be but that there are powerful political pressures to keep insolvent financial and non-financial institutions alive to try to avoid a further crisis. Will we have another Japanese-style series of zombie banks and institutions with the resultant drag on economic growth?

The second problem is more general and is the constraints on economic policy in the current period. Monetary policy was practically the sole tool of economic policy for much of the most recent period, especially after the great financial crisis. Then the pandemic hit and virtually every developed country and many developing countries spent dramatic amounts of money – justifiably so – to keep their economies going in the face of a global pandemic. Fiscal policy in most countries is now heavily constrained by a very large public debt burden coming out of the global financial crisis and the pandemic. In an ideal world we would have a monetary policy that was accompanied by a fiscal policy. We understand that the monetary policy necessary in the current circumstances is going to be restrictive, and so we would have a fiscal policy that would try to cushion the blow, especially for some of the more vulnerable segments of the population. However, in previous periods monetary policy carried too much of the burden. Now, we would hope that there could be some sharing of the burden of economic policy with a shift toward fiscal policy, but most countries find their fiscal policy possibilities tightly constrained by the existing burden of public debt. I think we face a very difficult time in the making of economic policy where monetary policy seems to have no choice but to focus on fighting inflation and fiscal policy that could dampen or soften some of the blows of that restrictive monetary policy is tightly constrained.

My final point is to think about some of the political implications of what is going on. We are only at the beginning of a period of restrictive monetary policy after at least three decades of the great moderation when interest rates were extremely low and growth was reasonable. In that context, as restrictive monetary policies kick in, they will slow growth, as they already have in some countries more than the US. From a political standpoint, we can anticipate substantial pressure arising to take the brakes off monetary policy. We could argue about whether this is justified and there are current debates in the US as to whether it is worth the candle to raise interest rates or what the appropriate balance is between concern over inflation and concern over employment. We find ourselves in a sweet spot now where employment is doing very well, but that will not continue forever. When there is a clear trade-off between fighting inflation on the one hand and creating jobs or avoiding unemployment on the other, I think there will be political consequences. To be very specific, in countries that face increasing recessions in the context of tight monetary policy, I think this will provoke a resurgence of populist pressure from segments of the population that believe that central banks and the bankers are doing what they can to impoverish the working population and that they should be taken under control by the political system. I think the medium-term political prospects also presage a great deal of controversy over the appropriate measures to be taken. Those are my thoughts about the intersection of the economic events we are experiencing and some of the political and policy dilemmas we will face moving forward.

Jean-Claude Trichet

Thank you very much indeed, Jeff. I only note *en passant* that inflation is also triggering populist reactions that are very violent. I interpret the dialogue between the President of the US and the Chair of the central bank, as the President more or less saying that you are responsible for inflation, and I count on you to do the job. I see you nodding and of course, we will discuss that.