

# Different Economic Strokes

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By Jean Pisani-Ferry,

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Do U.S. and European economic policy makers live on the same planet? It doesn't seem so.

In the last few weeks, amid turbulence in markets and the economy, the U.S. Federal Reserve lowered interest rates by 125 basis points and Congress agreed on a \$168 billion fiscal package. But at the same time, the European Central Bank left interest rates unchanged. European governments showed no appetite for reflation and the European Commission continues its call to reduce deficits.

These contrasting approaches stem, in part, from different circumstances. Signs of recession have been coming thick and fast in the U.S. The real-estate market is caught in a depression spiral, growth in services is weakening, unemployment is up, and the general mood gets bleaker by the day. In the euro area, the property market is a problem in Spain, but not in Germany. Unemployment is still on its way down. Growth has slowed but not faltered. Households are worried, but business remains more upbeat. So, in short, clear and present danger on one side of the Atlantic and only apprehension on the other.

Beyond that explanation for the policy prescriptions favored by the EU and U.S., however, we're also seeing dissimilar philosophical approaches to economic policy in action. The American response, though not especially prompt, has been astonishingly muscular. By making two cuts in interest rates in less than 10 days and by rallying to the fiscal stimulus, the Federal Reserve has unambiguously expressed strong concern.

Fed officials have elaborated why. According to Governor Frederic Mishkin, when the situation seriously deteriorates, it is no longer possible to treat upside and downside risks symmetrically. The priority is to head off downside risks, even if they have little chance to materialize, on account of the serious impact they would have if they did. In other words, better to run a one-in-two chance of ending up with a bit too much inflation than a one-in-10 chance of having a depression on your hands.

By contrast, ECB President Jean-Claude Trichet and his colleagues hold that composure is the main virtue of a central bank. Unlike the Fed's Ben Bernanke, they do not see their role as that of an insurer whose presence encourages markets to throw caution to the winds. They stress that, through well-intentioned bustle, the central bank itself runs the risk of being a cause of volatility. The ECB also likes to say that there is much more inertia in the functioning of the euro area economy than in the U.S., and a more sluggish economy justifies moving policy rates more slowly.

Much the same argument is made about budgets. Europeans doubt the ability of governments to manage deficits reasonably and prefer them therefore to do nothing. For the U.S., keeping the boat on an even keel implies being ready at any moment to clamber onto the deck in order to adjust the sails. For

Europe, it is more advisable not to allow too much canvas and to minimize any movement that might capsize the boat.

The diverging philosophies are partly the result of historical experience shaped, on the U.S. side, by memories of the depression and, on the European one, of inflation. So institutions were built to produce different results.

This is very clear in fiscal matters. In Europe decision-making is the preserve of individual member states. The EU's role is confined to setting limits to the deficit and making sure these limits are adhered to. There is no federal budget of macroeconomic significance and no way to engineer joint fiscal stimuli. The union can legally instruct the member states to reduce their deficits (and does so, with admittedly uneven success), but not to increase them.

A similar dynamic can be seen in monetary policy. The Federal Open Market Committee has 12 members, of whom seven are centrally appointed, and decisions are made by majority. It is a very responsive body capable of abrupt swings in position. From the Fed's accountability to Congress to its dual mandate (to fight inflation and spur job creation) and the four-year term of its chairman, the incentive is to be reactive.

Its European counterpart has 21 members, among whom 15 are the national governors of the euro-zone countries and only six are centrally appointed. It operates by consensus. Because some of the founding countries had an inflationary tradition, the bank was protected from political pressures.

Inevitably, decision-making is slower and action is measured. It's true that last autumn the ECB reacted very swiftly to liquidity shortages. But this was a technical matter, since the decision to intervene is far easier to push through in Frankfurt than to move rates.

The real question for Europe isn't whether it should follow the U.S. now and embark on an all-out reflation. The situation today does not call for that. It is: If it was necessary, could the euro area muster the will and the capacity to act swiftly in order to ward off a serious macroeconomic risk? The system was not designed for that purpose and anything that would require coordination among the various players is bound to raise a host of difficulties. However, a policy system must be assessed by its ability to respond to all sorts of threats, not only those that were prevalent at the time of its design.

This is a question as much for the EU member states as the ECB, and it's high time Europeans start discussing it seriously.

Mr. Pisani-Ferry is director of the Brussels-based think tank Bruegel.