Transatlantic contrasts

Jean Pisani Ferry, Le Monde, 6 February 2008

In the space of less than ten days the US Federal Reserve has lowered interest rates by one-and-a-half points. In barely two weeks Democrats and Republicans agreed on a fiscal stimulus of $150 billion which no one had been talking about a month earlier. In Europe the European Central Bank (ECB) left interest rates unchanged and the European Commission continues its call to governments to reduce their deficits. Hyperactivity on the other side of the pond, no action over here. The contrast has never been more stark.

The discrepancy is attributable in part to the business cycle. Signs of recession are coming thick and fast in the US. The number of families with their own home has dropped by one million, unemployment is up and jobs down. Growth was virtually at a standstill at the end of 2007 and the mood of households is bleak. In the euro area the property market is a localised problem, unemployment is still on its way down, growth has slowed but not faltered, households are worried but business remains more upbeat. Clear and present danger on one side, concern on the other - the difference in political tack is justified.

But this misses the real point. Leaving aside all comparisons, the American response has been astonishingly muscular. Why did the Fed opt for a public holiday to decree a drop in interest rates? Why did it repeat the exercise a week later? Why did Fed president Ben Bernanke rally to the fiscal stimulus? In acting in this way the central bank ran the risk of compounding the disquiet by implying that it was in possession of particularly alarming information. Why did it do this?

The Fed board has elaborated a sophisticated argument to justify its action. One member, Frederic Mishkin, explained recently that the role of the Fed was not only to manage the cycle but also, when the economy or financial markets are upset, to avoid situations getting out of hand. Alan Greenspan, Bernanke's predecessor, had already aired the theory that central bankers must provide insurance against macroeconomic risk, and had applied it in 2003 in order to prevent contagion from Japanese deflation.

His successors are more explicit and argue that, when the situation deteriorates, it is no longer possible to treat upside and downside risks symmetrically. It is, according to this argument, a priority to head off downside risks, even if they are unlikely to materialise, on account of the serious impact it would have if they did. As far as Mishkin and Bernanke are concerned, it is better to run a one-in-two chance of ending up with a bit too much inflation than a one-in-ten chance of having a depression on your hands.

The European approach is very different. Jean-Claude Trichet and his colleagues hold that serenity is the number-one virtue of a central banker. They do not assimilate their role to that of an insurer whose presence encourages markets to throw caution to the winds, and they stress that, through well-intentioned bustle, the central bank itself runs the risk of being a cause of volatility. Much the same argument applies to budgets. Europeans doubt the ability of governments to act reasonably and prefer them therefore to do nothing.

For the US, keeping the boat on an even keel implies being ready at any moment to clamber onto the bridge in order to adjust the sails. For Europe, it is more advisable not to allow too much canvas and to minimise any movement which might push the boat to capsise. These opposing philosophies are doubtless the result of historical experience, marked on one side by memories of the depression and, on the other, of inflation. But they are also in large measure the result of institutional differences.

This becomes clear in fiscal matters. In Europe, decision-making lies with the individual member states, the Union's role being confined to setting limits to the deficit and making sure the limits are adhered to. There is no equivalent tool in the federal budget, and no procedure provides for the possibility of conducting joint fiscal stimuli.

It is even true in monetary matters. The US monetary policy committee has twelve members, of whom seven are appointed by the executive and five represent the federated states, and decisions are made by majority. It is a sensitive body, capable of abrupt swings in position. Its European counterpart has twenty-one members, among whom the fifteen governments of the euro area, and operates by consensus. Inevitably its decisions are rarer and more moderate. True, in autumn 2007, the ECB reacted very swiftly to market tensions. But there it was a technical issue, where decisions are much more centralised than for setting interest rates.

The real question for Europe is thus not whether they should follow the example of the Americans. The situation today would not warrant that. And the question is not whether to give instructions to the ECB. The bank has committed fewer errors than national governments since it was established. The question is: if necessary, could the euro area muster the will and the capacity to act firmly in order to ward off a serious risk? This question is addressed as much to the EU member states as it is to the ECB. It is high time they put their thinking caps on.