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2010

Global Macroeconomic Review

The slowing in global recovery brings risks and uncertainties

Spotlight

on Country Risk

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Economic Outlook

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Editorial

I ♥ JCT

"The Board of Governors of the US Federal System and the Federal Open Market Committee met jointly on September 21, as they do at least eight times a year, but the minutes of that meeting were published only on October 12. Those minutes mark a new turning point in the epic of the crisis of 2008, whose aftershocks, like those of an earthquake, continue to shake the world's economies. They mark a turning point because, without explicitly stating it, the Fed considers that deflation still threatens the US economy – in other words, that in these final months of 2010 the crisis in credit and in demand has still not ended. The Fed thus shares the view of its counterpart, the Bank of Japan, which on October 3 decided to take its lead interest rates to 0%, based on the same diagnosis. The minutes marked a turning point, above all, because the Fed also announced a willingness to conduct a second campaign of quantitative easing, in order to stimulate the supply of credit, by resuming purchases of long-term US treasury securities and, in exchange, inject further liquidity into the economy. In this, the Fed has indeed broken a taboo – the taboo that holds that a central bank exists in order to limit inflation and certainly not to raise inflationary expectations on the part of economic agents, and that the independence of central banks specifically ensures that the national debt is never monetised.

All monetary doctrine since the mid-1980s is based on this principle. Initiated notably in a 1983 research article by Robert Barro and David Gordon, *Rules, Discretion and Reputation in a Model of Monetary Policy*, the principle is that, without central bank independence from political power, the electoral cycle will tend to drive monetary creation to an above-optimum level, sustaining excessive activity or even driving inflation to cut nominal debt, and, principally, public debt. Now, too much inflation ends up in distorting expectations of economic agents and blocking up the economy. The credibility of monetary policy – that, is, its coherence over the entire economic cycle independent of the electoral cycle – requires its strict separation from the political powers of the day.

This autumn, the Fed's suggestion is that not only must we move away from this doctrine and concentrate more on maximum levels of employment than on price stability, but also that, basically, central banks can play a role in reducing government debt. This is the exact opposite of the position defended by the European Central Bank (ECB) and by all its governors – from its President, Jean-Claude Trichet, to Axel Weber. They, to the contrary, continue to hold that the mission of central banks is to oversee inflation. Indeed, Trichet has refused to endorse the Franco-German deal to soften EU measures to enforce strict debt and deficit control, finding it insufficiently rigorous for public finances in Europe.

This clash of central bank doctrines has now already had two visible consequences: a surge in the euro against the dollar and a rise in stock market indices due to speculators' delight at learning that Keynesian intervention in the US economy will continue.

However, one day everyone will realise that the Fed is in the process of printing money in vain. That its monetary policy now has no effect on the real economy. And that it is repeating the error made before the financial crisis and that provoked that crisis: thinking that limitless debt is both possible and that it would be healthy for the economy. The outcome, however, showed that, in the end, the bubble always bursts. In its rigid stance, the ECB is not making any friends, neither among the governments of Southern Europe, nor among short-term investors. And yet in the medium term it is the ECB that will be proved right. So, yes, I love Jean Claude Trichet.

Revised forecasts

GDP growth 2010

	Jun. 2010	Oct. 2010	Revision
World	3.4%	3.6%	0.3%
USA	3.1%	2.6%	-0.4%
Canada	3.6%	3.1%	-0.5%
Japan	3.4%	2.9%	-0.5%
Euro zone	0.8%	1.5%	0.7%
Germany	1.6%	3.3%	1.6%
France	1.0%	1.3%	0.3%
Italy	0.8%	1.0%	0.2%
Spain	-0.6%	-0.5%	0.2%
Netherlands	1.2%	1.9%	0.7%
Belgium	1.2%	1.8%	0.6%
Austria	1.1%	1.6%	0.5%
Finland	0.4%	2.4%	2.1%
Greece	-4.1%	-4.0%	0.1%
Ireland	0.3%	-0.5%	-0.8%
Portugal	0.8%	1.6%	0.8%
UK	0.9%	1.5%	0.7%
Sweden	2.9%	4.2%	1.3%
Denmark	1.2%	2.3%	1.1%
Norway	0.8%	0.5%	-0.4%
Switzerland	1.9%	2.7%	0.8%
Central and Eastern Europe	2.6%	3.1%	0.6%
Russia	3.2%	3.3%	0.1%
Asia (excluding Japan)	7.6%	8.2%	0.6%
China	9.5%	9.8%	0.3%
India	8.0%	8.5%	0.5%
Latin America	4.4%	5.0%	0.6%
Brazil	6.7%	7.5%	0.8%
Middle East and Africa	4.2%	4.2%	0.0%

Sources: IHS Global Insight, Euler Hermes forecasts

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