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Research and macroprudential policy

Pierre Jaillet, Director General for Economics and International Relations

With the financial crisis, the concept of macroprudential policy, aiming at limiting the building up of systemic risk within the financial system, has emerged. This new public policy has appeared necessary to deal with problems involving a multi-dimensional vision and to complement, at the macroeconomic level, monetary policy, as well as micro-prudential supervision of financial institutions. Indeed, beyond the risk incurred by each institution, the financial system as a whole submits society to a risk of a macroeconomic nature, the systemic risk.

The consensus on the necessity of a new public policy has justified the setting up of institutions charged with preventing this risk: in France, the Conseil de Régulation financière et du Risque Systémique (COREFRIS), in Europe, the European Systemic Risk Board (ESRB), at the world level, the Financial Stability Board.

However, we do not have, in practice, any experience of macro-prudential policies, the definition and implementation of which raise many conceptual, operational and institutional questions. In this terra incognita, economic research should first provide the analytical framework for formalizing these policy objectives, specifying their implementation procedures and assessing their potential effectiveness. Should macroprudential policy stabilize credit growth and at what level? How can we measure systemic risk? We also have to set up diagnosis tools: detection of asset price bubbles, contagion effects between markets or countries, impact of financial volatility on the banking system… It is also necessary to think about the relationships between macroprudential policy and other public policies: in particular, what are the interactions between macroprudential policy and monetary policy as well as fiscal policy? Finally, we have to determine the most suitable tools for each risk: how can we prevent speculative bubbles? How can we avoid contagion between markets?

The Banque de France, along with its academic partners, but also in close relationship with other central banks (in particular within the MaRs network of the European System of Central Banks), is strongly involved in this multidisciplinary research area which requires skills at modeling financial stability, prudential supervision and macroeconomic analysis. Thanks to its practical experience and research track record, Banque de France is in a position to make a relevant contribution in these domains.
Three questions to...
Jean-Charles Rochet

“Macro-prudential” has become a buzzword in the area of financial regulation. Has it led researchers onto new and fruitful paths?

Jean-Charles Rochet: There is a real contrast between the relative scarcity of academic research on systemic risk prior to the crisis and the flurry of new papers seen currently. Progress has been particularly significant in the field of contagion and herd behavior, be it through the modeling of banks’ portfolio correlations behavior or simply though their exposure to common aggregate shocks. Research has also spread to a variety of new directions. It may even become a formal and questionable exercise, probably due to the pressure to develop tools for quantifying systemic risk, when the analysis in terms of welfare is completely overlooked.

The macro-prudential framework is concerned with the financial system as a whole. Is there an optimal degree of financial stability, and what is its relation with banks’ strategy?

J.-C. R.: In the tradeoff between activity and volatility, attention should be paid to not directly grafting a micro-prudential reasoning onto the macro-prudential framework. While minimizing the probability of failure of a single bank is meaningful, minimizing the probability of a crisis is reductive from a systemic point of view. There is no legal framework for a system’s failure. A new logic needs to be developed, based on a clear mandate of the new authorities in charge of macro-prudential regulation.

Isn’t there a parallel to be drawn between macro-prudential policy and monetary policy, where central banks are entrusted with instruments, independence and accountability in their tasks?

J.-C. R.: Yes, there is a time-consistency problem both in macro-prudential and monetary policy. Systemic authorities are faced with enormous political pressures, in particular from banks, when in an upswing there are good grounds for believing that risk-taking is justified. I have recently argued\(^1\) in favor of a mandate based on two broad objectives—the control of SIFIs (Systematically Important Financial Institutions) and the mitigation of financial cycles—each with its own specific instruments. In the experimentation phase, several variants may be considered, just like there are variants in monetary policy, with or without inflation targeting, more or less flexible, etc.

What type of research should we focus on at the moment?

J.-C. R.: Central banks should go beyond standard stress-testing methodologies, which are backward-looking exercises where bank portfolios are taken as given, and develop calibrated financial stability models in which banks’ decisions matter. What can be said about correlation measures based on historic losses distributions, while bank portfolios have nothing in common with what they were in the past? In contrast, it would be nice if regulators could carry out simulations with various restrictions on the Loan-To-Value ratio and help themselves to specific models that are not simply an average of currently available models.

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1 “A doctrine for macro-prudential regulators”, FINMA, Berne, 17 March 2011

Books

« Politique monétaire » (in French), François Drumetz, Christian Pfister (De Boeck)

This monetary policy textbook is designed for students, researchers, but also for journalists, market economists and portfolio managers who have an interest in the behavior of central banks. This book focuses on the Federal Reserve and the European Central Bank action during tranquil and turbulent times, but other central banks are featured such as the Bank of England, the Bank of Japan and the Bundesbank before the euro. This textbook covers the whole area of monetary policy, from its theoretical and strategic foundations to its implementation and transmission mechanisms. It concludes on the three challenges it must face today: globalization, financial system crisis, transparency. The authors, who have an experience as both practitioners and researchers in this domain, emphasize the close link between the latest state of research and central bank practice. This approach allows them to assess theory in the face of facts and to present the theoretical foundations of monetary policy choices. As underlined by Jean-Claude Trichet in his foreword, this textbook is not only useful, it is also innovative as it makes the link between research and practice.


“Housing Markets in Europe: A Macroeconomic Perspective”, Olivier De Bandt (Sous la direction de), Thomas A. Knetsch (Under the leadership of), Juan Penalosa (Under the leadership of), Francesco Zollino (Under the leadership of) printemps-Verlag Berlin and Heidelberg GmbH & Co


A journal quality and impact factor list was needed to help the staff target papers at journals of an appropriate standard and facilitate ex post comparisons with other institutions. Running through the Blue Ribbon publications in the economics profession is relatively easy. But not everyone publishes in the top five. There are currently over 750 journals indexed in EconLit and it is hard to pass a compelling judgment on the rest. Researchers tend to value more highly journals which are useful from their vantage point. The Banque de France also holds views regarding which field journals are topical in the national and international context.

There are some good reasons why maintaining a ranking by classes of journals is helpful for an institution. First, cardinal rankings based on citation counts are not very precise. They depend on the methodology used and, in particular, on how the underlying indexes are chosen, weighted and possibly extrapolated to assess quality. Second, differences within a given class may not be significant. Discrete rankings are the natural outcome when peer assessment of journal quality is used and conveniently summarize the consensus reached in a group. Finally, it makes sense for an institution to tilt the distribution in favor of those publications which it deems more relevant. For example, a central bank might have a bias for policy-oriented research or for specialized areas such as monetary policy or prudential regulation.

The proposed ranking relies on a few benchmarks and pre-specified rules. More judgmental eclecticism could be exerted but has limits, as the final trade-off might reveal more local political economy than quality considerations. Three benchmarks are used: the ECB ranking reflects the views of a central bank, the AERES 2008 journal list underscores national preferences and Mingers & Harzing’s 2007 provides an integrated ranking of 17 journal rankings based on factor scoring. Journals are ranked from 4 (highest quality) to 1 (lowest quality). Then ranks are matched and a particular mark assigned to a journal when at least two out of the three benchmarks concur on that mark. It is also important to keep track of the weights by classes as, say, three level-3 publications do not count as one level-1 publication. Comparing Journal Citations Report indexes and RePEc discounted impact factors, one finds that their medians in the second and third levels are very close in proportion to that of the first level. The final list features 17 journals in the first class (weight 100%), 67 in the second (40%), 78 in the third (15%), with all others in the last (5%).

Such an outcome could be viewed as a stopgap until a more formal approach, based on recursive citation counts, is adopted. Combes and Linnemer2 (2010) show for example that standard algorithms can be designed to reach EconLit journals for which no citation counts exist as well as control for the field of specialization of articles. They are also consistent with schemes providing extra weighting to institutional preferences. Such methodologies entail significant implementation costs but are more satisfactory. It would be interesting to vet them if rankings became used as a management tool in the future.


See the Banque de France journal quality and impact factor list:
Structural reforms and crisis exit and growth strategies

Conclusions of the Banque de France-OECD symposium of 9-10 December 2010

On 9 and 10 December 2010, the Banque de France and the OECD organised a symposium on structural reforms and crisis exit and growth strategies. It brought together representatives from central banks, governments, the European Commission and the OECD. In the three sessions, a series of original studies were discussed by J. Mairesse (CREST, Banque de France), A. Épaulard (DGT) and F. Daveri (University of Parma). A round table discussion and two presentations, by T. Boeri (University of Bocconi) and P. Aghion (Harvard University), outlined possible reform avenues.

Given the risk of a weakening of potential growth and the already strong mobilization of cyclical policies, the recent financial crisis leads us to examine the role that structural reforms may play in crisis exit strategies. The picture is mixed depending on the markets.

On the goods and services market, the positive impact on productivity and growth of competition reforms has generally been emphasised, for the deregulated sectors and the sectors downstream from these sectors in the production process, for domestic and international competition. Under different angles, several papers presented during the seminar (Daveri, Lecat and Parisi; Barone and Cingano; Bourliès et alii; Roeger) supported this argument. Only Amable, Ledezma and Robin, on the basis of preliminary results, reach different conclusions, by studying a specific transmission channel, that of the impact of competition on R&D spending. Other empirical analyses seem necessary to explain the different results obtained in the literature.

On the labour and credit markets, the effects of the reforms carried out appear more complex. The recent crisis seems to have called into question the benefits of the prior partial measures taken to improve the flexibility of the labour market, which in fact increased its segmentation. This phenomenon was widely illustrated by three presentations on this subject (Boeri, Scarpetta, Duval). As regards the credit market, Lenza and Reichlin put forward a number of arguments supporting the view that the liberalization of financial markets encouraged excessive risk-taking and reduced economies’ resilience to the crisis.

This mixed assessment clearly has implications as regards the role of structural reforms in the crisis exit strategy, whose terms of implementation, in particular on the labour market, shall no doubt need to be adjusted progressively. In addition, the speakers stressed that the fiscal consolidation efforts limit the possibilities of financing or accompanying the reforms. In this context, P. Aghion presented different options for renewing the role of government: counter-cyclical policies that target the determinants of long-term supply, an emphasis on sectoral policies and government investment in equity capital.

The list of seminars and symposiums is available at http://www.banque-france.fr/gb/publications/seminaires/seminaires.htm


“Comment on Has Globalisation changed the Phillips curve? (article by E. Gaiotti)”, H. Le Bihan, International Journal of Central Banking, 6 (1).


« Stress tests: avantages et limites », S. Avouyi-Dovi, Revue Banque, No. 727


R&D and credit constraints

The impact of economic cycles on long-term growth has been the subject of recurrent discussions among economists. According to learning or doing, a recession wipes out the least competitive companies and, among those that remain, tends to promote R&D – an engine of long-term growth – to the detriment of short-term investment. A recession thus reduces an economy's wealth but raises it growth potential: in the long run, its effect may be neutral. However, if economies are faced with a credit constraint during recession, they may also cut back on R&D. In this case, the irreversible investment loss reduces potential growth.

The individual data collected by the Companies Observatory of the Banque de France, together with its payment incident database, may be used to empirically settle the debate. The period covers the 1990s and the early 2000s. A payment incident involving a trade bill is recorded in a database accessible to commercial banks during one year. Philippe Askenazy and his co-authors show that, in the year following the incident, the company will receive less bank financing and thus face a credit constraint. At the top of the cycle, an incident is neutral on a company's R&D capacity. At the bottom of the cycle, the company facing a credit constraint cuts back on R&D, but is unable to make up for this loss during the upturn.


Financial development and global supply chains

With global supply chains, the various production stages required to produce a good are located throughout the world. Multinational firms play a significant role in this process, accounting for a third of total world trade.

According to Juan Carluccio and Thibault Fally, financial development has a decisive role. Drawing on ideas from the literature on incomplete contracts, their model shows that global firms prefer to locate the production of technologically complex intermediate goods in countries where access to external finance is easier. In these countries, local suppliers have a greater capacity to finance their own investments. This is particularly relevant when the traded input is complex, because the risks associated with complex production prevents global firms from co-financing the operations of their suppliers. Financial development also encourages arms’length transactions between firms and their suppliers, that is, when local entrepreneurs remain independent subcontractors.

These theoretical predictions are tested and validated against detailed data on the imports of multinational firms located in France. Their econometric analysis shows that multinational firms are less likely to import R&D intensive inputs from suppliers located in countries with lower
levels of financial development. Furthermore, when financial development is low, imports of complex inputs are more likely to occur within the boundaries of the firm, from foreign affiliates. Their results contribute to a large literature showing that financial development is a pre-requisite for a successful integration into the global economy.


Juan Carluccio is an economist with the Microeconomic Analysis Division and Associate Professor of International Trade at the Paris School of Economics (University Paris 1). His PhD thesis received a distinction from the Association Française de Science Economique in 2010.

Real-time monitoring of acceleration cycles in the euro area

In addition to the quantitative forecasts of GDP growth, economic analysts often use cyclical assessments to evaluate business conditions and anticipate future turning points. In this paper, Laurent Ferrara and Olivier Darné focus their attention on the acceleration cycle within the euro area, i.e. the peaks and troughs of the series of GDP growth rates, which mark out the periods of acceleration and deceleration in economic activity.

First, the authors propose a monthly chronology of the turning points in the acceleration cycle using the GDP and an industrial production index. This dating technique is based on non-parametric measures of the cycle, such as its amplitude, its length and the synchronization with other euro area countries. Second, they develop a probabilistic indicator for detecting the turning points in this cycle by estimating a non-linear multivariate model using business survey data. The Banque de France monitors this indicator in real time.


Do banks’ financial conditions matter for monetary policy transmission?

The 2007-2009 financial crisis has highlighted the need for the design of a macro-prudential policy that aims at preserving financial stability as a whole. Its principles, tools and transmission channels, as well as its interactions with monetary policy, however, are not yet fully understood.

Ramona Jimborean and Jean-Stéphane Mésonnier use a novel approach to assess whether banks’ financial conditions, as reflected by bank-level information, matter for the transmission.../...
To be or not to be in a monetary union

What are the pros and cons of joining a monetary union for a small open economy?

Within the voluminous literature addressing this question, there exist two main branches: one dealing with the implications for macroeconomic stabilization, the other with the implications for monetary policy credibility. While participation in a monetary union is invariably a costly affair for the former, it unambiguously improves welfare for the latter, as the union-wide central bank is more credible and therefore more effective in taming inflation.

Olivier Loisel, with Laurent Clerc and Harris Dellas, combine these two branches of the literature and construct a simple welfare criterion in a New-Keynesian framework to evaluate jointly the economic costs and benefits. They produce examples where participation in a monetary union may be welfare-improving even for low-modest levels of inflation bias (in the range of 2-3%, i.e. even below those present in Europe in the pre-euro era) as long as business cycles are not too a-synchronized across countries.


Olivier Loisel is Deputy Head of the Monetary Policy Research Division. He has published articles on monetary policy and international economics in the European Economic Review, the Journal of Economic Dynamics and Control, the Journal of Economic Theory and the Journal of International Economics.
Making forecasts

The French and euro area forecasting division has developed New Amazone for the euro area based on the New-Keynesian model of Smets and Wouters (2007). The next step, currently in progress, is to construct a two-region DSGE model representing France in the euro area. This project, one step of which is described by Adjemian and Devulder (2010), is conducted jointly with CEPREMAP.

The model, which is estimated using euro area data since 1995, describes how, and at what pace, the imbalances observed at the date at which the forecast is made are reduced in the future. The current forecast is that of a moderate revival with an acceleration in inflation.

In a forecasting exercise, we generally have access to data beyond the last available quarter. Some information is monthly and provides indications on the current quarter. Other data are partially revealed by the futures markets or the yield curve. A last set of data, which is more qualitative, reflects a “sentiment” about future developments. It is technically possible to incorporate them in a DSGE model and this approach shall be developed in the future.

Michel Julliard is coordinator of the DSGE network at the Banque de France and researcher at the CEPREMAP.