Editorial

The Banque de France, a partner for Universities  
Pierre Jaillet, Director General, Directorate General Economics and International Relations

Headlines

Three questions to... Richard Portes  
Richard Portes, Chairman of the CEPR, answers our questions on the role, the functioning and the achievements of the Fondation Banque de France.

Macroeconomics of real estate markets  
Is there a housing cycle in Europe and how can its effects on the real economy be measured? Olivier de Bandt reports on the international symposium on the subject held in Paris in December 2009.

Focus

Are prices rigid?  
Prices are relatively rigid at the microeconomic level. Hervé Le Bihan looks at restaurant prices and shows that in this sector they are intrinsically rigid.

Diffusion of ICT  
Continental Europe lags behind the United States in terms of Information and Communication Technology (ICT) diffusion. Jimmy Lopez explains why.

Monetary policy gradualism  
Disinflation was extremely gradual in most euro area countries in the 1980s. Julien Matheron looks at its effect on growth.

Does inflation targeting represent a risk for real estate prices?  
The real estate boom of 1995-2006 was exceptional in terms of its scale, its length and its geographical scope. Jean-Stéphane Mesonnier shows how inflation targeting strategies may have played a role.

Does the monetisation of deficits represent a risk in monetary union?  
Can the issuance of public debt by member states of a monetary union be inflationary? Hubert Kempf shows under what circumstances that could be the case.

Why is inflation global?  
What is the best predictor of domestic inflation? Global inflation, according to Benoît Mojon.

The procyclicality of government spending  
Does government spending lead to an increase or a decrease in private demand? Xavier Ragot explains how to maximise its effects on economic activity.

Upcoming events  

Past events  

Publications

» Journals  
» Working papers

Acknowledgement of discussants

DSGE Report  
of Michel Juillard
The Banque de France, a partner for Universities

Pierre Jallet, Director General for Economics and International Relations

The Banque de France is a long-standing partner of Universities. The Bank’s economic and financial research and analysis activity, which underpins the preparation and the implementation of monetary policy, gives rise to regular exchanges in seminars, symposiums or during joint working sessions. For over 15 years, the Fondation Banque de France has hosted researchers, funded their projects and organized conferences that have allowed fruitful exchanges with academia. Besides, Richard Portes, Chairman of the CEPR and member of the Board of the Fondation Banque de France, stresses in this newsletter the important role played by the Fondation in European research (see “Three questions to…” p.3).

The relations between universities and the Banque de France have gathered momentum in the past few years, with the Bank’s strategic choice of strengthening its analysis and research potential, the objective being to reach the highest international standards. Partnership contracts have been signed with the Toulouse School of Economics (which also involve the Directorate General Operations and the Prudential Supervision Authority) and, since 2010, the Paris School of Economics. These long-term partnerships contribute to the development of close relations, in the form of joint work, through high-level joint seminars and conferences, such as “Economic Linkages, Spillovers and the Financial Crisis” in January 20101 and “The Monetary Policy in The Current Crisis” in March 20092. Naturally, these partnerships also cover more targeted or occasional cooperations, in France or abroad.

The multiplication of events and publications involving Banque de France economists and academia also shows the vitality of these relations, which have developed outside the strictly institutional field. In the first half of 2010, 19 publications were the fruit of cooperation between the Banque de France and universities (see p.6-7), a joint conference was organised and 14 seminars gave academics the opportunity to present their work to the Bank (see p.5).

These relations are based on reciprocal interests that have continued to grow in the past few years. The preparation of the Eurosystem monetary policy and the activities related to financial stability rely increasingly on research, in particular to improve the understanding of relations between the real and financial spheres. The assessment and forecasting tools are of a more and more technical nature, and require the skills of specialists at the cutting edge of their field of activity and from very diverse backgrounds.

For universities, central banks contribute their experience of the functioning of financial markets and the banking system, unique databases and leading research teams. In an increasingly competitive environment, the Banque de France has become a recognized player in the field of French, European and world research. The investments made over the past five years are thus starting to bear fruit and, I hope, herald still greater rewards.

2 http://www.banque-france.fr/fr/publications/seminaires/pol_mone_200309.htm
Three questions to…

Richard Portes

Chairman of the CEPR, Professor at the London Business School and member of the Board of the Fondation Banque de France

In your opinion, what is the place of the Fondation Banque de France in European economic research?

R. Portes: There are very few organisations in Europe that offer funding for serious economic research. The Fondation Banque de France therefore plays an important role in funding high-level research. This is reflected in the very large number and the high quality of the projects that are submitted in response to our call for proposals.

The second point I would like to stress is the way in which the Fondation Banque de France follows up the research that it funds. We are particularly attentive to the results of the research projects.

In both respects, the Fondation occupies a special place in Europe.

Could you present the principles underlying the action of the Fondation Banque de France?

R. Portes: Of course, we finance work that is relevant to monetary policy and finance. However, since the crisis, these areas have become much broader, which makes the work that we support very exciting.

The second principle is a very strict screening process. We have an excellent Scientific Council and the Board reviews their assessments very carefully. There are therefore two very rigorous levels of control of the quality of research. Furthermore, the seminars are an opportunity for high-level applicants to present their work to the Scientific Council.

The third principle is the global approach of the Fondation. We examine research projects from all over the world, without any bias as to their origin.

Finally, we tend to favour empirical research when the data are of good quality.

In your opinion, what have been the main achievements of the Fondation Banque de France?

R. Portes: I think the Fondation has helped to create a European cross-border community of researchers that are, in this manner, connected to the Banque de France and to each other.

Second, the research funded by the Fondation has been of very high quality and been published in leading journals.

Third, the Journées de la Fondation, a series of excellent conferences mainly aimed at presenting the research projects funded by the Fondation, have been highly successful.

As a result, the Fondation has acquired an excellent reputation.

---

3 Fondation website: http://www.banque-france.fr/fondation/qb/home.htm
Macroeconomics of housing markets

Summary of the symposium of 3 and 4 December 2009

Olivier de Bandt, Director of Business Conditions and Economic Forecasting

Is there a housing cycle within the euro area, distinct from the economic cycle, which would require concerted action on the part of monetary authorities?

As shown by M. Iacoviello (Federal Reserve Board), it is important for macroeconomic analysis to take account of the existence of housing cycles. They are easily identifiable at the national level, but their correlation, which has increased since the creation of EMU, is more difficult to demonstrate for the major euro area countries given the specific nature of the German cycle (L. Ferrara and S. Koopman). However, a stronger correlation does appear between OECD countries, with the United States playing a dominant role (O. de Bandt, K. Barhoumi and C. Bruneau).

Econometric studies show the role played by credit supply shocks (P. Antipa and R. Lecat) and destabilising factors such as German reunification (T. Knetsch) in determining house prices. Structural factors, such as the financing system and the tenant/owner ratio, have a significant impact on wealth effects (J. Muellbauer, Oxford Univ.). On the basis of a common methodology for France (V. Chauvin and O. Damette), Spain (T. Sastre and al.) and Italy (A. Bassanetti and al.), the wealth effects, without being insignificant, seem lower for housing assets than for financial assets. L. Arrondel and F. Savignac analyse, on the basis of the Wealth Survey, French households’ choices between real-estate assets and equities.

How may public authorities identify shocks to house prices before they have potentially adverse effects on the real economy? P. Antipa and C. Schalck focus on the effects of fiscal policy. J.-S. Mésonnier shows that countries that have adopted an inflation targeting policy often on housing markets.

In conclusion, housing issues will continue to feature prominently in central banks’ research agenda. Indeed, a number of topics have not been sufficiently investigated: contagion between real estate markets, the feedback effect of the real estate cycle on financial intermediaries, the factors influencing household preferences, the relatively strong rigidity of real-estate prices, the integration of choices regarding housing demand and labour supply or the role of public policies in the regulation of the real estate cycle.

The conference was the fruit of joint work between economists and researchers from the Banque de France, the Bundesbank, the Banca d’Italia and the Banco de Espana, together with leading academics.

“Housing markets in Europe: a macroeconomic perspective”, Springer, forthcoming

The list of seminars and symposiums and the links to the articles are available at the following address: http://www.banque-france.fr/pub/publications/seminaires/seminaires.htm
Diffusion of ICT

The diffusion of Information and Communication Technologies (ICT), fostered by the fall in prices of these goods and services, has been considerable over the past few decades. This diffusion has been more pronounced in the United States, a producer country with a head start, thus contributing to the economic growth gap with Continental Europe.

The levels of ICT diffusion are now stable in all industrialised countries, but Europe still lags behind the United States. By estimating a structural model on a panel of OECD countries, Jimmy Lopez shows, together with Gilbert Cette, that, beyond the obvious influence of education, the flexibility of labour markets and the regulatory constraints on the goods and services markets played a key role in the 2000s when the extensive diffusion process was starting to slow.

According to the counterfactual analyses, almost half of the persistent diffusion gaps between European countries and the United States could be closed by reforming the labour and goods and services markets.


Jimmy Lopez is an economist in the Structural Policy Analysis Division. He is also a PhD student at the GREQAM and has published articles in Économie Internationale and Applied Economics Letters. His fields of research include labour economics, the regulation of the goods and services markets and innovation.

Are prices rigid?

The Eurosystem and the Banque de France in particular have analysed large individual price databases in order to estimate the degree of price rigidity. In the context of monetary policy analysis, these measures are particularly useful for calibrating micro-founded macroeconomic models of price and wage rigidity or highlighting sector heterogeneity.

Does the observed rigidity reflect price adjustment constraints or simply the low variability of price determinants? By focusing on the restaurant industry, Hervé Le Bihan shows, together with Erwan Gautier and Denis Fougeré, that wage costs are entirely passed onto menus but with a one to two-year time lag. There is clearly an intrinsic rigidity in this sector, in addition to the rigidity induced by costs of production.

Within this programme, further research avenues include the identification of structural factors delaying price adjustments (physical or administrative costs linked to the price revision process, the reaction of companies to consumers’ opposition to price changes, etc.) and the incorporation of microeconomic stylized facts into macroeconomic models.

D. Fougeré, E. Gautier, H. Le Bihan, “Restaurant prices and the minimum wage”, Journal of Money, Credit and Banking, Octobre 2010

Hervé Le Bihan is Head of the SAMIC (Microeconomic Analysis Division) within the DEMS (Microeconomic and Structural Analysis Directorate). He has regularly published applied econometric studies in journals such as the Journal of Business and Economic Statistics, the Journal of Econometrics, the Journal of Economic Perspectives and the Journal of the European Economic Association.


Monetary policy gradualism

Owing to proactive monetary policies, euro area inflation declined from the early 1980s to the early 1990s, albeit in a very gradual manner in most member countries. At the same time, these economies experienced prolonged recessions.

According to economic literature, there are two classic transmission channels of disinflation shocks: (i) persistent and excessive real wages and (ii) excessively high real interest rates. Julien Matheron, Patrick Fève and Jean-Guillaume Sahuc conduct a Bayesian estimate of dynamic general equilibrium models to decide between these two suspects.

Their work shows that monetary policy inertia, both in terms of gradualism in the implementation of disinflation and in terms of inertia of the interest rate rule, led to prolonged increases in real interest rates, which caused persistent output losses in the 1980s. Conversely, it appears that the real wage channel is not a significant explanatory factor of the sluggish growth during this period.


P. Fève, J. Matheron, J.-G. Sahuc, “Disinflation shocks in the eurozone: A DSGE perspective”, Journal of Money, Credit and Banking, 42

Does inflation targeting represent a risk for real estate prices?

By restricting the horizon for controlling inflation to two to three years, some central banks may have overlooked the development of macro-financial imbalances, such as the formation of bubbles on the housing loan market, which turned out to be very costly for macroeconomic stability. Their apparent success in controlling inflation may have given borrowers the impression that low nominal interest rates would last forever, thus contributing to the boom.

For a panel of 17 OECD countries since 1980, Jean-Stéphane Mésonnier and Sébastien Frappa find that growth in real house prices has been stronger, all other things being equal, in those countries that have adopted an explicit inflation targeting (IT) strategy. The study relies on a program evaluation technique (the so-called treatment effect estimator) which is borrowed from labour microeconometrics. The idea is to compare average growth of house prices in inflation targeting and non-inflation targeting countries by adjusting it for the bias resulting from the endogenous choice of the targeting strategy. Indeed, some IT adoption factors, such as the degree of development and sophistication of the mortgage market have their own effect on house price dynamics.


Jean-Stéphane Mésonnier is Head of the Financial Economic Research Division. He has published studies on monetary and financial economics in the European Economic Review, the Journal of Financial Stability, the International Journal of Central Banking.
**Does the monetisation of deficits represent a risk in monetary union?**

The Greek crisis of 2009-2010, triggered by the acknowledgement by the Greek authorities of a larger government deficit than expected coupled with an already record high debt, led to one of the most serious crises experienced by the euro area.

How should these deficits and the growth in Greek debt be financed? What type of solidarity between euro area countries should be put in place? What would happen if Greece suspended its repayments? Should the euro area central bank intervene? These are a few of the issues addressed by Hubert Kempf, together with Russell Cooper and Dan Peled, in an article published in the European Economic Review.

On the basis of a microfounded model of a two-country monetary union, he shows that two options are possible. In a “Ricardian” equilibrium, bonds are reimbursed upon maturity by taxes in the issuing country; in a “monetization” equilibrium, the central bank of the monetary union finances the debt securities that have reached maturity. The multiplicity of equilibriums reflects a commitment problem of the central bank. A key factor for determining the equilibrium is the breakdown of holdings of government debt securities within the monetary union: if sovereign debt is held by a third country, the central bank will be encouraged to intervene. The problem is that Member States anticipate the possibility of this monetary financing of debt and therefore have a tendency to build up excessive deficits.


**Why is inflation global?**

The observation of inflation data in OECD countries since 1960 brings out several salient features. In particular, inflation increased progressively in the 1960s before declining in two stages, at the start of the 1980s then at the start of the 1990s, before leveling off at close to 2% in most of these countries.

In addition to these slow developments, the short cycles of inflation have also tended to coincide. In fact, a strict measure of this co-variance shows that it is around 70%, which is a high percentage if one takes into account all the high-frequency noise in the inflation series. We also show that each country deviates only temporarily from its long-term relation relative to the OECD inflation mean and that this “mean reversion” may be used to forecast national inflation. The forecasting models that use global inflation as an explanatory variable display many fewer forecasting errors than the traditional Philips curves and the best univariate forecasting models in two thirds of OECD countries.


Benot Mojon is Head of the Monetary Policy Research Division. He has regularly published studies on monetary economics in the European Economic Review, the Journal of Monetary Economics, the Journal of Money, Credit and Banking, the Review of Economics and Statistics.
Acknowledgement of discussants

The following discussants in the DGEI seminar contributed through their remarks and suggestions to strengthening the production of internal research over the 2009-2010 academic year. They are warmly thanked for their contributions.

Frédérique Bec (ENSAE), Marie Bessec (DGTPF), Florin Bilbiie (École d’économie de Paris – PSE), Didier Blanchet (INSEE), Wilko Bolt (DNB), Georges Bresson (Panthéon-Assas), Jean-Charles Briceongne (DGEI), Herbert Brücker (Institute for Employment Research, Nuremberg), Matthieu Bussière (DGEI), Jérôme Coel (OFCE), Serge Darolles (CREST), Francesco Daveri (Parme), Gabrielle Demange (École d'économie de Paris – PSE), Martial Dupaigne (TSE), Marc Ferracci (ENSAE), Jean Imbs (Lausanne), Marek Jarocinski (BCE), Bruno Jullien (TSE), Jan-Pieter Krahnen (Goethe University Frankfurt), Augustin Landier (TSE), Yang Lu (European University Institute), Thierry Magnac (TSE), Philippe Martin (Sciences-Po), Isabelle Méjean (École Polytechnique), Valérie Mignon (CEPII), Alain Monfort (ENSAE), Francesca Monti (ECARES), Pierre Morin (Metz), Gernot Müller (Bonn), Ernesto Pasten (TSE), Gert Peersman (Gand), Thierry Penard (Rennes), Christophe Périsignon (HEC), Patrick Pintus (GREQAM), Sergio Rebelo (Northwestern), Jean-Marc Robin (PSE), Vincenzo Spiezia (OCDE), Amine Tarazi (Limoges), Jaume Ventura (CREI).

The procyclicality of government spending

The procyclicality of government spending is at the heart of a theoretical and empirical debate whose importance has recently been brought to the fore.

In order to overcome the ambiguity of empirical results, Edouard Challe and Xavier Ragot study the effects of a fiscal stimulus plan in the presence of financial imperfections. They assume that certain risks, modeled as unemployment risks, cannot be perfectly insured against. This is referred to as the incompleteness of insurance markets. It is widely justified empirically, but it is difficult to introduce it into macroeconomics. Faced with such risks, households demand liquid assets in order to self-insure themselves against risks of unemployment. In other words, they build up precautionary savings.

The effect of a fiscal stimulus plan and of an increase in government debt in such a context thus depends on economic agents’ liquidity needs. If they are substantial and if government spending is financed through debt, government stimulus packages can have a positive effect on private demand and wages. This model argues in favour of debt financing of government spending if one wishes to maximise the effects on economic activity. However, this work does not take account of all the distortions associated with a very high level of government debt. The interaction of these distortions with the model’s mechanisms is an obvious area of research.


DSGE Report

Several dynamic stochastic general equilibrium (DSGE) models are used in the analyses of the DSGE for the governing authorities of the Bank. The French and euro area forecasting division has constructed New Amazone, a model of the euro area primarily used for forecasting; it shall shortly include France. The Monetary Policy Research Division has developed a series of models for monetary policy analysis. The Structural Policy Analysis Division has contributed to the construction of EAGLE, a multi-country project of the European System of Central Banks. The International Outlook division uses GIMF, an international, multi-zone model developed by the IMF. A large number of researchers at the DGEI also use DSGE models, albeit often smaller, in their research papers.

The economists involved in this type of modeling regularly take part in our working group to present work in progress and discuss the problems that they may come across. In recent meetings, the following topics were brought up: the integration of microeconomic data, optimal policy computing, heterogeneity, international models and identification of impulse response functions. In the coming meetings, we will focus on estimating the government spending multiplier, modeling the financial sector and analyzing the fiscal spending consolidation plans, a topic which is being studied by a specific working group.

The DSGE modeling activities give rise to a large number of cooperation projects. We have a cooperation agreement with the Federal Reserve of Atlanta on financial sector modeling and on Markov-Switching models. New Amazone is being developed with CEPREMAP. The Banque de France also takes part in the DSGE-net network.

Michel Juillard, coordinator of the DSGE network at Banque de France and researcher at CEPREMAP.