ECONOMIC POLICY

Twentieth Anniversary Panel Meeting

London, 21-22 October

Summary of Panel Discussion

1 Guide to Reform of Higher Education: a European Perspective

Bas Jacobs & Frederick van der Ploeg

1.1 Civil Involvement in Reforms

Several panel members brought up the point that it was not *what* reforms to make, but *how* to make them. As a starting point to implementing reforms, Christian Gollier suggested that pressure to reform must come from the citizens. He suggested that this was possibly missing in Europe, because of two types of information shortages– the citizens and students are unaware that the education they receive is of low quality and because they under value the returns to education. On the more practical side of implementing reforms, several panel members echoed the suggestion made by Esther Duflo that the governance of universities is important. Harald Hau cited INSEAD as a successful European example that has succeeded in the absence of public funding and a history of private funding. Hau suggested that fundamental reform was necessary, that a beaurocratic reform, micro-managing at the margin was not sufficient. He stressed that the key is to involve the civil sector in education, and to cut links with the political sector. Barry Eichengreen said that UC is a European-style university in California and it sis kept efficient by competition. The authors replied to these comments saying that governance structure of universities is so far a relatively unexplored topic one for future research, but also that the paper was based in welfare economics and aims to look at the ideal reform first, and to put across some straightforward ideas.

While the consensus seemed to be that greater private sector involvements is needed to fund higher education in Europe, von Thadden said that points should be taken in a general equilibrium context, considering the interaction of donations with the incidence and levels of taxes. Neil Gandal's take on the issue was to privatize the (key) universities, which may then have positive spillover benefits to nearby public universities. Rob Chote from the IFS pointed out that if more private funding was to be implemented, the marketing of ICLs for example would be very important as, while students are not adverse to debt when it comes to credit cards, the perception of debt with regards to spending on education is rather more negative.

1.2 Wages and Incentives

Ernst Ludwig von Thadden made the point that wage differentials are as high as 5:1 in the USA, where as they are flat in Sweden for example, and that this has an effect on the motivation of professors and the quality of education.

1.3 Allocation of Educational Benefits

A number of redistributive points also came up in discussion:

Ernst Ludwig von Thadden believed that the redistributive effects of reform, in particular in relation to the income contingent loans (ICLs) should be looked at more closely, Lars Bovenburg thought the ILCs may have disincentive effects that had not been considered, and that equity efficiency tradeoffs had been treated too optimistically. The authors replied to these comments saying that they had looked into the issue of moral hazard in the ICLs and found that it was low and less significant than any moral hazard effects that might come about from a 40% income tax.

Lars Jonung felt that the gender issue was important, and suggested that the high welfare in Nordic states could be attributed to the high education of women who pass their human capital onto their children.

The opinion of Charles Wyplosz was that an ideal mixture was a few top schools and rather more, weaker schools. Europe needs to concentrate on creating just a few first class schools and as this may be politically difficult for national governments, the Commission should do this. Gilles Duranton suggested that the dual roles, and associated trade-offs of universities between research (performed by a few universities) and education (performed by all universities) should be given more consideration in the paper. Differentiation of universities, as pointed out by Eichengreen, requires students to be willing to move within their country, and within Europe to the most suitable universities.

2 European Unemployment: The Evolution of Facts and Ideas

Olivier Blanchard

2.1 Employment Levels, Unemployment Levels and Participation Rates

Several people commented on the information also conveyed in *em*ployment levels, as opposed to simply the *unem*ployment levels. Pam Woodall (The Economist) pointed out that participation levels in the labour force in Europe has increased, in the USA it has fallen and consequently, although average unemployment rates are higher in Europe, the two countries have the same employment levels. Chris Giles (The Financial Times) explained that, for example, in the UK, the evidence is that the earned income tax credit has had a limited effect on unemployment, but has had an impact on employment. Paul Seabright suggested that there was an interesting connection between changing labour market participation rates and increased university attendance, and asked whether the new highly educated were more or less employed, and whether, given increased skill specificity in jobs, (life long) education would make the unemployed more employable. Arellano suggested that another reason for changing unemployment rates in Spain was the influx of immigrants, who tended to be fully employed.

Stephen Nickell suggested that the phenomenon seen in Belgium whereby the labour institutions are the same across two regions, but unemployment varies significantly may be a reflection of very different levels of labour productivity in these two regions. Pierre Cahuc pointed out that prime-male employment rates are very homogenous and that differences in unemployment rates between countries lie in a few demographic groups. Therefore it would be interesting to focus on these, usually young individuals, and the family structure. Blanchard replied that certainly some groups are more affected than others, but they also reflect the aggregate unemployment state – when there is higher unemployment, there is also higher unemployment, or example of the young.

Georges de Ménil asked how the data in figure 12 (Job destruction and job reallocation in France 1985- 1996) treated very small enterprises and part time jobs. He suggested that more flexible markets may not be picked up in the data.

2.2 Unemployment and Inflation

Steven Nickel also said that he was *not* a believer in the impossibility of negative nominal wages increases, saying there had been several examples. He also said that between 1999 and the end of 2000, while unemployment dropped from 9.5% to 8%, inflation increased from 1.1.% to 2.7%.

Christopher Pissarides said that there were two institutional changes in the UK that, in combination affected the Phillips curve and pushed unemployment up (lower the natural rate) in 1993: the strength of unions and the monetary policy framework which reduced inflation expectations. Pissarides suggested that more emphasis should be put on the role of an interest rate shock (which played an important role in the 1980s from the matching models' forward looking perspective), than on the role of the insiders/ outsiders. Christian Gollier however, asked what is known about wage preferences of unions of outsides, as opposed to the insiders. Portes said that there was more emphasis on the earlier period regarding the insider/outsider and the later period, focus was more on the tax wedge (consumption tax component) and Prescot paper.

Pierre Cahuc suggested that further attention may be given to the role played by product market institutions, as opposed to labour market institutions. Portes felt the OECD measures of institutions make sense (they shows some correlation between the product market institutions and labour market institutions) but their construction uses debatable methods and thus it important to go beyond the aggregated information.

Nickell mentioned that the paper does not talk about early retirement and other disastrous legacies and Jonung thought that the role of sickness and retirement schemes is likely to be important and changing over time, also as a response to unemployment developments. Van der Ploeg felt that while the earned income tax credit is a good idea, it may be politically difficult to credibly keep giving little to inactive people. Van der Ploeg also suggested that as much unemployment is concentrated in certain areas, where it then persist, psychological policy would be useful. The detail in the design of unemployment benefits is thus very important. Portes felt that the Blair carrot-and-stick policies appear to have worked and asked whether they could be imported to other countries.

3 The International Monetary System in the last (and next) 20 years

Barry Eichengreen, Paul Razo-Garcia

3.1 Capital Mobility

Charles Wyplosz asked why the paper put so much emphasis on the bipolar view, instead of putting more emphasis on the opening of capital markets. Since the end of the Washington consensus, most emerging countries want stable exchange rates, because it helps trade, helps counteract the phenomenon of beggar-my-neighbour, because it aids credibility in monetary policy, because financial markets are needed to hedge exchange rate variability, and a wide variance can hurt. Furthermore, several countries cannot borrow in their own currency and so need a stable exchange rate. Eichengreen replied, saying he felt that technology and democracy were developing so that it is harder to regulate the capital account. Eigengreen felt that capital account liberalization is gradual and set to continue.

Hélène Rey pointed out that over a longer time frame large shocks such as war and decolonization imply that capital mobility is endogenous. It is moving in spurts, and it is hard to tell whether its evolving steadily or not.

Lars Jonung felt the forecasts in the paper were too optimistic and suggested two threats of financial integration – wars and depressions. He said that the thinking was previously that financial integration could damped business cycles, but that now the thinking is that financial integration could allow big imbalanced to develop in the economy.

3.2 Markov Chains

Ernst–Ludwig von Thadden suggested that the Markov conjections in section 3 and the economic trends in section 6 were not brought together as much as they might. Paul Seabright pointed out that the methodology of Markov chains assumes that policy markets have the same probability of leaving a regime at all points in time, and this implies they learn nothing over time.

3.3 Net Income Balance and Sustainability

Hélène Rey explained that the income balance of the USA is such that liabilities still exceed assets by 30%. The net income balance was more positive in the 1980s, and while this may not yet be negative yet, if a risk premium is included, this would mean that the USA position is even more leveraged and the net income balance would move to the negative. Eichengreen picked up on the comments made by Kaletsky concerning the possibly sustainability of the net income balance which reflects the failure of Americans to save. Eichengreen indicated while the imbalance had lasted for a long time, it could not continue at current magnitudes and the dollar would have to depreciate.

3.4 Number of Currencies

Hélène Rey highlighted that a model with network externalities suggests there should only be one international currency. The addition to the model of regional trade links however, can allow several currencies. Eichengreen responded, saying he half agreed because network externalities do still limit the number of technologies.

3.5 IMF

A number of commentators noted the absence of the IMF in the paper. Eichengreen explained that this is a reflection of that fact that it has a smaller role as lender of last resort as more countries can borrow in their own currencies and thus the national banks can act as lender of last resort. Eichengreen also said that the IMF may not be the best institutions to design policy.

4 Road Pricing: lessons from London

Gordon Fraser and Georgina Santos

4.1 Political Acceptance of the Congestion Charge

Chris Giles (Financial Times) pointed out that the congestion charge was opposed by the bulk of the media at the point of its introduction, with the widespread expectation that congestion would build up on the outside, and east of the zone. Despite its simplicity, panel members were struck by the enormous cost of the scheme, which may prevent it being adopted in other cities. It was asked if this cost would drop as technology improves. Paul Seabright asked what level of government would ideally mastermind the adoption of similar schemes in other cities – a small local charging scheme becomes less attractive as more outsides come into and use a zone. An important question is the overlap between voters and the gainers/ residents.

4.2 Measurement of Benefit on Congestion

Pissardes and Porters drew attention to the fact that many Londoners (and taxi drivers) believe that roads 2001 and 2002 leading up to the introduction of the charge, were (deliberately made) more congested than normal, and therefore the benefits on congestion as measured relative to those years over-state the true improvement.

There was a large difference in the cost benefit ratio calculated by transport for London, and in the paper. One explanation may be that the tfL estimate was moved downwards for political reasons, as it would be easier to realize and any excess would be commended.

Gilles Duranton suggested that the welfare measurement could be broadened to include factors other than retail sales for example and the overall assessment of the changes depends on what kind of city and lifestyle we want.

4.3 Tax Effects

Bas Jacobs said that as transport is an intermediary good in production then a Pigouvian tax can be computed. However is there is also a consumption aspect to transport, then taxing it would have an income effect. (Because drivers have different utilities of income, there is a distribution effect of the charge. This could mean larger benefits because the gainers are poor.) It may be important to consider the interaction of the congestion charge with other taxes. Georgina Santos replied that the congestion charge may reduce the labour supply for commuters who already have to pay labor tax. By law in the UK however, revenues cannot be used to reduce labour taxes.

Christian Gollier said that the authors do not include the long term benefits of the charge, whereby people and businesses may relocate, and the land use in London thus becomes more efficient.

5 Competition Economics and Antitrust in Europe

Damien Neven

5.1 Assessment of use of Economics

Ernst Ludwig von Thadden felt that the analysis in the paper did *not* bear out the negative conclusions that inquisitional approaches in legal institutions in EU do not work well given the type of evidence available and that elements of economics have been misused or neglected by the Commission. Gilles Duranton drew attention to the value of the relative and pointed out that the use of economics in antitrust is considerably further advanced than the use in other sectors such as trade, agriculture and regional policy.

Damien Neven admitted that the EC has adopted significant guidelines on market definition and has a good understanding of Unilateral effects. He felt that he and John Vickers probably agreed that the current thinking on abuse of dominance is not satisfactory, and that any different in their opinions is merely a matter of emphasis.

On the other hand, Frederick van der Ploeg suggested that costs estimated by Neven in figure 1 did not include the public sector costs and therefore were probably an underestimate.

5.2 Improvements in use of Economics

Jonathan Haskey suggested that economists can still improve in their design of surveys and interpretation of hypothetical responses. He also suggested that the competition authorities have to be robust to the armies of economists and lawyers deep-pocketed parties bring to their defense. This suggestion was taken on board by Neven, who agreed he should have emphasized more the discrepancy of resources between the Commission and the parties, however he also said that he suggested a context where this discrepancy would matter less.

Diane Coyal and several other panel members suggested that there may be benefits from further introduction of behavioural economics in competition economics. Paul Seabright, on the other hand, warned that this could be dangerous. He pointed out that competition has been discovered to work in areas where it was not thought to work before, for example small firms have been shown to respond rationally to incentives. The use of behavioural economics could reintroduce the old hypotheses.

In response to Diane's remark stressing the understanding and linking of evidence and theory, Neven said that there is still a judgment to be made on the type of evidence that would constitute proof.

Frederick van der Ploeg suggested that more focus should be given in the paper to the national competition authorities and how they overlap with the European authorities.

6 Has the Inflation Process Changed?

Guy Debelle and Steve Cecchetti

Olivier Blanchard said that there seemed to be a result that the timing of the breaks for actual inflation and inflation expectations. The break in inflation expectations is *before* the break in inflation. However people should need to see a break before their believe it. This therefore indicates that the break measured in all three cases is not in the monetary policy regime, but it is a recession. The authors said that they looked at disaggregated data so that they could see all components change, and see the changes in monetary policy regime, which furthered their hypothesis.

Steve Nickel asked about a hypothetical increase in the price of oil, which would cause inflation. If there were then *no* second round effects (such as wage expectations going up), then there would be no persistence in inflation and a monetary policy response would not be required. Nickell then asked that if the shock was then very big, and there was no monetary policy response, how large would the shock have to be before expectations diverged from the inflation target and inaction destroyed credibility. In this case, how do the economists respond and calibrate their models? The authors said that they didn't know exactly – expectations have shifted before and this is the policy point of the paper.

Nickell remarked that box I would be solved analytically and didn't need to be simulated.

Hélène Rey felt that, if the structure is not known, as with a univariate analysis, it is hard to get a policy inference. The authors replied that the relevance of regime breaks was important for policy implications **(?)**.

Hélène Rey said that it is possible to solve for aggregation bias. There will be a bias, but one can show it's increasing in sector heterogeneity. So a change in the aggregate series persistence could come from a change in the sector heterogeneity. The authors replied that they do not use the word "bias" because what matters is the aggregate's persistence.

Carlo Favero said that using US data, allowing for heteroskedasticity, there is no evidence of regime breaks and the parameters are stable. It was interesting that volatility a la Cogley & Sargant does not apply here, and he asked whether this was because of heterogeneity.**(??)**

Georges de Ménil said that he would like to see the mean of expectations, before and after the breaks, and more detail in the dynamics.

7 European Monetary Union: The Dark Sides of a Major Success

Charles Wyplosz

7.1 A Success?

Charlie Bean asked, when considering whether the EMU was a success or not, what the counter-factual was. He felt that perhaps the only unambiguous success of the EMU was the logistical aspects of introducing the € coins and notes. Portes considers the EMU also to be a success in integrating monetary policy, creating financial stability (e.g. Greece's current efforts) and establishing credibility. Charles agreed it may be too early to tell whether EMU had been a success or not, though certainly no "doomsday" predictions of divergence and poor growth had come true either.

7.2 Debt and Leaving the Currency

Charlie Bean felt that the spreads regression did not say anything about the markets' expectation of exit from the Euro area because debt (and inflation) itself captures some of the incentive to leave the Euro area and de-link the currency.

7.3 Using Okun's Law to measure whether Europe is an OCA and the labour market can adjust as well under a single currency to asymmetric shocks

Charlie Bean said that the use of Okun's law to measure whether Europe is an OCA (and the labour market can adjust as well under a single currency to asymmetric shocks) introduces a mis-match and does not measure the welfare loss from excessive changes in unemployment and activity.

7.4 Have the Maastricht Convergence criteria and the SGP affected the conduct of fiscal policies in Europe?

Charlie Bean suggested that while the finding that procyclical fiscal policy has been replaced with acyclical fiscal policy, is good, the abandonment of discretionary fiscal policy may not be – it could have a historical basis and it is not necessarily true that the automatic stabilisers always deliver the best result. Harald Hau asked why there was such a problem with the removal of fiscal sovereignty as part of the SGP. On the normative side it can be a good thing and has happened throughout the development of democratic economic and legal institutions. Charles replied saying that giving up the budget deficit may actually be feasible for politicians and redistribution would still be possible. Lans Bovenburg felt that fears of lapsed fiscal discipline were strong before the pact and asked whether this was still a problem. In the Netherlands, he said that the SGP has made the Ministers of Finance stronger domestically.

De Ménil remarked that the EMU have done as well as other OECD countries in terms of budgetary stabilisation; however they may have been the countries that most needed the discipline beforehand. Corsetti asked whether insufficient (too little, too late) stabilisation was really the key issue and suggested newer OCA models (Wordford and others) suggest too little stabilisation will have a level effect in output and only a small welfare effect. The new models suggest looking for a national rate of interest.

Charlie Bean suggested that in the USA the Congressional Budget Office could be a model for an institution providing fiscal forecasts.

7.5 Inflation Target and Inflation Convergence

Charlie Bean pointed out that an inflation target not only is useful for explaining policy but also insulates against political pressure in case of a supply shock. Ignacio Angeloni disagreed with Wyplosz that inflation convergence would have happened without EMU citing the Italian experience where both monetary policy and fiscal policy were influences by the convergence struggle in 1996-1998. Charles argued however that during the convergence period, all countries, including non EMU countries, with budgetary and inflationary problems converged. EMU just provided a political reason to do this for some. Hans Werner argued that interest rate differences are a problem particularly under a low ceiling which have pushed some countries such as Germany to deflation and thus unemployment. The Balassa-Samuelson effect has apparently been forgotten in the formation of the ECB, it implies that price level convergence naturally is associated with inflation divergence. Sinn proposed that capital market integration which forces real price convergence would reinforce this effect. [GB: ? if perfectly integrated, the local terms inflation rate would not matter a lot]. Portes believes that the monetary policy had not been to restrictive , the ECB has kept rates lower than the Bundesbank or Federal Reserve would have done and this has also had a positive effect on long-term rate measures.

Lars Jonung felt that financial integration is missing from that paper, in particular, cross ownership of assets creates risk sharing and consumption smoothing. He asked whether the financial integration counterbalances the problem for countries such as Italy, Portugal and Greece where they have a boom-bust economy but the bust is still to come. Lars asked which crisis is better – a short term one solved by a devaluation or a prolonged one addressed by internal devaluation - reforms and moderation.

7.6 Competitiveness

Ingancio Angeloni felt that recent dynamics reflect the different starting points and are a catch-up effect. The dynamics moving forward are more of a concern.

7.7 What to ascribe to the single currency, what to policy?

Von Thadden argued that the paper does not deal sufficiently with the real economy – especially regarding the capital markets. Many changes such as reference bonds and benchmarks, pressure on banks to reduce transactions have emerged since 1999 and Von Thadden felt that these came from the EMU rather than the Commission developing policies. Eichengreen felt that the paper ascribed too much to monetary union and felt that the single currency has been successful in its aim on addressing financial policy

Carlo Favero suggested that mention of stock markets should also be made, they are behaving differently to GDPs. (Italy's has been the best performing in Europe).

8 Improving Fiscal Policy in the EU. The case of Independent Forecasts

Lars Jonung & Martin Larch

Van der Ploeg was slightly suspicious of independent forecasts, pointing out that the "prudent budgeting" approach in the Netherlands means that politicians deliberately *under-forecast* to resist spending pressure. Van der Ploeg suggested that independent forecasting should be done at a national level and Sinn pointed out that Germany has two independent forecasting institutes. Ignacio Angeloni stated that the Commission has a commonly agreed methodology to make forecasts and independent national forecasts would not. Bovenburg explained that the Central Planning Bureau in the Netherlands is critical of the common methodology. Bovenburg felt that a refinement in the rules would be useful for SGP. The authors replied that the Commission is more concerned about optimism bias than a pessimism bias.

Wolf asked how to measure a forecasting bias in an unobservable and Charlie Bean pointed out that the Bank of England has published figures on potential output (/forecasts) since 1997. Wolf furthermore pointed out that the Treasury publishes a statement saying that its published forecasts are systematically pessimistic because they are based on a trend 0.25% below the real trend. Sinn indicated that the forecast data may also be biased as it is often revised and by large amounts.

Wolf felt that the main problems were forecasting revenue buoyancy, and not growth. Bean agreed with this and added that fiscal projects require accurate projections of spending and tax revenues, which are more important that output expansion. He said that the treasury has this information and possibly misuses it. Robert Chote said that the composition of GDP is changing, and the components all have different fiscal impacts. The wise and independent people who would make predictions closely in line with one another would be hard to find.

Bean highlighted one problem with Walsh contracts – because only probabilistic assessments are sensible for forecast predictions, the contracts should run over a period of time long enough to calculate the bias in the assessments. The authors replied that the it would be important to ascertain whether slippage was temporary or permanent (by luck or deliberate).

8.1 extra misc comments/ replies from authors:

Schlau(?). paper with 15 countries is limited in time dimension. The four countries chosen allow longer time series and resilience to shock bias and they were responsible for changes in the stability pact. The proposal is meant to improve competition and is a step towards Wyplosz. It is possible to go halfway in policy.

9 Price Setting and Inflation Persistence. Did EMU matter?

Ignazio Angeloni, Luc Aucremanne, Matteo Ciccarelli

Neil Gandal was impressed by the data from a micro perspective and asked whether the single currency had an effect of increasing competition for example, in certain industries.

Olivier Blanchard was very interested in the evidence on the increased frequency of price changes and after hearing that a price change also included those that came about through rounding, suggested that small price changes below a threshold per cent should be excluded.

Esther Duflo asked why consumers everywhere seem to be so convinced of price changes and she suggested that the data could be used to investigate whether consumers have a different basket of representative goods to the CPI. The authors replied that they had found quite significant increases in limited, quote protected less competitive industries which are also very visible to consumers.

In reply to Hélène, the authors said that there was no aggregation and they had looked instead at the mean of estimated parameters.

The authors replied that the paper looked at inflation persistence as a sign of non-credibility, if there were no change in AR(1), that would really say something.