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▶ To cite this version:

Jean-Paul Fitoussi. What first assessment can be made of the monetary strategy since 1999 ?. 2003. hal-00972682

HAL Id: hal-00972682

https://hal-sciencespo.archives-ouvertes.fr/hal-00972682

Submitted on 22 May 2014

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European Parliament

COMMITTEE FOR ECONOMIC AND MONETARY AFFAIRS

Briefing paper n° 1 - 7 February 2003

What first assessment can be made of the monetary strategy since 1999?

Jean-Paul Fitoussi

Introduction

Assessing the ECB's performance is unusually difficult because both the Bank and the context within which it operates - the integration of 12 national foreign exchange markets - are so radically new. There is no historical precedent. Nor are there any criteria against which to judge monetary policy designed for a group of states, which are closely integrated but fall short of a federal structure. One does not need to be an economic expert to appreciate that monetary policy is much more complicated in this novel situation than it is for in a nation state or a federation which can resort to historical precedents. There are technical difficulties – eurozone statistic are far less reliable as a basis of policy decisions than national ones – and political ones, in particular the preponderance of national interests. European governments still tend to europeanise their problems and nationalise their successes. Since European integration is still very much a work in progress, it is all too easy to criticise the work of the ECB, not least because it is build on various, perhaps even conflicting ulterior motives.

Any evaluation of the ECB's first years in action has to start with the fact that the worst fears of the single currency's opponents have not materialised. Economic growth has not been stifled by a soaring euro; on the contrary. And the recent appreciation of the currency has geopolitical roots. If anything, the ECB's policy has stimulated economic growth as real interest rates have been much lower compared with the low-growth period of 1991-97. Nor has the euro's weakness generated a significant rise in inflationary pressure. Against this background, the ECB's monetary policy appears more effective than the monetary policies of the EU's national central banks that preceded it. This positive assessment should put the more critical comments that are to follow into context. Although the ECB has done well, there is room for improvement, especially since it is still a young institution that may have a lot to learn from its own mistakes.

I will conduct this assessment in two steps. The first is a quick analysis of the decisions by the European Central Bank, that as we shall see has gone through different phases both regarding its activism and its efficacy. The second step is an attempt to relate these phases to the doctrine that underlies the action of the ECB and/or to the difficulties that arose from the fact that it is a newly established institution.

The European Central Bank in action

If the overall assessment is pretty positive, it is because the ECB is a young institution that has to manage monetary policy in reference to an heterogeneous area, and that in a few years had to go through a series of significant external shocks: The effects of the East Asian crisis; the Oil "mini-shock"; the food prices increase due to animal diseases and bad weather; the depreciation of the Euro; the US slowdown; the terror attacks of September 11; and the slow agony of stock markets. All of these shocks have had, with different delays, effects on prices, and hence had to be addressed by the ECB in its decisions about interest rates. For these reasons the task was not easy and the Bank dealt with it quite skilfully.

But if the ECB has done well, there is room for improvement. In effect, looking at the same shocks chronologically, and analysing how the ECB reacted, one is left with the impression of an insufficient degree of reactivity of the Bank, which may have its roots in too restrictive a conception of the role of monetary policy[1].

In a *first phase*, from the launching of the Euro to the fall of 1999, the Bank took an expansionary stance to face the deflationary effects of the East Asian crisis. In April 1999 its main refinancing rate went down from 3% to 2.5%, until the following September. Over this period it became clear to the observers that the inflation target had a lower bound, as the ECB cared about the danger of deflation as well.

The *second phase* began in the fall of 1999 in response to the second and third shocks, namely an increase of inflation due to food and oil prices. These factors, in addition to Euro depreciation, increased imported inflation and pushed the ECB to change its stance to restrictive. Over the following year the refinancing rate was progressively brought up to reach 4.75% in November 2000.

The *third phase* marks a change in attitude of the ECB. In spite of clear and increasing signs of economic slowdown, the Bank kept its rate unchanged until May 2001. At that moment, it began a timid rate reduction in response to the US recession and the continuing European slowdown, bringing the rates down of 25 basis points; the same reduction was carried over a few months later, in August. A more serious cut, of half a point, occurred at mid September, but it was of course more due to the exceptional circumstances created by the WTC attacks than to a real concern for growth. In fact, over the following couple of months the Fed proved to be largely

[1] For a more detailed account of the first four years of the Euro, see Jean-Paul Fitoussi and Jerôme Creel: *How to Reform The European Central Bank*, Centre for European reform, London, October 2002.

more aggressive in its rate cuts. At the end of 2001 the Fed funds rate was at 2%, while the Refinancing Rate of the ECB was only cut of a further half point to 3,25% (November 2001). It would not move from that level until the half point decrease of December 2002, in spite of sluggish growth and decreasing inflation (especially once the transitory effects of the introduction of the Euro are discounted). This inertia is even more puzzling if we consider that over the year 2002 the Euro appreciated of more than 25% with respect to the US dollar[2], and that a further appreciation is expected.

The principles guiding the ECB monetary policy

What does this rough division in phases tells us about the principles that guided the ECB action? Mainly two things. The first is that the Bank was reactive to shocks that directly affected inflation (oil and food prices, Euro depreciation), but much less so to shocks that firstly had an impact on income and only through that channel on prices (as the US slowdown). The second, and related point, is that the ECB strictly followed its main objective (price stability), but much less so its secondary one, the promotion of economic growth, even when it was becoming evident to most observers that a cut in rates to sustain growth would not hamper the objective of price stability[3]. To say it differently, the inertia that characterised the behaviour of the Bank since the beginning of 2001 shows that its behaviour was in fact not sufficiently forward-looking. The future disinflationary effects of the slowdown in growth were not taken into consideration.

Over the past year at least, there has been a growing consensus on the fact that the strategy of the ECB was not sufficiently balanced, and that its fear of inflation was excessive. The criticisms were so widespread that the ECB itself is carrying on an evaluation of its first years of activity, an initiative that has to be applauded, as it increases the degree of responsibility and hence of credibility of the Bank.

But then we are left with the central question: Why did the ECB focus so narrowly on inflation, both in its actions and in its communication strategy? Two explanations, strictly related, may be highlighted.

The first is that the ECB follows what has now become the new orthodoxy in Macroeconomics. As I argued in a previous report[4], this orthodoxy amounts to reducing as much as possible the scope for policy, by constraining monetary policy to exclusively focus on price stability (possibly by preferring clear, intelligible rules to discretionary decisions), and by avoiding discretionary fiscal policy through the Stability Pact. According to this vision the task of enhancing growth and productivity

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[2] The appreciation took place in two phases. The first, from the minimum (0.86 dollars for an Euro, at the end of January 2002), brought the two currencies to parity in July. The exchange rate then oscillated around 0.98 until November, when the upwards movement started again to reach the maximum of these days (1.08-1.09 dollars for an Euro).

[3] The Maastricht Treaty gives the ECB the task of conducting "a single monetary policy and exchange rate policy the *primary objective* of both of which shall be to maintain *price stability* and, *without prejudice* to this objective, *to support the general economic policies* in the Community" (Art. 3A, emphasis added). It is important to recall that in the United States the Humphrey-Hawkins Act of 1978 gives growth and price stabilisation the same weight in the Federal Reserve's statute.

[4] Jean-Paul Fitoussi, "The Stability (and Growth) Pact and Monetary Policy" European Parliament Briefing paper n° 4-15 November 2002.

should be exclusively left to structural reforms aimed at eliminating distortions particularly in the labour market. Whether this conceptual framework is coherent and convincing is not an issue to be addressed here. It is nevertheless obvious that it is shared by most central bankers in the industrialised countries. In spite of that, almost invariably, this theoretical orthodoxy is coupled with a much more pragmatic attitude in actual behaviour. The most striking case is the Federal Reserve, that continuously manoeuvred its interest rates to influence markets with the objective of keeping the economy on a low inflation-high growth path. Why is it so, then that the ECB seems to be practically the only central bank that make its acts coherent with monetary (and fiscal) orthodoxy?

This calls into play the second explanation, that is specific to the ECB: The need to establish a reputation. Credibility is an invaluable asset for an institution that deals with (financial) markets in which expectations have an essential role to play. This is a serious issue, and it would be unwise to disregard it. A young central bank has to convince markets that it is serious about reaching its objectives, and that it has the means and the skill to do it. Taking this into consideration, the restrictiveness of monetary policy, and the inertia that has characterised the ECB attitude facing the economic slowdown may be seen as signs that the Bank is focussing on its main objective, and that it does take the time to accumulate information in order to act efficiently.

While believing that these credibility considerations are important, I do not share the opinion that they should be sufficient to justify the course of action the ECB chose, particularly since early 2001. In fact, it is my opinion that the ECB has not gained much in credibility. If a restrictive policy was the price to pay in order to acquire credibility, then that price was largely paid in vain.

Through its actions, the ECB has acquired the reputation of being tough, but not of being as forward looking as it pretends. Patrick Artus and Charles Wyplosz[5] have shown that if we take a standard measure of the influence of a central bank on agents expectations, namely the responsiveness of market-determined long term rates to changes in the Central bank rates, the ECB has been much less effective than the Fed and the Bundesbank.

There are various reasons why the ECB did not fully convince markets:

(a) The first and more obvious is that the inflation objective the ECB has chosen is simply too ambitious. Even in a period of low growth, inflation was above the 2% threshold for all years except one (1999). And of course it is not beneficial to the reputation of a central bank to miss almost systematically its target. The 2% target reflects the particular circumstances in which it was decided (1998), a period of atypically low inflation. Most economists believe that a target between 2% and 3% would definitively be more appropriate[6].

(b) The second reason regards the rule followed by the Bank in defining its strategy. The ECB has been following, at least in theory, the strategy called of the "two pillars", heritage of the compromises that underlie its creation; on one side, it

[5] *La politique monétaire de la Banque centrale européenne,* Conseil d'Analyse Économique - La documentation Française.

[6] See Fitoussi and Creel, *How to Reform* ..., op.cit., p. 42.

was supposed to target money growth (the "reference value" is 4.5% per year[7]); on the other hand, it had to take into account a composite indicator of inflationary pressures. In practice, the money growth objective was not followed, and the ECB simply focussed on the second pillar. But this ambiguity between the strategy the Bank was supposed to follow and the one it actually implemented, was a nuisance for the transparency of its acts, the effectiveness of its communication strategy, and finally damaged the ECB in its quest for credibility.

(c) The third reason why the ECB has not yet established a good reputation is subtler, but at the same time it may potentially be the most important. In fact, it is impossible for a central bank to acquire credibility if, while attaining its objective, *it imposes excessive costs to the society*. Most theories advocating the sole objective of price stability rely on the hypothesis of rational expectations, that in turn implies an absence of social costs: Private agents correctly anticipate the bank's action, and their behaviour is modified accordingly with no effects on employment or growth. In these conditions price stability comes for free, and a central bank that does not pursue it acquires a negative reputation. But reality is another thing, and the low inflation objective often comes at the cost of reduced growth, as may have been the case in Europe in recent years. How credible can a central bank be, if in the middle of a general slowdown on both sides of the Atlantic, with the Euro zone economy on the brink of a recession, it refuses to lower rates because of a (largely undemonstrated) inflationary threat? The roots of this problem are not within the ECB itself, but rather in the Maastricht Treaty, that gives priority to inflation, and does not provide for accountability. Political accountability means that the Central Bank has to account for its actions in front of an institution that possessed the right – however carefully defined – to modify the Central Bank's statute. Although the ECB reports to the European Parliament, the latter has only the power of persuasion to influence the ECB. The fact that National Parliaments have hardly ever made use of this power does not prove that it serves no purpose. Its very existence force Central Banks to take into account the preoccupations of a country's elected representatives and make better use of the information available. As a consequence, the ECB has not to take into account the social costs of its actions, and may lack information on their magnitude. On the other hand, the American institutional set-up makes the Fed accountable (mainly in front of the Congress)[8], and gives it the task of pursuing the twin objectives of price stability and growth. In doing so, it forces the Central Bank to internalise the social costs of disinflation and hence to implement a more balanced and effective policy.

Conclusion

The analysis carried on in this short brief gives the possibility to conclude by advancing some proposals:

1. The first is the easier to implement: The 2% objective for the inflation rate inflation is too low, and it has to be substantially revised. This can be done either by directly increasing it, or by allowing a larger fluctuation band around it. Regular

[7] This may be arrived at by summing potential output growth, estimated at 2.5%, the target inflation rate, say 1.75%, and a trend shift in velocity of about 0.5% per year.

[8] It is important to remark that this does not make it less independent. Lack of accountability and independence are not synonyms.

(even if infrequent) revisions of the inflation ceiling would allow to adapt the ECB action to changing economic conditions.

2. In order to increase the accountability of the ECB, the revision of the target rate should be carried on after consultation with politically elected organisms, like the Council and/or (preferably) the Parliament. Being democratically responsible, these institutions are more sensible to the social costs of monetary policy; involving them in the process, hence, would allow to internalise these costs into the ECB action. Of course the ECB would conserve its full independence of means.

3. Increased transparency and simplicity are important determinants of credibility. The ECB should formally abandon the money growth objective (that is routinely overlooked) and make explicit the exclusive focus on the second pillar that is now hidden; by doing so, it could avoid baroque communication strategies. Furthermore, the Bank should clarify how the different economic indicators (expected inflation, output gap, exchange rate level, and so on) enter in its decision rule.