# An Assessment of ECB Action

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## Executive Summary

An assessment of the conduct of monetary policy in Europe must necessarily be made along two distinct and complementary lines. The first is a comparison with the policies followed in the past. The second line has to assess whether monetary policy is adapted to the new conditions that came into existence with the inception of the Euro. The picture with respect to these two criteria is mixed. Monetary policy has certainly improved with respect to the policies followed in the 1990s, during the run up to the euro. In fact, the ECB proved to be much more growth friendly than its predecessors. On the other hand, though, the challenges posed by the new environment, the management of a large open economy, have not been internalized by the ECB, that was less reactive than the Fed, and too focussed on current inflation. The tightening of monetary conditions in the euro zone, mainly due to the euro appreciation, was not sufficiently cautioned by monetary policy. Especially considering the poor economic performances of the euro zone in the past few years, we must conclude that monetary policy was not helpful in fostering growth recovery in the euro area. The ECB did not fully recognise its new responsibility of conducting the monetary policy of a "big country".

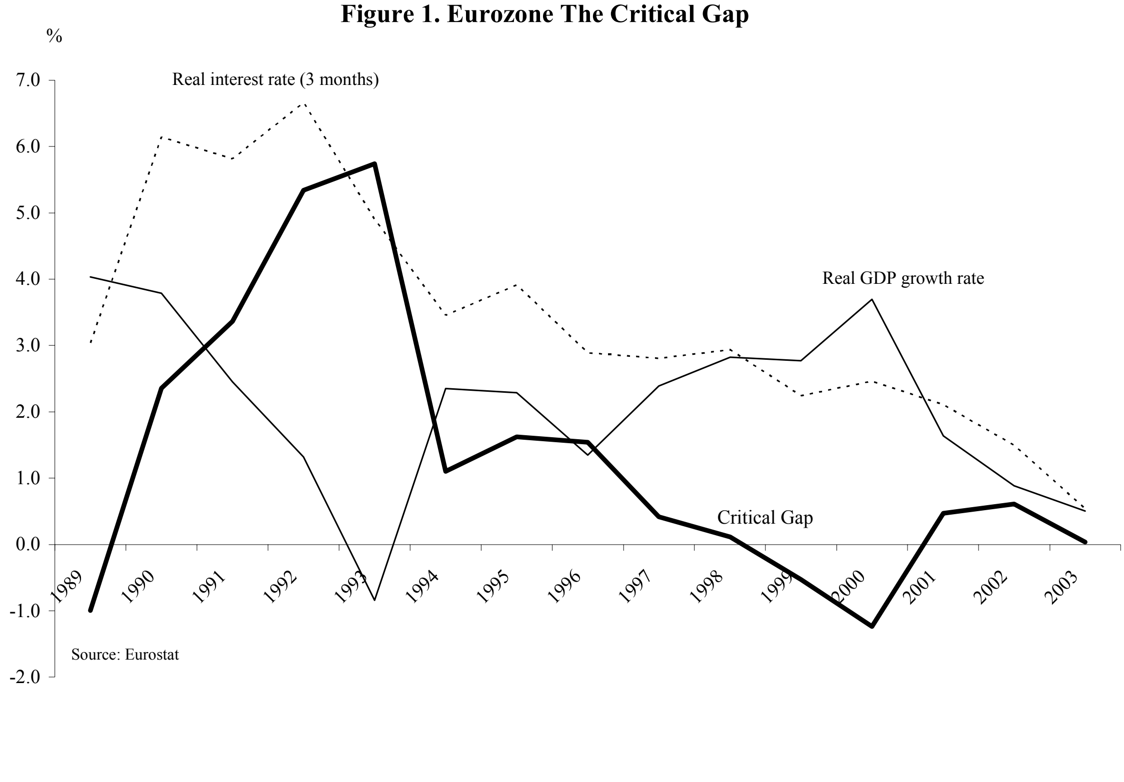
The most obvious way to assess monetary policy in Europe since the ECB came into existence is to compare it with the policies that preceded it, particularly in the years immediately preceding the inception of the euro. Nevertheless, such an analysis would necessarily be incomplete if we did not ask at the same time whether the policy framework put in place by the ECB is consistent with its environment. Such a dual assessment is all the more necessary, that the monetary union represented a regime change for Europe. Before, if we except Germany, monetary conditions in each single European countries of the EMS were determined by the exigency of keeping the exchange rate parity with the DM. No wonder then if most of the time, it was not adapted to internal economic conditions. Now, the ECB enjoys full monetary policy autonomy, and has to take into account the global effects of its policy. Thus, any assessment necessarily has to consider whether the ECB stood up to this increased responsibility. The natural benchmark against which to compare the ECB is of course the US Fed, the only other central bank that faces such a global responsibility.

To anticipate on the conclusions, if on one side the record of monetary policy under the ECB has considerably improved with respect to the policies followed in the 1990s, on the other it does not seem to have fully internalized the regime change, and has been too inertial if we consider its increased responsibilities.

## A Comparison with the 1990s: A More Appropriate Monetary Policy

Figure 1 shows the short term real interest rate, and the growth rate, since 1989. It further reports the "critical gap", the difference between the two that can be seen as a first broad measure of the degree of restrictiveness of monetary policy (a more sophisticated measure will be discussed below).

**Figure 1. Eurozone The Critical Gap**



It is clear that since the run-up to the euro began, the monetary stance progressively became accommodating, and that since 1999 the critical gap remained stable at low levels. Thus, a comparison with past behaviour seems to show a monetary policy more growth friendly.

## The ECB and the New Policy Regime

Limiting the assessment of ECB action to a comparison with past behaviours in Europe is not enough for at least two reasons. First, in general, evaluation should never be solely based on comparative terms; second, this is even truer when there is a regime change. Standard textbook analysis routinely separates the study of small open economies, facing external constraints, from the study of large economies. It is no doubt that with the Euro, the model of reference for Europe became the latter, reducing the constraints facing monetary policy, but at the same time increasing its responsibility. How did the ECB behave, faced with this new responsibility?

*The First Years*

The relatively short period since the European Central Bank came into existence was characterized by a number of important challenges for the authorities in charge with European economic policy management: the end of the internet bubble, the Afghan and Iraqi wars, the terror attacks of September 11, the droughts and the agricultural prices fluctuations, the animal diseases, the oil price fluctuations. The first three years of operation of the ECB were the object of a previous briefing paper (BP 1-2003, February[1]). The Bank was reactive to factors that directly affected inflation; thus, it was quite active in the years 1999-2000, in response to shocks in oil and food prices, and in trying to contrast the depreciation of the euro. On the other hand, it showed more inertia in reacting to shocks that firstly had an impact on income and employment, and only through that channel on prices: facing the US slowdown of 2001, and its consequences on output in the euro zone, it did react only slowly and under exceptional circumstances (notably the 9/11 events). In a sentence, the ECB strictly followed its main objective (price stability), but much less so its secondary one, the promotion of economic growth. While this behaviour could be justified by the institutional tasks of the ECB, it also showed two important problems with such a state of affairs. First, the objective of price stability was pushed too far, even when it was becoming evident to most observers that a cut in rates to sustain growth would not hamper the inflation objective of the ECB. Secondly, the excessive focus on inflation, unveiled an insufficiently forward looking attitude, as the future disinflationary effects of the slowdown were not taken into consideration. The briefing paper concluded by arguing that if the restrictiveness of the Bank's behaviour had to be explained by the attempt to establish a reputation, that attempt had not been entirely successful.

*The Period 2002-2004*

What are the main events that characterized the past two years, and against which we need to assess the conduct of monetary policy in the euro zone? We can enumerate three of them.

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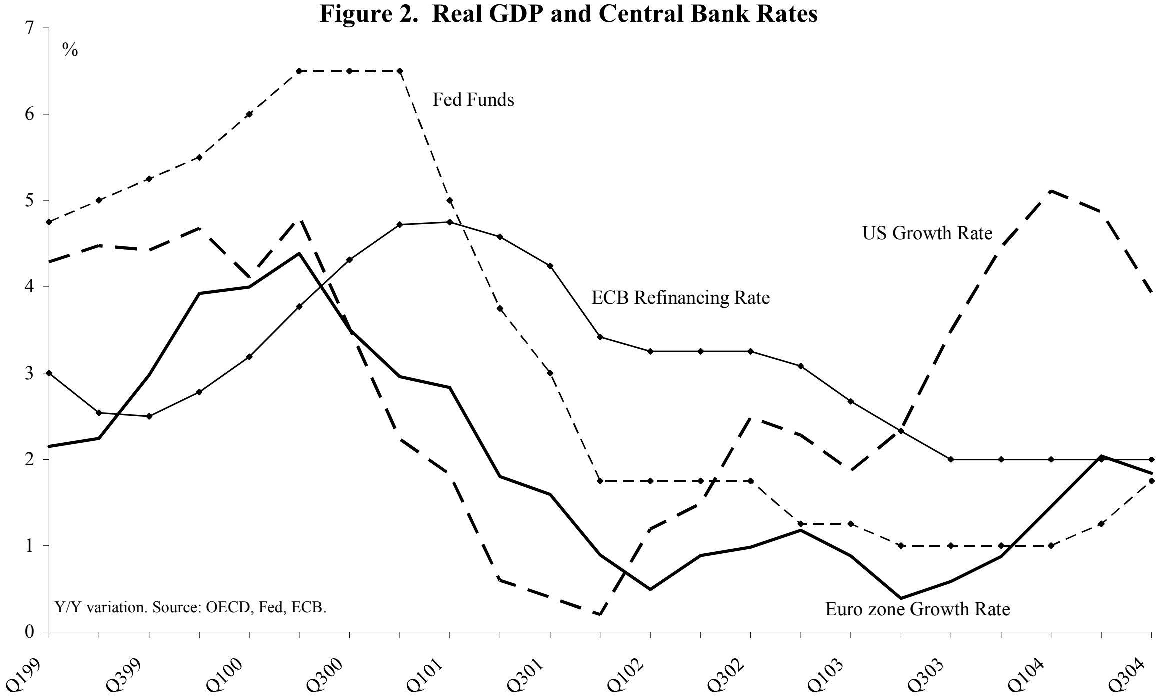
[1] http://www.europarl.eu.int/comparl/econ/pdf/emu/speeches/20030217/fitoussi.pdf

*(i) The prolonged stagnation of the European economy.*

Figure 2 compares the growth performances of the US and of the Euro zone in the past few years. It clearly shows that, though deeper than in Europe, the recession on the other side of the Atlantic was very short lived, and followed by a growth recovery as soon as 2002, and impetuous growth in the two years 2003-2004. Europe, on the other hand, experienced a prolonged period of disappointing growth, with the three largest economies *de facto* stagnating. In spite of sluggish growth, since the first quarter of 2001, the ECB refinancing rate was always higher than the Fed Funds Rate, and the gap was closed only late in 2004, following the gradual rate increase in the United States.

**Figure 2. Real GDP and Central Bank Rates**




*(ii) The stabilization of inflation*

The second remarkable fact of the last two years is the stabilization of inflation. After the shocks of the years 1999-2001, inflation in Euroland fluctuated around 2%, the level targeted by the ECB (see figure 3). In fact, since April 2002, it oscillated between a minimum of 1.7% and a maximum of 2.4%. Much of this variation was furthermore due to the sharp increase of oil prices. If we consider core inflation, its level has been constantly below 2% since January 2003.

**Figure 3. Inflation and ECB Rates**

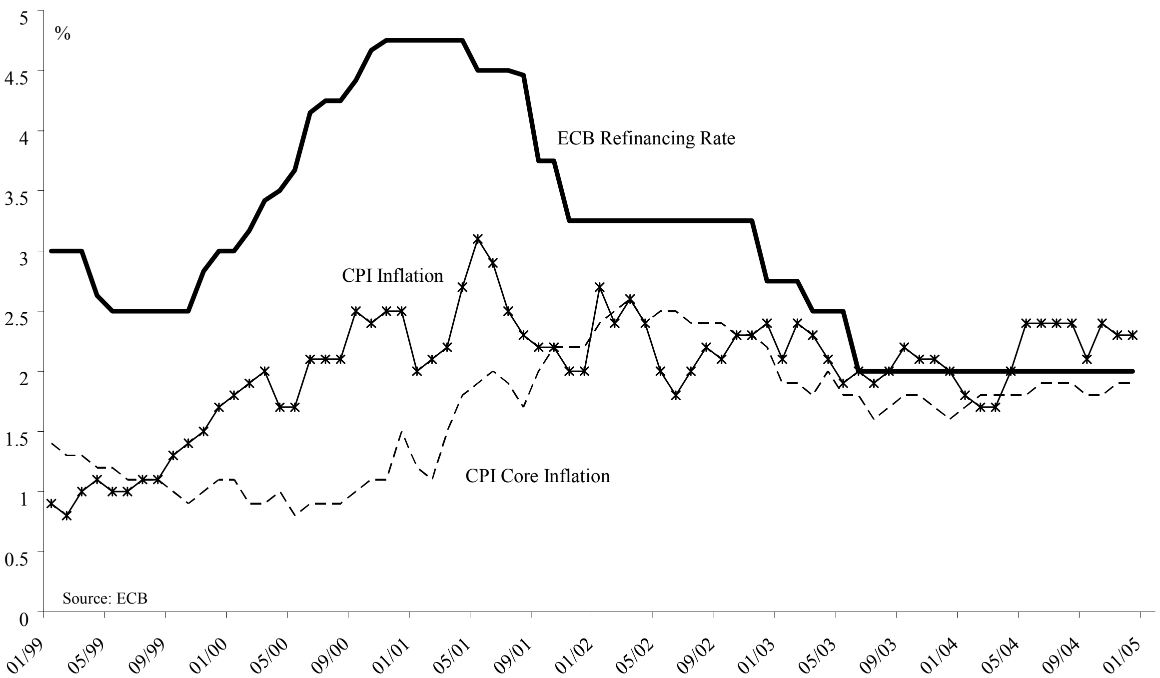
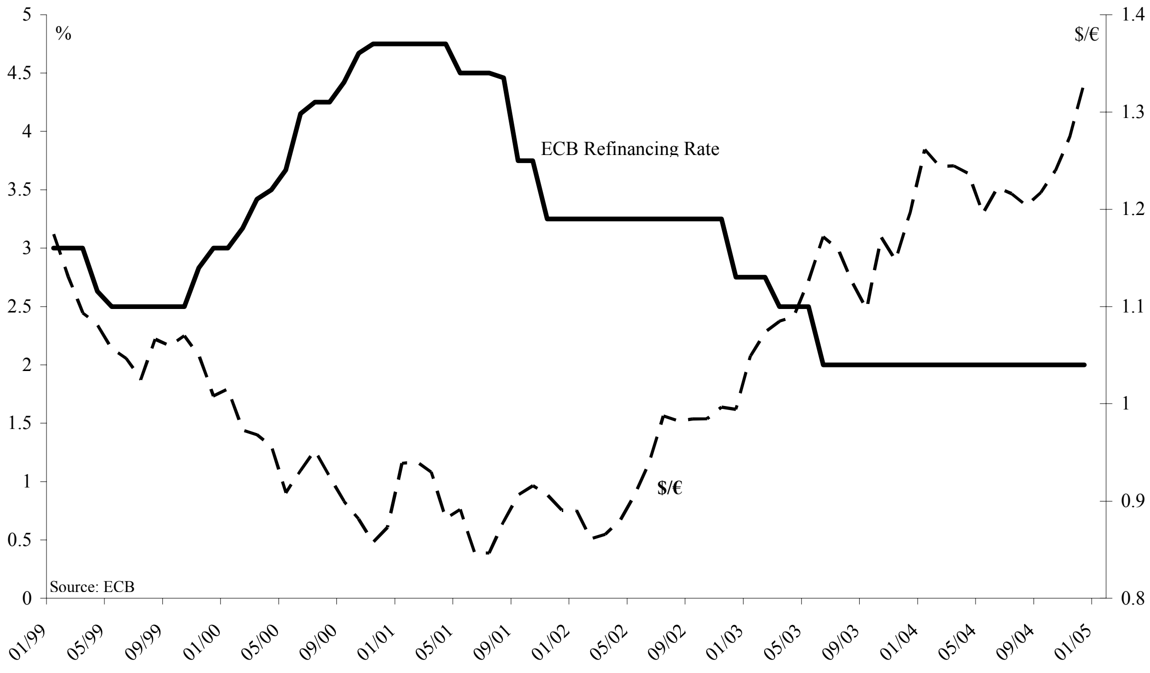



**Figure 4. \$/€ Exchange Rate and ECB Rates**




*(ii) The spectacular depreciation of the dollar*

Since its minimum value (0.84 dollars for an euro) in July 2001, the exchange ratio between the US dollar and the euro has climbed almost 60% to its current level of around 1.30 (see figure 4). In the years 2003-04 the dollar depreciated by 35%. The euro also appreciated with respect to the currencies pegged to the dollar, in particular the Chinese Yuan. With some notable exceptions, European exports suffered from this exchange rate dynamics.

*The ECB Inertia in a Changing World*

The pattern that was appearing towards the end of 2001 – an extreme cautiousness of the ECB – has been confirmed by the policy followed since then. After the drop following the terror attacks, the main refinancing rate was left unchanged at 3.25% from November 2001 to November 2002. Then, over the following semester it was brought down to 2%, and since then (June 2003), it has been left unchanged. One could argue that this conduct was appropriate, given that the inflation rate was more or less regularly around its target level, and that the statutory mandate of the ECB is to maintain price stability.

Nevertheless, if we broaden the perspective, we obtain a somewhat different picture, in which the inertia of the ECB is harder to justify. Figure 5 exhibits the Monetary Conditions Indicator (MCI), built by OFCE (see box 1 for details on how the index is constructed). This indicator gives a synthetic measure of monetary policy tightness. It embeds both interest rates and the exchange rate; as such it is well suited to capture the remarkable appreciation of the euro. We can see that since 2002 monetary conditions have strongly loosened in the US, thanks to the strong depreciation of the dollar; not even the gradual tightening of monetary policy, over the past few months, has changed the trend. In Europe, over the same time span, the indicator of monetary conditions has been constantly tightening, mainly because of the euro appreciation that was not contrasted by an aggressive monetary stance. In other words, the combination of interest rates and the effective exchange rate is tighter today than it was in 1999, a period of higher growth.

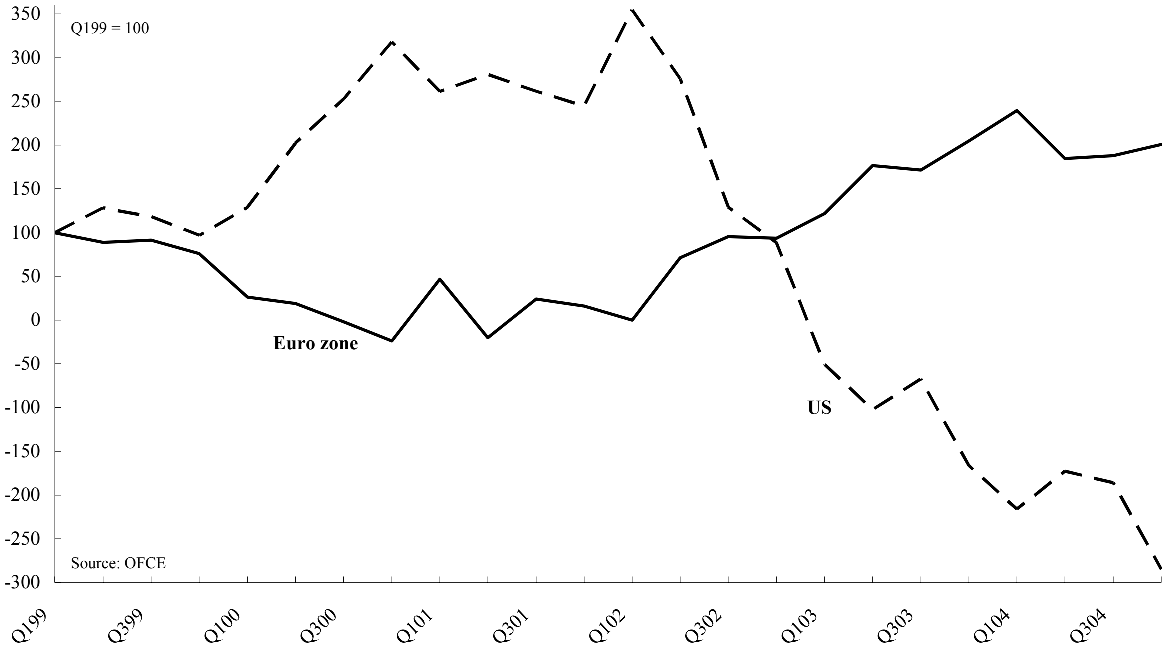
**Box 1. The Monetary Conditions Indicator (MCI)**

The MCI is aimed at giving a synthetic measure of the financial constraint faced by an economy. First it considers the deviation of real interest rates from the rate of growth (the "critical gap"), that affects the economy mainly through the investment function and the cost of credit. The second element is the effective real exchange rate, that represents an indicator of competitiveness.

The real interest rate variable is an average of the short term rate, determined by monetary policy, and the long term rate determined by the markets. By taking the critical gap, we obtain a relative measure that allows comparisons across countries. Comparability across countries is also the reason why the exchange rate variable is taken as a deviation from its 10 years average.

Finally, the weights come from the macroeconomic model OFCE uses for its forecasts: 1 for the interest rate, and 0.2 for the effective exchange rate.

**Figure 5. Monetary Conditions Indicator**




The second reason that calls for an in depth analysis of monetary policy is the inflation target *per se.* If it is true that inflation has been fluctuating around 2% in the past two years, justifying the stability of ECB rates with respect to its target, it is also true that precisely the decision of the ECB to set the target rate at 2% may be seen as the "original sin" of monetary policy in the Euro zone. In fact, the period of low inflation that preceded the inception of the single currency has created an historical anchor that in view of the following events proved to be too low, and hence induced a restrictive bias in monetary policy. I argued elsewhere[2] that a correct target rate for inflation should be 2.5% or 3%.

## Fit for the New Role?

The preceding analysis gives a mixed picture of the ECB action. On one side, the bank showed more responsiveness to current economic conditions than the central banks of individual countries of the euro zone over the 1990s. On the other hand, though, the ECB policy did not prove to be completely adequate to the new regime introduced by the euro. Even if it can't be said that monetary policy was procyclical, it is quite evident that the overall monetary stance in the past few years was not supportive of growth. The bank did not seem able to meet the challenge posed on one side by its new capacity to influence global variables like the exchange rate, and on the other by the constraints on fiscal policy in the EMU that leave monetary policy as the only union-wide tool to sustain growth and income. It is not by chance that the other "large open economy", the US, statutory imposes growth as an objective for its central bank. The anomaly of the ECB statute, an exclusive focus on inflation, may be seen as a "small country" legacy and should be corrected. The European Constitutional Treaty is a missed opportunity in this sense.

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[2] Fitoussi, J.-P., *La Règle Et Le Choix*. Paris, La république des idées, Seuil, 2002.

The inertia of the ECB, compared with the activism and the pre-emptive moves of the Fed may have two different explanations; one could think that the ECB correctly focused on inflation, and hence that its limited activism reflects the good accomplishment of its mission. Or, one could conclude, at the opposite, that the ECB has been unable to base its policy on anticipation of future events, as the Fed does, and that its inertia derives from a backward looking attitude (a "feedback policy"), unfit to the leading role monetary policy has to have in a currency union of such a big size.