Economic and monetary conditions in the Euro area : the ECB, the FED and the euro

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Outlook

Will Europe be immune to the slowdown of growth in the US? According to the US treasury secretary Paul O'Neill it will be illusory to believe that Europe will avoid to be hit by business conditions in the other side of the Atlantic. In my last briefing paper I tried to sketch the broad reasons explaining why the transmission of the US slowdown to Europe will not be as mechanical as some would like us to believe, provided that monetary conditions in Europe do not become more restrictive. True growth forecast for Europe have been generally revised downward – the IMF revision being the more severe (from 3.4 to 2.4) – but most institutes are agreeing on a figure slightly under 3%, the consensus forecast being 2.7%. At least for the moment a strong impact is not in sight. But there is also the question of Europe's responsibility towards the global economy. World growth which has been buoyant in 2000, at a rate around 5% is expected to be a little above 3% in 2001. It is thus no wonder that bitter comments are coming from IMF officials about the excess of prudence of the ECB: according to Michael Mussa the IMF's chief economist "It is time for the ECB to become part of the solution, not part of the problem of slowing growth…on purely domestic ground the balance was at least neutral, and from a global perspective the case for easing was unambiguous". These are strong words especially if one considers what would be appreciated as a good move by the ECB, a moderate cut of, say a quarter of a point. To say the least, the absence of such a move by the ECB – an actual interest rate of 4.75% instead of 4.5% -- would be, in the worst case, considered as a very small mistake. (And, incidentally was the FED right in not having cut its rate between may 2000 and january 2001?)

"On purely domestic ground", the case against the ECB is not so obvious: headline inflation can well in May revisit its peak of november (2.9%). This is due to a serie of price shocks that have hit the euro-area in the past two years: oil, euro depreciation, food prices etc.. Core inflation may also hit the 2% level. This succession of unfavourable events should not have lasting effects, but may well refrain the ECB from cutting the interest rates. Especially in view of the potential second round effect that the rate of inflation could have on wage pressure. If the ECB were using a Taylor rule, the interest rate would not be so different from what it is now.

Expectations and the euro-dollar exchange rate

But monetary policy should have a forward looking character. What matters is growth say in six to nine months ahead and inflation in eighteen months. There is little doubt that in 2002 inflation will recede in the euro area to a figure slightly under 2%. For most observers, this expectation embodies the assumptions of a quarter of a point cut in interest rate towards the end of the first semester 2001, and a rebound of growth in the second semester. Thus at constant monetary policy, the rate of inflation would be lower. It seems also that the expectation for inflation is more firmly asserted than the expectation for growth. That means that with respect to last year the balance of risk has shifted: the probability of a further slowdown of growth seems higher that the probability of a further increase in the inflation rate or even of the probability of inflation staying at the current level. Hence a move for "insurance" purpose could be justified even if the present exchange rate of the euro implies that monetary conditions remains accommodative. But there is no need to rush and such a move may still await a few more weeks.

There are plenty of alternative explanations for the present "weakness" of the euro (see my briefing paper of june 2000). One of them is worth considering because it may lead to some indeterminacy as to the effects of European monetary policy. According to this explanation, the euro-dollar exchange rate is governed by growth differential, and despite the present slowdown of growth in the US, most institutes and observers (and the markets) expect the growth differential to become again favourable to the US by the second semester 2001. The V shape recovery scenario for the US economy is thus favoured and this is why the European currency did not recover. Hence the argument goes, a decrease in european interest rate, because it enhances growth, is also likely to lead to an appreciation of the euro. But that leads to an indeterminacy with respect to the net effect of monetary policy. If a cut in interest rate leads to an appreciating currency, monetary conditions in Europe may not change. The boost to internal demand would be partly compensated by a decrease in net exports. Intriguingly, the standard effect of crowding out of net export which was associated with expansionary fiscal policy is now associated with monetary policy. Presumably, however, the first effect will dominate the second, the euro area being a big country less open to trade. On top of that, this "new" theory implies that an expansionary monetary policy will have a mitigated effect on the inflation rate, the rise of the exchange rate of the currency leading to some imported desinflation. Is there a rationale for this new view of seeing the consequences of monetary policy?

The only rational explanation we can think of is the following : present conditions are such that the current rate of growth has a lasting effect on *potential* growth because it enhances investment in new technologies. It thus leads to a permanent increase in factors productivity and in the rate of return of capital. This effect has already shown up in the US but not yet in Europe. There is thus a strong incentive for capital to flow in Europe, provided the ECB gives unambiguous signs that it cares for growth. This total factor productivity effect, together with the term of trade effect, adds to the desinflationary consequence of a decrease in short term interest rates. If there is some true in this reasoning, there is a lot to gain for the ECB in cutting its main lending rate and very little to loose. Indeed, favouring growth may be part and parcel of monetary policy *stricto sensu,* a kind of intermediate goal to achieve price stability, at least during the few years to come.

Asymmetrical effect of monetary policy

We know that in view of the heterogeneity of business conditions within the euro area, monetary policy might have asymmetrical effects. As underlined by the ECB annual report (May 2001) the dispersion of inflation rates has widened. A decrease in interest rates may thus add to inflationary pressures in countries where the inflation rate is already comparatively high, and have only delayed effects on output in other countries. An appreciation of the euro will also have asymmetrical effects due to the different exposures of european countries to extra-european trade. For example, will Germany benefit more from a decrease of interest rate or from a "weak" currency? We will have to wait for more careful studies on these questions before giving an informed answer to them.

But the point I would like to make here is rather different. The euro area is characterised by countries having different levels of development. The weight of the countries having a relatively low GDP per capita is for the moment significant. Things may change when the UK and Scandinavian countries will enter the area, and will change again with the enlargement. But for the time being, that means that due to the Balassa effect a sizeable dispersion of the inflation rates should be allowed for. The only way of achieving such a result is to allow for a higher average rate of inflation. The less than 2% objective of the ECB may be too low to embody this structural factor.

A supplementary argument is that, even absent the former factor, such an objective is difficult to reach in a period – the last three years – characterised by a variety of external shocks. That it has been reached in 1998 and 1999, is also the consequence of an unexpected shock, the huge decrease of the price of oil. As a result, headline inflation has been higher than the objective in 2000 and will stay also higher this year. Quite rightly the ECB has acknowledged this fact, stressing that its aim is medium run price stability. But it is also obvious that this gap between headline inflation and the objective, limits strongly its room for manoeuvre, especially when growth slows and when a case can be made for a more expansionary monetary policy. If the slowdown has an adverse effect on productivity (the so called productivity cycle), it will temporarily add to inflationary pressure due to the increase in unit costs.

But admittedly, it is not yet time for the ECB to amend its objective. May be the pragmatic way in which *de facto* it is handling it can be rationalised – a medium term objective under 2% is entirely consistent with short term variations up to 3% -- so as to add rather than to substract to its credibility.

The FED

Because the FED has constitutionally an eye on the growth rate, its room for manœuvre is objectively greater. First these duality of objectives has the great advantage of preventing to put explicitly a figure for inflation, with the side effect of avoiding to be accused for not reaching the objective. From 1980 to 2000, the US inflation rate has been lower than 2% only one year, namely in 1998. This sheer fact tells a lot on how a central bank can buy a strong credibility without having to be dogmatic about a figure. It is not a question of conservatism: it is widely held now that Central bankers should be more conservative than the average of society. It is a question of allowing for mistakes. Monetary policy is a human activity, an art, which implies a lot of judgement. It has to take account of the future and the uncertainty surrounding it. Nobody could be persuaded, and certainly not the Peoples of Europe, that it is a technical matter obeying mechanical laws of motion. Credibility is not the property of an institution never doing a mistake – that is out of this world – nor never taking a risk – that could be very dangerous under certain circumstances. It is, on the contrary, linked to an institution learning from its mistakes and having the capacity of repairing them.

One could argue that the FED has probably made a big mistake in not having cut its interest rate before January 2001. Some are even asserting that the slowdown of growth in the US is man made, as it obeys the traditional pattern of recessions which have generally been the consequence of monetary policy having stayed too restrictive for too long. Most institutes and many observers in the fall 2000 were expecting a slowdown of the US economy: the only uncertainty was about whether the landing would be soft or hard. As a central bank should be forward looking, the FED should have changed the course of monetary policy before the landing. Admittedly, the job of monetary policy has become much more complex nowadays, were central banks have to look both at the inflation rate and at asset prices, especially in the US were these are playing such an important role. The widely held view that asset prices had to deflate a bit more may explain the lateness of the reaction of the FED. But whatever judgement will prevail in retrospect, we have to recognise that even if there were a mistake, the FED did act energetically to repair it, having decreased in less than 4 months the interest rate by more than 200 basic points.

Summary

1) So far, there has been nothing wrong with the ECB not having cut its main lending rate. What may be expected in the weeks to come is a decrease of a quarter of a point. There is some arrogance in the pressure coming from the other side of the Atlantic and the ECB should not obey to this. The policy conducted by the FED is not exempt from mistakes.

2) An important question raised by a common view – shared by many economists and the markets -- is that a move towards lower interest rates by the ECB will lead to an appreciation of the euro. A possible interpretation is that current growth affects potential growth because of higher productivity due to new technologies. If that is true there is a strong case for the ECB cutting its rate, as this would be on the whole desinflationary in the medium run.

3) When comparing the ECB and the FED actions, one should have in mind the rather different explicit objectives of both institutions. The absence of a formal inflation objective of the FED, (a consequence of the fact that the FED has also a growth objective), allows for a greater room for manœuvre, but also for more mistakes, along with the possibility to repair them. Credibility is probably the outcome of this "trial and error" process.

A way out for the ECB, that it seems to be taking *de facto* is to stress that the medium run character of its objective is entirely consistent with an headline inflation rate, say, up to three per cent, and to rationalise when it will allow such a gap to develop. This will increase the legibility of European monetary policy, and will give it both more credibility and more room for action.