

J' accuse! Monetary Mischief in the Eurozone

By **Fredrick Erixon**

Pure inflation targeting – without rules for the instruments to achieve stable prices – has proven to be a source of instability in the Eurozone. If ECB policy instruments respond to aggregate performances in Europe, it will be a policy that will fit the German economy well but not necessarily the other and smaller economies.

The history of central banking is a story of many failures. Many central banks, like the Federal Reserve in the United States, were born in the ashes of financial crises. But few central banks, if any, have managed to avoid becoming sources of macroeconomic instability. The fingerprints of central banks can be found on most financial crises the world has experienced in the past century.

In that vein: how should the actions of the European Central Bank (ECB) – before and during the crisis – be judged? And what does its recent history tell us about the future of European monetary policy – and its consequences for money and economic growth in China?

Two grand mistakes in the ECB's short history deserve particular attention.

From loose to tight monetary policy

First, the ECB failed to fully understand the forces of disinflation in the 1990s and 2000s – and what those forces implied for monetary policy. On paper, the ECB has been an inflation hawk since its inception. Yet a fear of deflation got hold of central bankers in the late 1990s, and the ECB thought the appropriate response to global disinflation was to breathe inflation into the Eurozone economy. The failure to fully understand how globalization changed the nature of prices and inflation in Europe led to a monetary policy that was far too loose or expansionary for a good number of years. ECB policy became a source of monetary disorder.

The ECB failed to act when mounting evidence suggested that loose monetary policy had gone too far. It had fuelled unsustainable current account imbalances in the Eurozone and an untenable build-up of debt in several countries. A housing bubble grew in some Euro-



zone countries under the ECB's watch. Europe's central bankers were almost asleep at the wheel. Like their colleagues in the United Kingdom and the United States, they continued to run an extremely expansionary monetary policy in 2004-2007.

How could monetary policy be extremely expansionary? After all, inflation was kept in the radar of 2 percent and the ECB was progressively raising its interest rates between 2005 and 2007. Yet the ECB, like many other central banks, neglected a simple, but not simplistic, insight: monetary policy is about money. This may sound too banal to merit attention, but money is not an important aggregate in several prevailing economic models of monetary policy.

At its creation, the ECB created a dual target-system, with one pillar targeting inflation and another pillar targeting growth in broad money (so called M3, for the monetary aficionado). Controlling money supply is imperative for price and macroeconomic stability. Nobel laureate Milton Friedman once said that "inflation is always and everywhere a monetary phenomenon". True. He could have added that financial bubbles often share the same origin. Banks and financial intermediaries that lend (and create) money are hardly innocent bystanders, but unsustainably rapid credit growth, mirroring a giant misallocation of resources, requires complicit central banks.

While the ECB successfully managed its inflation target in its first ten years, it never managed to control growth in broad money, let alone to the target of 4.5 per-

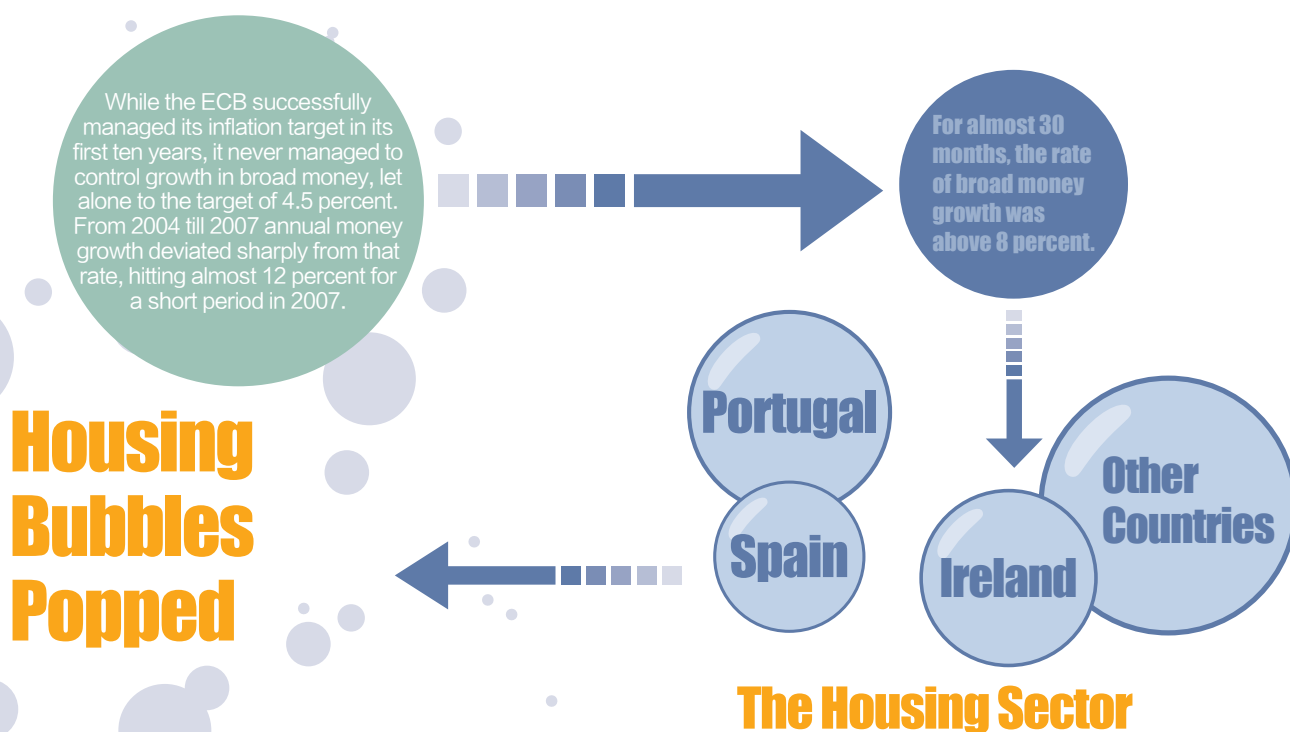
cent. From 2004 till 2007 annual money growth deviated sharply from that rate, hitting almost 12 percent for a short period in 2007. For almost 30 months, the rate of broad money growth was above 8 percent. A good part of this money expansion ended up in the housing sector in Ireland, Spain, Portugal and other countries that have suffered from popped housing bubbles in the past five years.

ECB during the crisis

Second, monetary policy has been overly tight in the Eurozone in the past years and in some countries it has reinforced downward cyclical trends in the real economy. But with interest rates at the zero lower bound, you may ask, what more could the ECB have done?

To start with, it should have stopped tightening monetary policy when the economic temperature cooled. In the second half of 2007 it was clear that Western financial markets were in for a turbulent period and that the overall economic climate was souring. The fall in US house prices had already gained speed and started to disable money and interbank markets. Yet the ECB kept monetary policy tight and made the dreadful mistake of raising the rate in the summer of 2008 when the recession was already upon Europe and its own credit bubble was bursting. The ECB ignored the evidence and was determined to fight climbing inflation that Europe then was importing, primarily through its oil bill.

Even if interest rates have been very low for the most



part of the crisis, monetary policy has still been tight. This is not what some standard economic models of monetary policy teach, but consider that interest rates in Germany during the Weimar hyperinflation years were progressively increased and that interest rates in the United States during the Great Depression were progressively lowered. The interest rate could neither stop hyperinflation nor put a break on deflation in these two examples. The problems rather had their origins in money supply and the velocity of money.

One of the worries now has been the general slow growth, and regional collapse, in broad money. The general trend is that growth in broad money has undershot – by far – the reference value of 4.5 percent. In the past four years, growth in broad money has rather averaged at 2.5 percent. Money expansion has simply not been big enough. The ECB has been too shy and too wet. An excessive belief in sterilizing its debt-market operations has drawn money out of the private economy. It has maintained a narrow focus on financing banks rather than expanding broad money with its operations. Unlike the US Fed and the Bank of England, it has not engaged in outright quantitative easing, not even conservative ones. Consequently, despite the talk of massive unorthodox monetary policy, the ECB's operations have had little effect on expanding aggregate demand and not slowed the process of passive monetary contraction that many Eurozone countries have been going through.

The Scylla of discipline and Charybdis of flexibility

Central banking is about finding the right balance between monetary discipline and flexibility. While the ECB has prided itself for having maintained price stability, it seems safe to say that it has failed in finding the balance between discipline and flexibility. The ECB has rather been a source of monetary disorder, causing unnecessary damage in the real economy. Ultimately, the ECB was complicit in creating huge internal current account imbalances, a giant misallocation of resources, and a housing bubble in the years up to 2007. It failed to discipline the economy. But then it switched into running an overly tight policy and failed to take necessary action.

When it did take action, it was often too late. Monetary policy in the Eurozone has been pro-cyclical: it fuelled a boom and subsequently reinforced a bust.

Maintaining price stability in the medium term is critical for a sound economy. The alternative to the current rule should not be a return to the stop-go and discretionary policy many European economies had before. Nor should a central bank target real economic variables, like unemployment or real growth, because real outcomes are not in the hands of a central bank. But the inflation-targeting policy of the ECB has created macroeconomic instability and should be changed. It is right at the heart of the failures of discipline and flexibility in the ECB's short history. A pure inflation-targeting policy does not work well in an age of supply shocks imported from abroad. And when it is based on headline inflation – incorporating inflation that is not created within the ECB's jurisdiction – it runs the risk of fighting imaginary problems. It becomes the Don Quixote of monetary policies.

Worse still, pure inflation targeting – without rules for the instruments to achieve stable prices – has proven to be a source of instability in the Eurozone. If ECB policy instruments respond to aggregate performances in Europe, it will be a policy that will fit the German economy well but necessarily not the other and smaller economies. While the economic temperature is low in some countries it may be hot in others.

These differences have been amplified by the Eurozone crisis. Monetary policy in the past years has had fragmented effects – or, to use the words of ECB President Mario Draghi, “the singleness of our monetary policy” has been contested. The fractured financial system, and an instinct against unorthodox policies by the ECB, has undermined the expansionary effects of low interest rates. There are evidence suggesting that the ECB program of Outright Monetary Transactions (OMT) – a commitment, launched in September 2012 but still not used, to purchase government bonds in order to drive down bond yields for crisis countries – has improved the financial system and the transmission mechanism.

Highly controversial, especially in Germany, the key argument for the OMT program is arguably that it takes away an existential threat that has been hanging around

the euro's neck in the past two years. Once default risks in the Eurozone became apparent financial markets have asked themselves: if the entire euro project is about to break apart, will someone step in to stop that from happening? After two years, the ECB has now given two thirds of the answer to that existential question.

The OMT is neither a vote for higher inflation nor a rejection of inflation targeting. Yet it illustrates the weakness of the past monetary policy rule: the ECB has stepped into a new universe because its past rule did not give answers to the pressing monetary questions. The OMT, like the Fed's quantitative easing, has not filled that gap; it does not build on an alternative rule or new rules for policy instruments. The new policy is purely discretionary and markets have to second-guess how it will operate. While the Fed is close to getting new rules for its policy instruments, markets are left with no alternative than having to read between the lines of Mario Draghi's statements to get an idea how policy instruments will operate. The inflation target remains unchanged, but it is obvious to any watcher of European monetary policy – for markets as well as discerning citizens – that the ECB now is far away from its home. Its authority, and the effectiveness of monetary policy, will gradually erode unless it offers a rules-based alternative to its current discretionary monetary policy and, critically important, how policy instruments behave in different circumstances.

The question now is: will the ECB change? Very unlikely, is the answer.

Consequences of Europe's monetary failure for China

Some fear that the Economic Monetary Union will turn into a Latin Monetary Union, determined mainly by the monetary-financing needs of Southern European countries and banks rather than the hard-currency instincts of Northern Europe. This may be happen, but is arguably a stretch too far. What is more likely is that the euro becomes a volatile currency. Absent changes in the monetary regime, and efforts to restore macroeconomic stability in monetary policy, the Eurozone is likely to become an unstable financial harbor.

Such a development poses controversial questions for China. The EU is China's biggest trading partner and a good part of China's production is effectively denominated in Euros (production destined for Europe). Already today China has difficulties finding a good rapport with the US dollar and the euro that ensures stable monetary conditions for China's own economy and assets. China's choice of monetary regime and financial infrastructure has fitted a developing country aspiring to grow its economy under stable monetary conditions borrowed from abroad. In time, it has been said, it will gradually move to a new monetary and financial regime that mirrored its own economy, and the currency will be internationalized in a step-by-step manner ensuring financial stability. All this has happened in the past years. But China is still far away from a monetary and financial architecture that reflects its own economic size and role in the world economy. Now they may have to deal with an international currency that is increasingly unsuitable as a means of transaction and store of value for China.

A weak euro contradicts the interest of those who favor a moderate reform process for China's monetary regime. The costs for China of maintaining status quo would be too big in the event the Chinese economy cannot use the euro to same extent as before. China would have to speed up financial reforms. And the more China internationalizes its currency, and opens itself for financial transactions, the more demand there will be for the Chinese currency, and the more money will flow into China. China has managed to balance appreciation risks rather well in the past years, but its strategies have been conditioned on a global reserve currency (the US dollar) that has moved in a predictable fashion to the euro. If the euro no longer plays that role, China will have to move to other strategies.

China, like other countries before it, may be about to learn that a fractured and disordered Europe is not in its interest.



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