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Refocusing the ECB on Output Stabilization and Growth through Inflation Targeting?

by

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ABSTRACT

Challenging the conventional wisdom that structural problems are to blame for the euro area's protracted domestic demand stagnation, this paper sets out to shed some fresh light on the role of the ECB in the ongoing EMU crisis. Contrary to the widely held interpretation of the ECB as an inflation targeter—and a rather soft one, too—it is argued that the key characteristic of the ECB is the pronounced *asymmetry* in its policy approach and mindset. Curiously, this asymmetry has not only given rise to an antigrowth bias, but to *upward* price pressures and distortions as well. There is a link between stagnation and inflation persistence that owes to the ECB's failure to internalize the euro area's fiscal regime. This raises the question as to whether inflation targeting would have led to better results, or could do so in future.

Key words: Monetary policy, European Central Bank, inflation targeting, inflation persistence, tax-push inflation, antigrowth bias.

JEL classifications: E31, E42, E58, E61

PRAISE THE ECB: EXCELLENT PERFORMANCE, NO NEED FOR REFORM, REALLY?

In the ECB's self-appraisal, the world's most independent central bank's performance has been an outstanding success story right from the start. This self-complimentary view is not only questionable in the light of persistent economic stagnation since 2001, responsibility for which the bank notoriously blames on everyone else. Given that the ECB has also missed—what according to its first President Wim Duisenberg represents—its "sole" goal, namely, price stability (as defined by the ECB as HICP inflation of below 2 percent) for five years in a row, the bank's embellished self-portrait is truly puzzling.

In general, academic ECB-watchers have reached a more mixed verdict on the bank's performance. On the one hand, there is a broad consensus that the ECB's policy strategy and communication, despite the strategy reform of June 2003, leaves much to be desired. On the other hand, the majority view seems to hold that the ECB's interest rate polices have not been too far off the mark. Commenting on the Duisenberg record, Wyplosz (2003) exemplified this ambivalent assessment well when he argued that the ECB's "faulty strategy" gives the "impression that the Eurosystem remains a prisoner of old and simplistic doctrines," while the bank—miraculously, it would seem—still achieved a "nearly impeccable record."

Hence there is currently no perceived need for any fundamental ECB reform. Instead, all efforts concentrate on liberalizing the euro zone's allegedly too "rigid" labor markets—the supposed culprit of all troubles. In Brussels on March 2, 2005, Commissioner Almunia reconfirmed once again what seems to be the consensus view among the euro zone's key policy makers, namely, that with interest rates at historically low levels and budget deficits around 3 percent macroeconomic policy stance seems very expansionary already, so that the root cause of the ongoing stagnation must lie elsewhere—and reform efforts must thus focus on the underlying problem, held to be entirely structural in nature.[1]

[1] It is worthwhile to recall here Knut Wicksell's (1898) path-breaking insight that the absolute level of interest rates is not an indicator of the monetary stance. Since the ECB adopted a "tightening bias" in September 2004, the bank appears keen to raise interest rates towards what it sees as a more neutral level. In truth, however, the ECB's belated and extraordinarily sluggish cuts since 2001 have merely allowed the market rate of interest to trail a declining neutral rate towards ever lower levels. Keynes's (1936) analysis suggests that the ECB's notorious reference to "historically low" interest rates itself may be an important reason for high liquidity preference and for monetary growth overshooting the M3 reference value. Of course "high" budget deficits, too, may not reflect a loose fiscal stance, but stagnation in a destabilized economy.

This paper argues that the euro zone's current single-minded policy and reform orientation may turn out to be a fatal mistake. In particular, current debates are characterized by a thorough misapprehension of the ECB's primary role in the current crisis. Far from achieving a nearly impeccable record, the ECB has failed dismally on its vital responsibility of managing domestic demand growth.

What follows is an assessment of ECB performance from within an "inflation targeting framework;" representing today's conventional wisdom on how sound monetary policy should best be run. Our objective is to investigate whether imposing inflation targeting upon the ECB might be the right way forward in refocusing the ECB on output stabilization and growth; the bank's supposed secondary mandate according to the Maastricht Treaty. A key issue is the inflation "stickiness" observed in recent years and widely interpreted as evidence of structural rigidities. The alternative hypothesis put forward here stresses the counterproductive part played by the ECB itself, which not only strangled growth, but also pushed inflation *up* at the same time. Arguably, there could hardly be any clearer evidence for the first-rate macroeconomic policy failure that has unfolded in recent years, representing the true cause of the ongoing EMU crisis.

IS THE ECB AN INFLATION TARGETER IN DISGUISE?

Suggesting that the ECB should follow inflation targeting may well seem puzzling at first, given that in the view of many observers inflation targeting is exactly what the ECB has been doing all along; even though in a rather disguised way. For instance, London's Centre for Economic Policy Research, perhaps the most prominent ECB watcher, attested that "… targeting inflation is very close to what the ECB has been doing—regardless of the rhetoric—and to what it should be doing" (CEPR 2001, p. 2).

The tenor here is that—for some reason—the ECB tries to obfuscate its inflation targeting approach. Yet, while the resulting lack of transparency and the bank's confusing *words* are surely regrettable, the argument goes, its *deeds* still bear a clear inflation targeting signature. A related issue concerns the ECB's repeated failure to meet its price stability mandate since 2000, which is interpreted from this angle as evidence of the bank's *flexible* inflation targeting approach and implicit concern for economic growth: "for half its life to date the ECB has

allowed inflation to exceed 2 percent, the upper bound of the target range. Any simple charge of a deflationary bias in monetary policy is not justified" (CEPR 2002, p. xiv).[2]

Perhaps watching the ECB's conduct through Anglo-Saxon eyes and inflation targeting lenses may be bound to lead to such an interpretation. And I also grant that in the light of inflation running above 2 percent since 2000 a "simple" charge of a *deflationary* bias may not be credible. In fact, the charge raised against the ECB in the following is rather more subtle, featuring complex interdependencies between monetary and fiscal policies as they have played out in the spirit of the Maastricht treaty. The point is that an inflation targeting central bank has to properly internalize the fiscal policy regime, in this case: the "Stability and Growth Pact," just as any central bank is well advised to be acquainted with the economic environment, financial market climate, and wider policy regime within which it is operating.

If anything, interpreting the ECB as an inflation targeter may serve to discredit inflation targeting; supposedly an "employment-friendly" approach to monetary policy. This interpretation thoroughly misreads the ECB's attitude and intentions as well as the bank's unimpressive achievements. On this point one should rather trust the ECB's words. The ECB's key leaders, Otmar Issing, Wim Duisenberg, and Jean-Claude Trichet, have not only consistently denied that the ECB follows an inflation targeting strategy. They have made it quite clear that they reject this approach and consider the ECB's own "two-pillar framework" as superior.

For instance, more than mere rhetoric (or vanity) was involved, when the ECB's chief economist (and mastermind behind the bank's strategy and interest rate decisions), Otmar Issing, at the press seminar on the evaluation of the ECB's monetary policy strategy in May 2003, asserted that "we have confirmed our two-pillar approach. This is totally different from what is normally seen as inflation targeting."[3] Similarly, describing inflation targeting as an oversimplification, Mr. Trichet stressed that "we do not rely on an equation or a system of equations. We do not rely on a forecast, as is the case in inflation targeting or, perhaps, in the previous concept of inflation targeting. When we take a decision, we look at everything, as we

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[2] More recently the CEPR (2004) even more explicitly interprets persistent inflation above 2 percent as reflecting the ECB's excessive softness.

[3] Referring to Otmar Issing's "dominating influence in the ECB's executive Board and Governing Council," Wyplosz (2003: 37) appropriately observed that: "This influence has been made possible by Issing's exclusive control of the ECB staff who prepare policy decisions. His presentations at the start of the Governing Council policy meetings are understood as giving him agenda setting power. The Duisenberg years are also the Issing years." (Cf. Handelsblatt 28/29 November 2001).

do every month" (Monetary Dialogue, 16 February 2004: 6). While this comment implies that the ECB pursues its allegedly forward-looking, medium-term oriented approach to price stability without a forecast, which is surprising enough, the essential message and underlying belief conveyed by the ECB here and elsewhere is that of an outright dismissal of any fine tuning. The ECB firmly believes that monetary policy is not about managing the economy. But what else, then, is the ECB trying to do?

BAD OLD BUNDESBANK TRADITIONS IN A NEW GUISE—AND WITH EVEN WORSE RESULTS

To understand the ECB it is of vital importance to acknowledge that this bank is firmly attached to Bundesbank traditions. It is well known that Germany's acclaimed guardian of monetary stability and the famous strength of the deutschmark provided the blueprint for the structure of monetary policy in EMU. In fact, the ECB's independence even surpasses the Bundesbank's, secured at the constitutional level rather than just by a simple law. The same holds for the monetary policy traditions that became established at the ECB, primarily through Otmar Issing (formerly the chief economist at the Bundesbank) and Wim Duisenberg (Germany's first choice at the time given that the Bundesbank President, Hans Tietmeyer, himself was not an option).

These traditions include the ECB's overall autocratic style and peculiar public relations, featuring a passion for continuous public criticisms of issues relating to any other policy area—paired with the standard dismissal of any criticism of its own policies and practices as an attack on its all-important independence. And the same traditions lie behind the ECB's attitude towards, and understanding of, monetary policy, which is well reflected in the ECB's "two-pillar framework." To begin with, the ECB's "monetary pillar" is not just a polite tribute to Bundesbank wisdom. Contrary to what many observers seem to believe, the bank's pseudo-monetarism is also of true practical importance. For the ECB uses its "reference value" in the same highly discretionary manner as the Bundesbank. In fact, the whole point about the "*M* mantra" is about maximizing discretion, since, at least at some junctures, emphasising *M* may provide a convenient excuse. For instance, at the current juncture, the ECB emphasizes above reference-value M3 growth to delay further interest rate cuts. By contrast, the ECB decided to play down the sharp slowdown in M3 growth starting in the spring of 2000 and continued on tightening policy until October 2000 although domestic demand was already slowing sharply.

Ironically, of course, Buba/ECB practice is actually turning monetarist wisdom on its head: the thrust of Milton Friedman's monetarist agenda was to take away discretion from independent central bank politicians. Issing (1997: 72) asserted that the Bundesbank's "pragmatic monetarism" constituted a "successful synthesis of a theoretical basis and practical implementation." Even Germany's pseudo-monetarist Bundesbank disciples admit though that the Bundesbank's "monetary targeting" was really a hiding shield for protection against political interference.

As regards the price stability pillar, which many confuse as inflation targeting in disguise, the key issue is the pronounced bias in the ECB's inflation risk assessments and application of its interest rate instrument. In fact, the key to "stability-orientation" *à la* Bundesbank is the *asymmetry* in approach and mindset.[4] Metaphorically speaking, the ECB acts like a driver who is quick at slamming the brakes, but notoriously abstains from using the accelerator. Obviously, this is not a recipe for smooth driving, which begs the question why it seems to have worked for the Bundesbank, and quite well for so long.

Essentially, it worked for the Bundesbank because, and as long as, everyone else behaved differently. In particular, the Bundesbank's peculiar driving style worked fine when nominal exchange rates were stable, Germany's trading partners' inflation generally higher than its own, and as the accelerator was applied skilfully "elsewhere in the world economy." Things worked best under Bretton Woods. The situation was then almost replicated under the "hard EMS" of the 1980s; with the rest of Europe bearing the economic and fiscal brunt of Buba wisdom. As an early warning of things to come, the Maastricht convergence process of disinflation cum coordinated fiscal consolidation saw Europe moving towards the brink of stagnation by the mid 1990s—when the U.S.'s "new era" growth and soaring dollar provided a last-minute external lifeline that allowed EMU to go ahead.

To Germany's surprise, exporting the Buba "success story" undermined its working at home. Having failed to grasp why the model worked in the past, Germany's "supply-side-only" economists are in hopeless disarray about why it does not work anymore today. Stubbornly sticking to the old ways, on their advice, the country is today flirting with "stability-oriented" deflation.

[4] Accordingly, attempts to recast the Bundesbank as an inflation targeter are similarly beside the point as in the ECB's case (Bernanke and Mihov 1997, Gerlach and Svensson 2003). It just seems to be too tempting to classify a central bank with a low inflation record as an inflation targeter. Yet there is a much simpler way to low inflation than inflation targeting: asymmetry.

At the same time, Euroland, much to its own surprise too, is finding out that emulating the Buba "success story" of asymmetric "management" of domestic demand, while fiscal policy is no longer allowed to take up the slack, actually means the opposite of the promised land of stability and growth.

Failing to come to grips with this surprising outcome, Europe's leadership is imaginative at one thing only: inventing structural excuses for protracted domestic demand stagnation and blaming the malaise on the rest of the world. If one dared to take a look at an economics textbook instead, the spotlight would be on macroeconomic policies as the primary candidate of domestic demand stagnation.[5]

Somehow demand management was simply written out of the Maastricht play though—as stabilization policies were replaced by "stability policy." More than mere words are at issue here. The attitude is that stabilization polices proper are neither necessary nor desirable. Maintaining price stability through "stability policy" is the best one can do. Unfortunately, unless one can rely on others to do the more difficult part of the job, namely stabilizing the economy, simply maintaining price stability is not nearly good enough.

It is thus something of an irony that Bundesbank wisdom provided the blueprint for the Maastricht EMU, as the Bundesbank was actually lacking the skills and experience in properly *managing* the economy. In fact, the whole Buba/ECB attitude is based on the illusion that one might get away without proper management—as was indeed true for Germany, but under peculiar conditions prevailing in the past. Watching the spreading of the "German disease" with amazement, the rest of the world sees a rudderless economic giant drifting along hoping for strong enough export currents to pull it along. The rest of the world cannot be pleased about this sight, especially in view of soaring global imbalances.

The ECB too appears confused about what is happening. Back in 2001 the world's most independent central bank often excused its conspicuous refusal to cut interest rates by arguing that occurrences in the U.S. were of little importance, since "the euro area is a large economy in which economic developments are determined mainly by domestic factors. Overall, the

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[5] In its recent "Integrated Guidelines for Growth and Jobs," the European Commission (2005) acknowledges that "the economic recovery has to a large extent been dependent upon the resurgence of global growth and the rapid increase in world trade" (p. 3), but goes on to "call for a focus on reforms to raise the Union's growth potential, while maintaining sound macroeconomic policies that underpin the success of reform efforts" (p. 6). In the Commission's view, "sound macroeconomic policies are essential to support a well-balanced economic expansion and the full realisation of current growth potential" (p. 13). So perhaps one should take more seriously the possibility that ongoing failures in all these respects might reflect unsound macroeconomic policies.

fundamentals in the euro area remain broadly favorable (ECB, February Monthly Bulletin, 2001, p. 5). After years of domestic demand stagnation Mr. Trichet appeared to look for help elsewhere when he referred to the following "normal sequence of events" in an interview: "Growth starts with exports, then passes on to investment and then to consumption. That is the normal sequence for Europe in this phase of the cycle" (*Financial Times*, 22 April 2004).

It *was* true for Germany: during much of its post-war history price stability, in a way, *caused* growth. It is this experience that has imprinted itself on Mr. Issing's mind. Reflecting this misunderstanding and fateful illusions about the past, the ECB mantra was framed that price stability *always and everywhere*, it seems, causes growth, as was announced at the euro's launch: "Maintaining price stability *in itself* contributes to the achievement of output and employment goals" (ECB, Monthly Bulletin January 1999, p. 40; emphasis added). Similarly, recalling no doubt his Dutch experiences,[6] Mr. Duisenberg explained that "… we always maintain—and we still do—that the best contribution that monetary policy can give to fulfil that second task is to maintain price stability" (Duisenberg, Monetary Dialogue, March 2001).

No wonder Anglo-Saxon ECB watchers trained in mainstream economic theory have a hard time making sense of the ECB's price stability mantra: "In this remarkable interpretation of the Treaty, the ECB fulfils its double mandate by reducing it to a single responsibility, a focus solely on price stability. All other objectives are then realized automatically. In this view the ECB cannot be held responsible for what happens in the real economy. We consider that this view is not just narrow, but mistaken" (CEPR 2002, p. 12).

Indeed, a mistaken view when seen from a mainstream perspective. Yet what is puzzling is that the same critical observers then try to portray the ECB as an inflation targeter in disguise, and one with a "nearly impeccable record" too. Time to face reality. The ECB is neither an inflation targeter, nor does it have a nearly impeccable record to show for its peculiar religion. Rather, the ECB's performance has featured a series of policy blunders that have left the economic giant euro zone stranded in stagnation and at the mercy of the rest of the world.

[6] Perhaps most memorable of Mr. Duisenberg's remarks is that: "In the 16 years that I was the Governor of the central bank of the Netherlands, there were two years in which we had deflation of 0.5%. I publicly declared then that I lived in a central banker's paradise; as long as the others have more inflation, it is not a problem" (W. Duisenberg, ECB Press Conference, 8 May 2003).

REVISITING THE ECB'S KEY POLICY BLUNDERS

It seems fair to acknowledge here that the Bundesbank's legacies confronting the ECB at the start of 1999 would have presented any central bankers with a formidable challenge. After the monetary overkill in response to German unification, followed by very sluggish interest rate cuts, which had left Germany in the doldrums by the mid-nineties, the Bundesbank for no good reason then proved all too keen to hike interest rates in October 1997. By that time Germany was barely emerging from stagnation—thanks to U.S.-sponsored export growth. When only a little later Germany was then hit by the Asian and Russian crises, the Bundesbank exemplified the peculiar tradition referred to above: it simply refused to cut interest rates; much in contrast to central banks like the U.S. Fed and the Bank of England. And on top of its failure to ease, the Bundesbank's communications even invited DM appreciation—in time for the euro to start from what was soon seen as too high a level, and with Germany dubbed the "sick man of the euro."

The ECB was not up to this challenge. The bank's performance since the start is best described as a series of policy blunders that pushed inflation up and GDP growth down.[7] The first blunder consisted of a clash between the ECB and financial markets, which resulted in a marked depreciation of the euro. The second featured the bank's refusal to cut interest rates and boost growth, which resulted in a productivity slump that pushed up unit labor costs. And the third blunder witnessed the ECB's continued refusal to cut interest rates so as to stimulate a recovery, which saw fiscal policy, constrained by the Stability and Growth Pact, shifting into reverse gear, prompting increases in indirect taxes and administered prices; apart from further destabilizing the euro zone. This series of policy blunders pushed inflation up and left Euroland in a very fragile shape when the dollar's depreciation prevented the world's second largest economy from free-riding on external demand yet again.

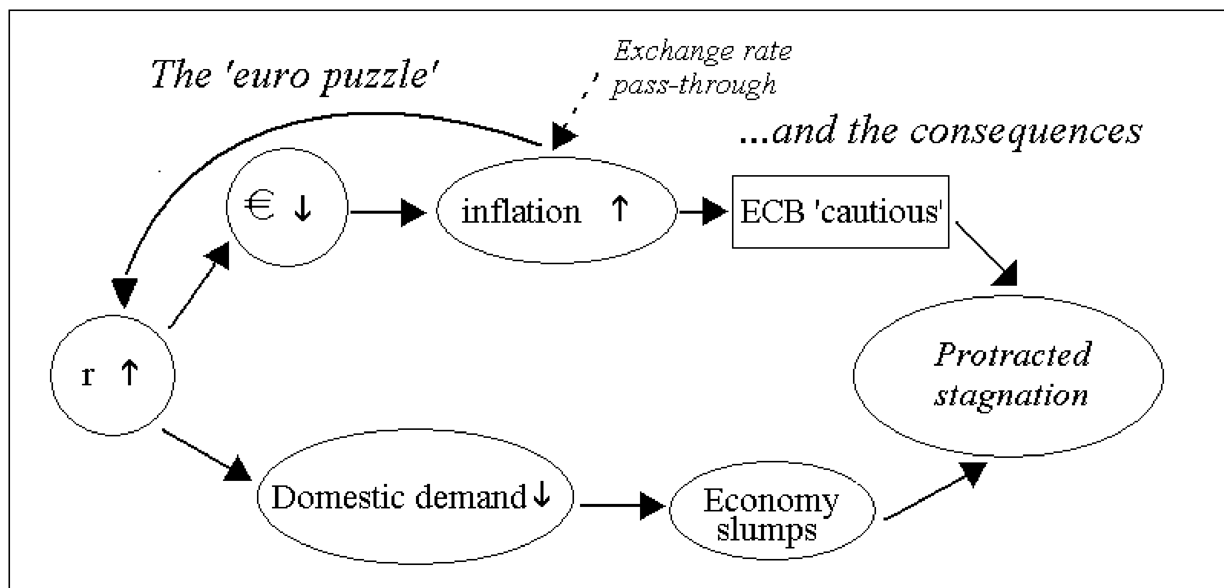
As to the euro's plunge, the ECB's role was one of acting as a two-fold propagation mechanism as the bank's words and deeds provoked market opposition. I can be brief on the bank's confusing words. Its first president was legendary for his gaffes. No less important was that Mr. Issing's monotone "price stability above all else" anthem was way out of tune with the climate in financial markets at the time. The climate was one of growth enthusiasm, with inflation risks not seen as any serious threat. So when the ECB backed up its confusing words

[7] For a more detailed analysis, including a critical assessment of standard Taylor-rule exercises, see Bibow 2004b.

with all too clear actions, nearly doubling interest rates within less than a year, the markets simply took fright, preferring policymakers that were perceived as more growth friendly.

Interestingly, the risks and foreseeable consequences of *euro-weakening interest rate hikes*[8] were clearly spelled out by the very authority that—later on—forgot all about it and today blames the whole malaise on structural problems. In its 2000 review of the EU economy, the European Commission vigilantly observed: "To the extent that the depreciation in the euro is due to cyclical divergence between the euro area and the United States, a rise in interest rates in an attempt to support the currency could even backfire if it was perceived as stifling the euro-area recovery. The risk of creating an even more unbalanced growth pattern with weak domestic demand and higher export growth would be serious" (EC 2000: 71).

Box 1. Crashing the euro ... setting the scene for caution and stagnation



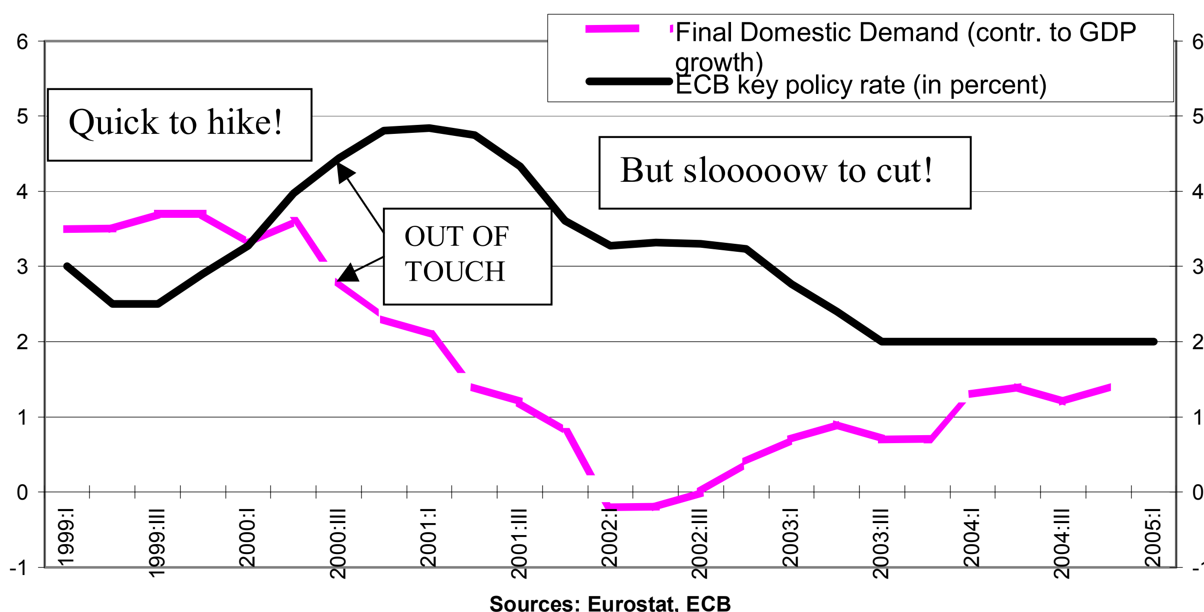
Similarly, the BIS's Annual Report (2001: 89) observed that: "On balance, market participants may have considered the Eurosystem's monetary policy stance to be excessively tight inasmuch as it may have negatively influenced the outlook for euro area growth." Meanwhile the OECD (2001: 106) referred to a "countervailing impact of interest rates on exchange rates via growth expectations" and an "unpleasant monetary policy dilemma" (118).

[8] See Bibow (2001, 2002) on the time-inconsistency hypothesis of the euro's plunge.

Box 1 summarizes blunder no. 1. Notice that the ECB managed to push inflation up while choking domestic demand through its aggressive hikes.[9]

Figure 1. Doing it the ECB way

Asymmetric and out of touch with markets and economy



At least to some observers inflation *above* 2 percent seemed to justify the bank's subsequent refusal to cut rates as fast as it had hiked them, nicely illustrating the Bundesbank tradition of "quick to hike, slow to cut" (see figure 1).[10] The trouble is that the ECB's "wait and see" attitude (when it comes to easing) then provoked a severe productivity slowdown and a corresponding rise in unit-labor costs. Facing falling sales business was under pressure to

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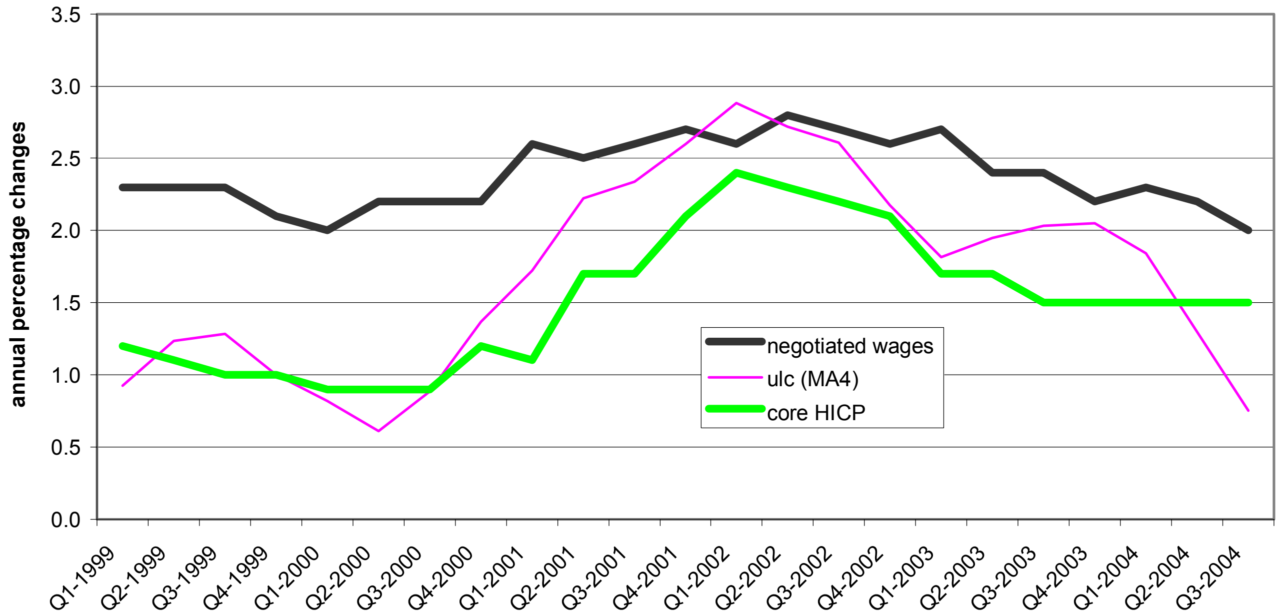
[9] I use interest rates here as shorthand for the whole transmission mechanism of monetary policy rather than the interest-rate channel alone; the effectiveness of which some researchers seem to doubt. The ECB's (2002) research on the transmission mechanism has revealed a strong impact of interest rates on domestic demand, primarily investment.

[10] The ECB's commentaries show that the bank was not just out of touch with financial markets, but also with developments in the economy. The January 2001 Bulletin's editorial discussed the U.S. Fed's first 50 basis points cut of 3 January 2001 with reference to increasing uncertainty surrounding the economic growth performance in the U.S., but in February the ECB declared: "While this deceleration will have some dampening effects on euro area net exports, the euro area is a large economy in which economic developments are determined mainly by domestic factors. Overall, the fundamentals in the euro area remain broadly favourable" (ECB Monthly Bulletin February 2001:, p5). Confirming this assessment in the March 2001 Bulletin, the ECB referred to an "element of uncertainty" as regards the world economy but argued that "at this juncture, there are no signs that the slowdown in the U.S. economy is having significant and lasting spillover effects on the euro area." As the euro's plunge extended the

keeping margins up. While the euro's plunge pushed up headline inflation through magnifying the price effects of high oil prices and rising import prices more generally, blunder no. 2 saw to it that core inflation followed suit in 2001 (see figure 2).

Figure 2. Business of keeping up margins
Wait and see as productivity slump pushes up core inflation



Sources: Eurostat, ECB
Notes: Index of negotiated wages refers to collectively agreed wage rises. Unit labor costs are shown as a four-quarter moving average. Core HICP measure excludes: energy, food, alcohol, tobacco, and administered prices.

It is noteworthy here that wage inflation has remained low and stable throughout, so low really as to leave little scope for further falls. While certain interests may be fond of the idea of independent central bankers as a disciplining device for punishing labor in case of misbehavior, it must be stressed here that the ECB was keen enough to apply *pre-emptive* punishment. Clearly, with this kind of attitude any potential benefits of wage moderation are wasted. The hoped-for employment gains simply do not materialize. Even worse, employees—who are also consumers!—are then punished twice, namely by moderate wage increases as well as job losses (or the fear thereof).

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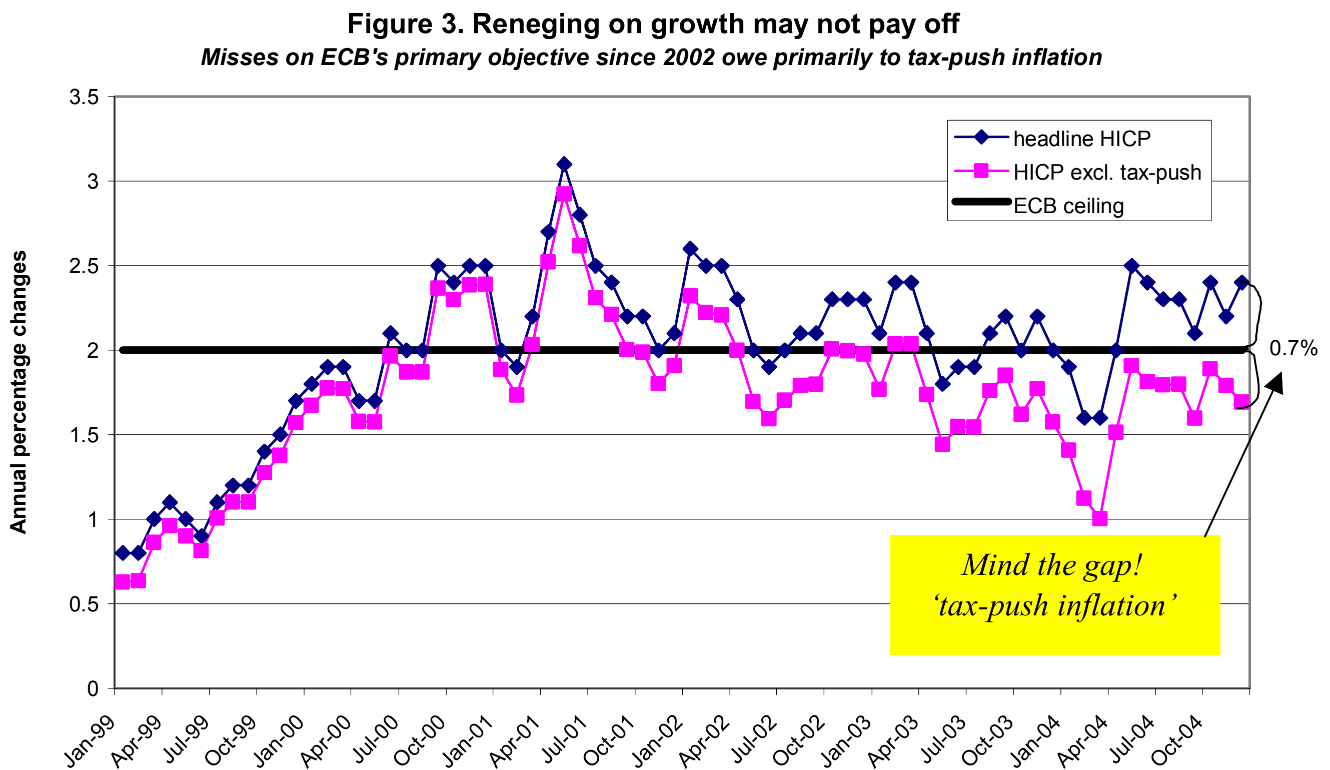
export boom, domestic demand tanked; seemingly unnoticed by those who had enacted stability-oriented monetary tightening in previous quarters.

No less a worry is that protracted stagnation and rising unemployment are bound to cause budgetary troubles. And this is where the ECB's blunder no. 3 comes in. A sound monetary policymaker internalizes fiscal policy. Given Euroland's fiscal regime, ill-named the Stability and Growth Pact, it was clear from the start that the ECB had to shoulder the bulk of the stabilization burden—or else face the consequences of a destabilized economy. The IMF's head at the time, Horst Koehler, even reminded the ECB of this textbook wisdom, when he explained that monetary policy would be "the first line of defence." Mr. Duisenberg responded that he had never heard of that ("Duisenberg defends holding rates steady"; *Wall Street Journal Europe*, 9 October 2002).

Figure 3. Reneging on growth may not pay off

Misses on ECB's primary objective since 2002 owe primarily to tax-push inflation



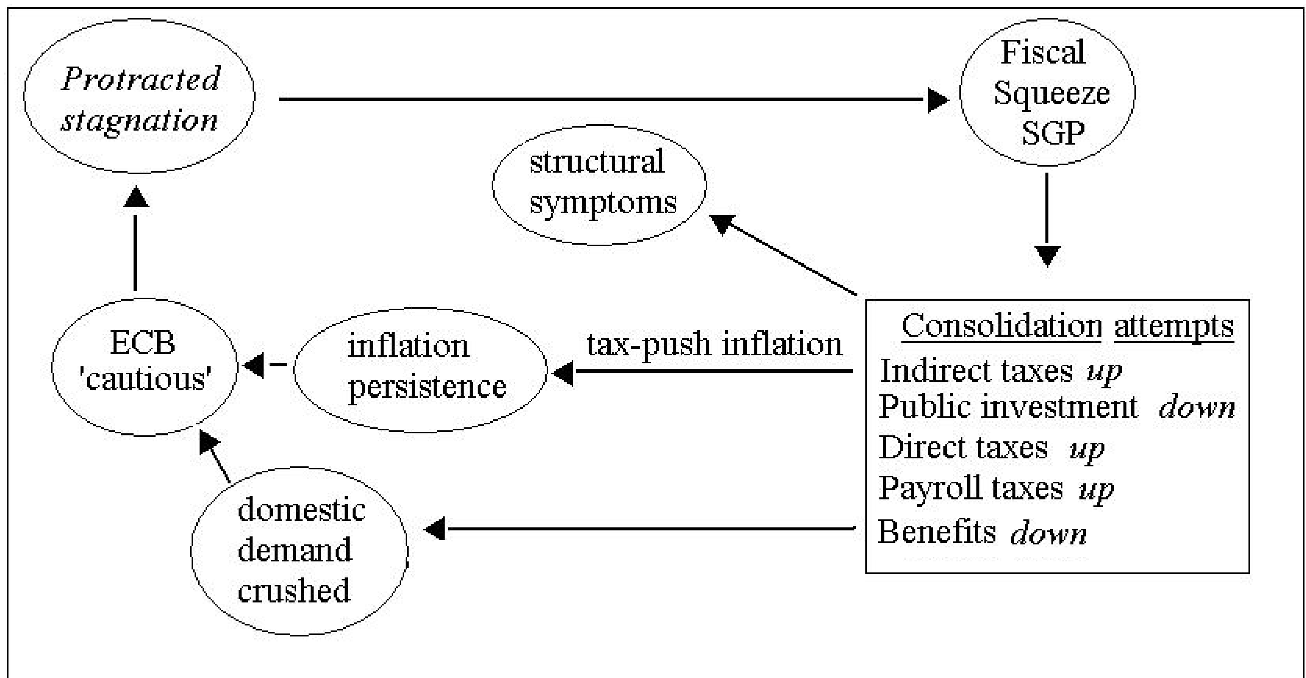
Source. ECB, Eurostat

Note. Taxes on tobacco products and measure of administered prices within the services sector (aggregate HICP weight of 5.6%) included here most likely underestimate true tax-push inflation.

Ignorance about economic theory may backfire in a nasty way. Most likely, had Mr. Duisenberg taken aboard Mr. Koehler's advice, he would not be remembered today as the ECB president who understood how to confuse financial markets but failed on his "sole" price stability objective in four out of five years of his presidency. For it was due to the resulting

protracted stagnation that inflation has stayed stubbornly above 2 percent ever since. In this regard, Figure 3 reveals a conspicuous gap that has opened up since 2001 between headline inflation and what may be seen as *market-determined* (as opposed to government-determined) inflation. Rises in indirect taxes and administered prices, reflecting finance ministers' desperate but vain attempts at keeping budget deficits below 3 percent, led to an upward distortion in headline inflation that reached 0.7 percentage points by the end of 2004. *Without "tax-push inflation" the ECB would not have failed on its price stability mandate in the last four years.*

Box 2. Monetary fiscal policy interaction a la Maastricht - stuck in a "stability oriented" vicious cycle



Box no. 2 summarizes the counterproductive interaction between fiscal and monetary policies of recent years, featuring a stability-oriented vicious circle with tax-push inflation as the key symptom in a macroeconomic policy blunder that has left the euro area stranded in stagnation—with inflation persistently *above* the set limit of 2 percent.

WOULD INFLATION TARGETING HAVE MADE OR MAKE ANY DIFFERENCE?

While the possibility of misreading the markets can never be excluded, an inflation targeter will be cautious enough not to unnecessarily provoke market opposition so as to crash the currency and push inflation *up*. Nor would a sound inflation targeter carelessly and needlessly provoke a productivity slump that pushes inflation *up*. Finally, a proper inflation targeter internalizes fiscal policy, especially when ignoring stagnation and unemployment results in a fiscal squeeze that pushes inflation *up*. In other words, even for the sake of maintaining price stability a proper inflation targeter has an interest in sustaining growth and employment, and *thereby* low inflation. Unfortunately, the ECB is not an inflation targeter, and this article can be seen as a call on those who make such claims to reconsider that view.

One key element in inflation targeting is that it prescribes a properly forward-looking policy conduct. It is about keeping tomorrow's rather than yesterday's inflation stable around some announced target, and thus also called inflation *forecast* targeting (Svensson 1997). Current or past inflation only matter in so far as they provide information about future inflation. While any forward-looking monetary policy must inevitably be based on a forecast, under inflation targeting the inflation forecast takes centre-stage in the policymaking process and policy communication. Policy is thereby made transparent, allowing accountability for performance. Another key element is the emphasis on *symmetry* in this approach, as deviations in either direction of the target inflation rate are equally unwelcome. Neither of these key features describes the ECB's conduct well.

Importantly, *any* short-term inflation forecast—as providing the basis for determining and communicating the policy stance under this strategy—must inevitably be derived from a forecast of the economy's evolution over the relevant time horizon. It is the evolution of the economy that the monetary policymakers attempt to steer by applying their interest rate tool. Effectively, inflation targeting means actively managing aggregate demand and employment, and *thereby* inflation.

So there is no denying that, conceptually, inflation targeting is little else but *fine tuning* the economy by means of monetary policy. It is all about optimally adjusting the policy instrument (i.e. interest rate) so as to stabilize the economy through deliberate demand management, with continuously updated and published inflation forecasts providing the key input for aiming at some desired mix between inflation and output volatilities. This implies that

inflation targeting is fine tuning in the sense that anything but optimally adjusting the instrument aimed at steering the economy along some desired path would be irrational. Obviously this does not mean that it would ever be possible to actually fine tune the economy precisely on that path.

No doubt this driving style requires skills and competence. The Bank of England has been a successful pioneer of this approach since Black Wednesday in September 1992. Today, the Bank of England is generally seen as a model of transparency and openness in all respects. Its conduct features relatively frequent and symmetric interest rate reactions to economic developments. It readiness to ease in adverse circumstances prepares the ground for appropriate tightening as growth resumes. The UK is blessed with a fairly smooth cooperation between monetary and fiscal policies, while wage earners enjoy wage increases in line with GDP growth. Overall, both nominal and real GDP growth have been very stable, with employment high and inflation low throughout. If the EMU outsider's economy is marred with imbalances today, these are largely due to its key external problem: having to operate in the immediate vicinity of a stagnating economic giant, destination of half of its exports.

If the UK is seen as the inflation targeting model for the ECB to follow, there is one aspect in which the two economies seem to differ that is pertinent to inflation targeting: UK wage inflation appears to be somewhat more responsive to the state of the economy than is the case in Euroland. It would be wrong though to focus on the higher degree of downward wage "flexibility" only, as is commonly done when comparing Euroland's famous wage rigidities with more flexible conditions in the UK and U.S. The point is that wage inflation is more flexible *in either direction* in those economies. Whereas euro zone wage inflation remained stable at a very low level since the mid-nineties, wages rose significantly faster in "flexible" economies in good times. Accordingly, wage inflation had more room for slowing down than in Euroland since 2001. To blame rigid wage inflation for Euroland's stagnation-cum-inflation persistence misses the point unless one is wishing for outright wage deflation.

This labor market feature matters greatly to monetary policy generally and inflation targeting in particular. When a growth slowdown or recession appears on the Bank of England's radar screen it is safe to forecast a slowdown in wage and price inflation. Appropriately pre-emptive easing then tends to stabilize the economy. By contrast, in Euroland a forecasted growth slowdown may not herald any significant decline in inflation, particularly as wage inflation is low and stable anyhow. It does not follow that an inflation targeter should not ease or be any less pre-emptive than in the UK kind of setting, though. It only means that the impact

of a negative demand shock will be largely real. Paired with a general reluctance to use the accelerator, unemployment is doomed to persist and become labelled "structural."

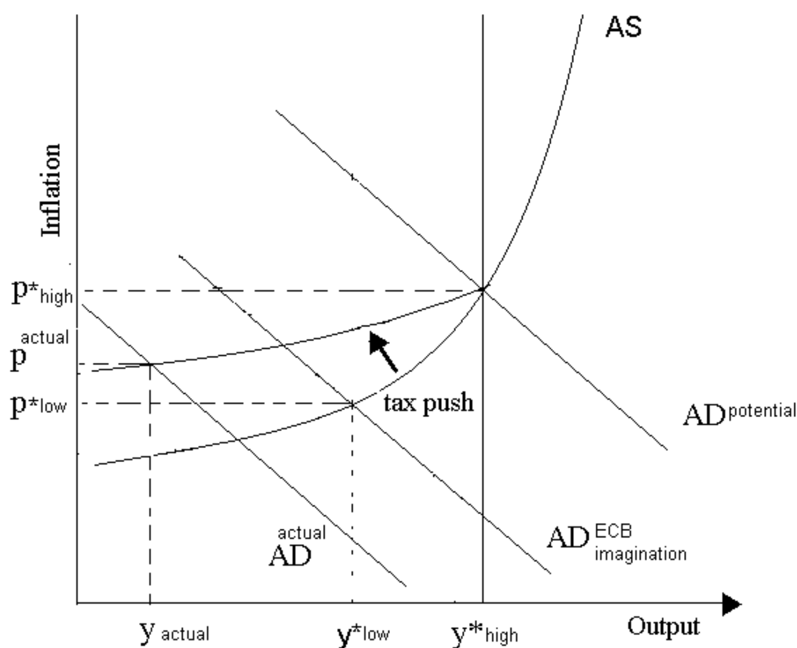
It thus becomes evident how very problematic the ECB's asymmetric mindset really is: it is bound to cause hysteresis—the process by which cyclical unemployment becomes "structural" as workers lose their skills and become "discouraged" from participating in the labor market while depressed business investment leaves a permanent gap in the economy's capital stock too—and thus represents the antipode to an employment-friendly monetary policy regime.[11] So let me emphasize that it would be wrong to criticize the ECB for not being forward looking. For when it comes to forecasting a recovery in growth and inflation risks the ECB is extremely forward looking. Ever since 2001 the ECB has forecast the economy to recover to its growth potential in the course of the current or following year—despite those allegedly all-pervasive structural problems. Ignoring any negative output gap that may have opened up in years of stagnation, even the imagination of a future return of GDP growth to the postulated trend makes the inflation alert flash red in Frankfurt. This kind of hysteria about inflation risks is replaced by a remarkable complacency when it comes to stagnation and deflation risks.

Ironically, the ECB can only "afford" this complacency because Euroland's wage rigidities provide it with a safety net against deflation risks. The more flexible wage inflation, the greater the required safety margin to stay clear of the deflationary abyss. When U.S. inflation fell below 2 percent in 2002, the U.S. Fed's deflation alert flashed red and emergency measures were taken. The ECB, by contrast, defines 2 percent as the *ceiling* of its inflation comfort zone. Operating within the flat range of a nonlinear supply curve does not imply that less pre-emptiveness with respect to negative demand shocks would be justified. It just means that deflation risks will not easily materialize—but the real damages will be no less real.

Keynes argued in chapter 19 of *The General Theory* that a stable wage unit would tend to simplify the conduct of monetary policy and reduce the risk of systemic instability. Unfortunately a stable wage unit also makes it easier for central bankers to free-ride on—what is effectively—a rather convenient safety net against deflation risks. Figure 4 summarizes the issues involved here, highlighting that two criticisms of the ECB's policy conduct must not be confused. One concerns the level of the ECB's price stability definition, which is probably too low, causing inefficiencies along the lines of Tobin (1972), Akerlof et. al (1996), and Wyplosz

(2001). Arguably, the asymmetry in the ECB's approach emphasized here is even more costly. It was due to this asymmetry that the ECB managed to actually shift the supply curve and inflation up when its disrespect for growth backfired on its sole goal of price stability through the channels discussed above.

Figure 4.
Always ready to hit the brake, never ready to touch accelerator - an asymmetry which backfired severely



No doubt the ECB's record of keeping inflation above 2 percent for five years in a row represents something of a miracle. With wage inflation so very low and stable as has been the case in Euroland since the mid-1990s, maintaining price stability would seem like a fool's job. Given the ECB's peculiar driving style it is not surprising that Euroland is getting nowhere on its aspired Lisbon growth route. Not the engine is stuttering though, it is the driver who lacks proper driving skills.

It is less obvious that the ECB's anti-growth bias also acted as a brake that kept inflation from falling more quickly toward levels more in line with severely depressed wage inflation. I

[11] Apart from Ball (1997, 1999), it is worthwhile here to recall James Tobin's (1994) prediction that "the European example [of gearing] monetary policy exclusively to price stability … has been very costly in Europe, and it is likely to be even more costly if it is enshrined as dogma by the Maastricht Treaty."

argued above that even for the sake of maintaining price stability, a proper inflation targeter has an interest in sustaining growth and employment, and *thereby* low inflation. It is an interesting thought to consider what would be the case today if Euroland had been under the monetary stewardship of a more competent driver, say the Bank of England.

Most likely inflation would be lower and interest rates higher today than they actually are. For it is through pre-emptive easing in view of growth risks that symmetrically forward-looking central banks nourish recoveries and thereby the basis for corresponding interest rate rises. And now, once again proving its keenness to hike for no good reason when it has never shown readiness to cut in time, the "ECB itches to raise rates, but why?" (*International Herald Tribune*, 5 April 2005). The ECB thus seems busy preparing its next blunder. Against this background, rather than single-mindedly pushing for labor market liberalizations that would only further undermine the ECB's safety net against deflation risks, policymakers should consider reforming Euroland's real key structural problem.

PROPOSALS FOR ECB REFORM

Structural reform in Euroland should focus on the key flaws in central banking institutions currently in place. In particular, the primary goal of policy reform should be to end the antiquated Bundesbank-type of central bank independence and peculiar despotism in monetary policy, representing the *Maastricht paradox*: "Starting from an overriding principle of disciplining policymakers as the foundation of stability, the ECB ended up as the 'benevolent dictator' in the scheme" (Bibow 2002: 33), enjoying *unbounded discretion*. In all too many respects the experience with the ECB has validated Milton Friedman's observation on the popular but thoroughly ill-conceived "time-inconsistency theme" that "from revealed preference, I suspect that by far and away the two most important variables in [typical policymakers'] loss function are avoiding accountability on the one hand and achieving public prestige on the other" (quoted in Bibow 2004a: 566). Indeed, the existing Bundesbank model is both undemocratic and economically inefficient. Reforms should take their cue from the U.K.'s monetary structure, which makes it clear who is master and who is servant.

While proper structural reform would require rewriting the Treaty, a more practicable way forward even within the existing regime might be to impose inflation targeting upon the ECB. A collaborative effort between Ecofin, the Commission and the European Parliament

should make this possible. There is nothing in the Treaty that says that it has to be left to the ECB to define price stability and get away with the most idiosyncratic interpretation of its stabilization and growth mandate.[12]

The very least the euro zone's governments could do without facing any obstacles whatever, and this would be an important input in any case, is to end the sad series of "accidents of personality" that has afflicted continental European monetary policymaking for all too long now. After all, it is governments' responsibility to select central bankers who are willing and able to do what they have to do, namely to manage the economy and thereby inflation. A key event in this respect is coming up in the spring of 2006, when the chance will arise to fill the position of ECB chief economist with an economist who understands this. The ECB's unbounded discretion might then allow the bank to quite voluntarily start doing a proper job—if it can.

[12] I propose this here as a practicable way forward even though I would prefer a U.S. Fed-style dual mandate. See Thorbecke 2000, 2004, and Bibow 2004b.

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