If the ECB cuts rates it should do so boldly

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Pressure on the European Central Bank to cut interest rates is growing as short-term growth prospects for the eurozone worsen. The arguments for a cut seem compelling: inflation is now below the ceiling set by the ECB itself and demand is so weak that there is no danger of pressure on prices increasing in the near future. Moreover, amid the uncertainty over a war in Iraq the eurozone economy is arguably in need of some stabilisation. However, a closer look at the economic effects of un- certainty suggests that this might be a poor strategy.

To deal with the influence of uncertainty on economic decisions, economists have developed the concept of the "option value of waiting". This formalises a common-sense rule: if a decision involves some sunk costs, or any other element of irreversibility, it makes sense to wait until the uncertainty has been resolved. The temptation to postpone investment decisions is particularly strong when the uncertainty is likely to be resolved in the near future.

You can imagine businesses assessing investment projects that would be slightly profitable under current circumstances, even more profitable if the uncertainty were favourably resolved, and lossmaking if not. Such a business would lose little (in terms of forgone profits) if it delayed the decision. Once the uncertainty had been resolved, it would still have the option to proceed if that was to its advantage.

A war in Iraq would not have any appreciable direct consequences for the European economy. However, the indirect effects could be substantial if the war lasted longer than expected, or if it led to a disruption of oil supplies and wider regional instability. Such an outcome cannot be ruled out. This explains why Iraq weighs so heavily on many apparently unrelated decisions.

This uncertainty is likely to be resolved soon, perhaps not in a matter of weeks, as the US administration maintains, but certainly in a matter of months. However, while it remains, you would expect demand - especially investment demand - to remain quite weak in the near future.

Should the ECB then not try to stimulate demand with an interest rate cut? A first argument against this approach would be that the concept of the "option value of waiting" applies to the ECB just as much as it applies to everyone else. A war may be averted, or it may be short and have little effect on oil prices. Hence, if the ECB cuts on Monday, it risks having to reverse its decision almost immediately. The ECB should thus cut today only if it is convinced that such a cut will make sense even if the uncertainty about Iraq is favourably resolved. A cut as an insurance against a bad outcome does not make sense.

The models of decision-making under uncertainty also have a second implication. All decisions involve some transaction costs - whether they are about investment, or about hiring and firing. These last are especially important in Europe. This implies that businesses facing only a small change in prices may not respond immediately. There is always a band of inaction - a price range within which it does not pay to change course. The size of this band of inaction increases as uncertainty increases. And, given the structural rigidities in the eurozone economy, uncertainties probably affect decision-making in Europe more than they do in the US.

So, under present circumstances, a small cut in interest rates is unlikely to have any effect on demand. If monetary policy is to be effective in these uncertain times, a large cut is needed. It does not make sense to cut interest rates by 25 basis points now. Either the ECB should cut now by at least 50 basis points, or it should wait for the uncertainty in Iraq to be resolved.

The increasingly apparent structural weakness of the European economy suggests the ECB should stay its hand. But if the ECB is not convinced of this, it should avoid cutting a little today, because that would not be a sensible compromise; in fact, it would just waste an option without helping the economy.

As the Germans say, "*Klotzen nicht Kleckern*": if you are going to hit it, hit it hard.

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