ECB OBSERVER

„Can the ECB do more for growth?"

14 November 2001

SUMMARY

Part 1: Shall the ECB assign a greater role to growth?

1. Forthcoming demographic problems coupled with high government debt levels in the euro area have made the objective of increasing the growth rate a "conditio sine qua non" for maintaining future macro-economic stability in the euro area.
2. There is strong theoretical and empirical evidence that the ECB's primary objective, that is maintaining price stability, is actually conducive to growth. Moreover, we find that the ECB's objective is not, contrary to a widely held view, a prioritisation of price stability over growth.
3. We do not find convincing evidence supporting demands that the ECB should gear its policy towards growth stimulation.
4. There may be some "confidence building" channels through which monetary policy could influence output. However, lacking sufficient knowledge of this transmission process, a growth-oriented policy for the ECB appears to be hazardous from the point of view of risks-rewards.

Part 2: Government finances and ECB policy – a discussion of the European Stability and Growth Pact

1. The Maastricht Treaty has forced national governments to embark on a policy of fiscal consolidation. The European Stability and Growth Pact ("Pact") is the logical continuation of this badly needed policy course.
2. Euro area governments' adhering to the obligations of the Pact is of the utmost importance in rendering the ECB's price stability promise credible. Deviations from the consolidation course would ultimately translate into a serious risk to the ECB's credibility.
3. To meet the challenges of forthcoming demographic problems and government debt levels, governments must reduce expenditures and start paying down government debt at a much quicker rate than is currently the case to prevent the tax burden from rising which, in turn, would certainly be detrimental to the euro area's growth momentum.
4. ECB's interest rate changes would tend to have an increasingly strong impact on governments' funding costs. This would certainly increase the lingering conflict between fiscal and monetary policy if budgets remain strained. A lack of commitment to bring about sustainable government finances clearly threatens the credibility of the ECB's price stability promise.

Part 3: "Price gap" versus reference value concept

1. We welcome the fact that the ECB has started officially analysing the information content of M3 for future euro area inflation on the basis of the so-called "price gap".
2. The ECB's reference value concept runs the risk of providing policymakers with misleading signals as it does not take into account monetary overhangs/shortfalls which have been built up in the past and affect future inflation.
3. That said, the ECB should base its policy decisions on the signals provided by the so-called "price gap" rather than on a comparison between the M3 growth and the reference value.
4. Even though there are risks to the stability of the demand for M3, we remain confident that M3 will retain its favourable indicator function for the foreseeable future.

Part 4: Assessment of current ECB policy and outlook

1. During the last six months, the ECB has been successful in stabilising inflation expectations, which is certainly an achievement given the fact that actual inflation deviated from the envisaged 2.0 % ceiling.
2. The interest rate measures taken were in line with securing price stability in the euro area.
3. Our "price gap"-based forecast model, which also contains the output gap, oil prices and the Euro-Dollar-exchange rate, implies a very benign inflation environment ahead, presumably not more than 1.7 % in 2002.
4. We expect the ECB to lower its refi rate to 3.0 % by the end of 2001. If signs of recovery fail to emerge, we expect the ECB to bring the refi rate to 2.5 % by the end of the first quarter 2002.

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