
ECB OBSERVER

*Analyses of the monetary policy of the
European System of Central Banks*

SUMMARY

Challenges to ECB credibility

**No 5
8 July 2003**

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SUMMARY

Part 1: Fundamentals of ECB credibility

Since its inception, the ECB's price stability promise has been credible from the point of view of financial markets. This achievement can be ascribed to a large extent to the institutional framework governing monetary policy in the euro area, that is, for instance, the independence of the ECB, its price stability mandate and the requirements of the European Stability and Growth Pact ("Pact"). Some of the pillars of ECB credibility seem to be increasingly challenged: the structural weaknesses in the euro area economies, resulting in low growth, high unemployment and unsound fiscal balances, run the risk of eroding the consensus for price stability oriented monetary policy. In particular, a continuation of the lack of persistent fiscal policy discipline is likely to pose a serious threat for a stable currency going forward. That said, it is of the utmost importance for governments to adhere to the Pact's requirements, e.g. achieve balanced budgets, and not only to continue but intensify reform efforts to improve economic growth perspectives.

Part 2: ECB strategy review – the problem of the “open flank”

An important outcome of the ECB's strategy review was the *de facto* downgrading of the role of money. In view of the fact that (i) the ECB's interest rate policy has been largely driven by actual rather than future inflation and (ii) inflation projections have been based on (real) economic rather than monetary developments, the rearrangement of the “two pillar strategy” appears to be a straightforward decision. However, it is certainly not supported by empirical evidence analysing the factors driving inflation in the euro area. Money – as measured through the “price gap” or “real money gap” – outperforms alternative measures, such as the “output gap”. Thus, it would have seemed rational to strengthen – rather than weaken – monetary analysis in the ECB strategy concept. As long as money demand is stable and the M3 price gap is a valid indicator for future inflation, M3 should be used – together with other variables – to derive the ECB's inflation projections and play a greater role in the bank's interest rate setting. Moreover, the rearranged “new strategy” runs the risk of increasing the bank's open flank vis-à-vis political pressure, and provoking a more discretionary monetary policy, which could ultimately negatively affect the bank's credibility.

Part 3: Uncertainty – provoking pressure for easy monetary policy

In the current low growth environment, accompanied by a high degree of uncertainty, calls for an even easier ECB monetary policy have gained momentum. However, our model approach – which rests on the so-called theory of the “option value of waiting” – shows that the impact of monetary policy on growth and employment is strongly diminished in an environment of high (revenue) uncertainty. This finding is actually based on the existence of sunk investment, e.g. hiring, costs. Against the background of the currently prevailing uncertainty, our model provides at least three important implications for ECB monetary policy: (1) cutting interest rates is not effective as long as high uncertainty continues to prevail; (2) by cutting rates under high uncertainty, the ECB reduces the option value of waiting, thereby reducing its effectiveness in future periods; and (3) a hectic ECB monetary policy, that is frequent interest rate changes, induces additional uncertainty to the economy which is likely to aggravate the weakness of investment and consumer goods demand.

Part 4: ECB policy review and outlook

Since December 2002, the ECB's rate cuts appear to have been largely motivated by the decline in the HICP inflation and short-term business cycle considerations. The medium- to long-term inflation indicators, such as the “real money gap”, did not play an important role in the bank's decisions. In the euro area, deflationary pressure is not discernible. Liquidity is very high with the “real money gap” having risen to more than 6%, representing a substantial inflation potential. Bank loan expansion, though having declined since 2000-Q3, does not suggest any supply side restrictions but seems to be in line with the cyclical position of the euro area. As things stand, the ECB is widely expected to lower rates further towards 1.5% until the end of this year. However, in view of the already very high money overhang and our inflation forecast of 1.8% for 2003 and 2.2% for 2004, such a policy might deteriorate the price stability outlook in the euro area. In the current economic environment, further monetary policy easing could run the risk of causing an “asset price inflation” and, in addition, reduce the economic incentives to bring about structural reforms in the euro area.

ZUSAMMENFASSUNG

Teil 1: Grundlagen der EZB-Glaubwürdigkeit

Das Preisstabilitätsversprechen der EZB wird seit ihrem Bestehen von den Marktakteuren als glaubwürdig angesehen. Dieser Erfolg kann zu einem wesentlichen Teil dem institutionellen Rahmen der europäischen Geldpolitik zugeschrieben werden. Hierzu zählen z. B. die Unabhängigkeit der EZB, die Vorgabe des Ziels Preisstabilität und die Vorgaben des Europäischen Stabilitäts- und Wachstumspaktes („Pakt“). Der Erhalt der Glaubwürdigkeit steht jedoch vor Herausforderungen: Die strukturelle Wachstumsschwäche, hohe Arbeitslosigkeit und unsolide Staatsfinanzen laufen Gefahr, den Konsens für eine preisstabilitätsorientierte Geldpolitik zu unterspülen. Insbesondere die wieder steigende Staatsverschuldung in einer Reihe von Ländern ist auf Dauer ein ernstes Bedrohungspotential für die Stabilität des Euro. Es ist daher von überaus großer Wichtigkeit, dass die Staaten am Pakt festhalten und ihre Anstrengungen zur Reform der Produkt- und Faktormärkte, die eine Verbesserung der Wachstumsaussichten versprechen, nicht nur beibehalten, sondern auch intensivieren.

Part 2: EZB-Strategierevision – das Problem der „offenen Flanke“

Ein wichtiges Ergebnis der Revision der EZB-Strategie war die de facto Abwertung der monetären Säule. Vor dem Hintergrund, dass (i) die EZB ohnehin ihre Zinspolitik primär an der laufenden Inflation und (ii) ihre Inflationsprojektionen auf Basis realwirtschaftlicher Variablen und nicht an monetären Größen erstellt, erscheint das Ergebnis der Strategierevision zunächst logisch. Aber die Ratio der Strategieneuordnung wird nicht durch die empirischen Befunde rationalisiert. Die Geldmenge M3 – gemessen anhand des „Price Gap“ oder „Real Money Gap“ – besitzt nach wie vor herausragende Qualitäten zur Prognose der Inflation im Euroraum. Sie „outperformed“ z. B. das „Output-Gap“. Es wäre daher rational gewesen, wenn die EZB die Rolle der Geldmenge gestärkt und nicht geschwächt hätte. Solange die Geldnachfrage stabil ist und sich das Price Gap als ein valider Inflationsindikator erweist, sollte die EZB diese Größe – zusammen mit anderen Variablen – zur Erstellung ihrer Inflationsprojektionen verwenden und auch ihre Zinspolitik verstärkt an der Veränderung des Price Gap ausrichten. Die neugeordnete Strategie könnte zum einen die „offene Flanke“ der Bank gegenüber politischem Druck vergrößern und zum anderen einer verstärkt diskretionären Geldpolitik Vorschub zu leisten. Dies könnte letztlich der Glaubwürdigkeit der Bank abträglich sein.

Part 3: Unsicherheit – Druck für eine Politik des billigen Geldes

Im aktuellen Umfeld langsamen Wachstums, das von hoher Unsicherheit begleitet wird, gewinnen Forderungen nach einer noch lockereren Geldpolitik zunehmend an Eigendynamik. Dennoch zeigt unser Modell, das auf der so genannten Theorie des „Optionswerts des Wartens“ beruht, dass der Einfluss der Geldpolitik auf Wachstum und Beschäftigung in einem Umfeld hoher (Ertrags-) Unsicherheit nur stark eingeschränkt zur Geltung kommt. Dieses Ergebnis basiert auf der Existenz von versunkenen Investitionskosten, wie zum Beispiel den Einstellungskosten. Vor dem Hintergrund der gegenwärtig nach wie vor herrschenden Unsicherheit lässt unser Modell mindestens drei Schlussfolgerungen für die Geldpolitik der EZB zu. (1) Zinssenkungen bleiben wirkungslos, solange hohe Unsicherheit fortdauert; (2) durch Zinssenkungen bei hoher Unsicherheit vermindert die EZB den Optionswert des Wartens, wodurch sie ihre Effektivität in zukünftigen Perioden verringert; und (3) eine hektische Geldpolitik der EZB, die sich durch häufige Zinsänderungen auszeichnet, ruft zusätzliche Unsicherheit in der Volkswirtschaft hervor, die mit hoher Wahrscheinlichkeit die Schwäche der Investitions- und der Konsumgüternachfrage noch verschärft.

Part 4: EZB-Geldpolitik- Rück- und Ausblick

Die Zinssenkungen der EZB seit Dezember 2002 scheinen vor allem durch die gesunkene Inflation sowie Sorgen über den Konjunkturverlauf im Euroraum motiviert gewesen zu sein. Mittel- bis langfristige Inflationsindikatoren wie z. B. die „reale Geldlücke“ scheinen eine untergeordnete Rolle gespielt zu haben. – Im Euroraum ist ein Deflationsdruck nicht erkennbar. Die monetäre Ausstattung, gemessen anhand der realen Geldlücke, ist mit mehr als 6 % mittlerweile sogar sehr hoch und repräsentiert ein beträchtliches Inflationspotenzial. Auch die Bankkreditexpansion im Euroraum, die sich seit 2000-Q3 deutlich abgeschwächt hat, steht im Einklang mit der konjunkturellen Situation und lässt auf keine ungewöhnliche Kreditangebotsrestriktion schließen. – Es wird weithin erwartet, die EZB werde den Leitzins bis Ende des Jahres auf 1,5 % senken. Mit Blick auf die sehr hohe Liquiditätsausstattung und unsere Inflationsprognose von 1,8 % in 2003 und 2,2 % in 2004 sind jedoch keine weiteren Zinssenkungen zu empfehlen. – Im aktuellen Umfeld ist nicht auszuschließen, dass weitere Zinssenkungen nicht die Konjunktur beleben, sondern eine „Asset Price Inflation“ auslösen und zudem auch Anreize für weitere Strukturereformen reduzieren könnten, die letztlich die Wachstumsaussichten im Euroraum schmälern würden.

A.2. – ECB OBSERVER – recent publications

Number	Title and content	Date of publication
No. 5	Challenges to ECB credibility Content: 1. <i>Fundamentals of ECB credibility.</i> – 2. <i>ECB strategy review – increasing the bank's open flank.</i> – 3. <i>Uncertainty – pressure for easier monetary policy.</i> – 4. <i>ECB policy review and outlook.</i>	8 July 2003
No. 4	International coordination of monetary policies – challenges, concepts and consequences Content: 1. <i>International coordination of monetary policies.</i> – 2. <i>Does the ECB follow the Fed?</i> – 3. <i>Stock prices – a special challenge for monetary policy.</i> – 4. <i>ECB monetary policy review and outlook.</i>	19 December 2002
No. 3	The Fed and the ECB – why and how policies differ Content: 1. <i>The US Federal Reserve System and the European System of Central Banks – selected issues under review.</i> – 2. <i>The reaction functions of the US Fed and ECB.</i> – 3. <i>The influence of monetary policy on consumer prices.</i> – 4. <i>ECB rate policy and euro area inflation perspectives.</i>	24 June 2002
No. 2	Can the ECB do more for growth? Content: 1. <i>Should the ECB assign a greater role to growth?</i> – 2. <i>Government finances and ECB policy – a discussion of the European Stability and Growth Pact.</i> – 3. <i>“Price gap” versus reference value concept.</i> – 4. <i>Assessment of current ECB policy and outlook.</i>	19 November 2001
No. 1	Inflationsperspektiven im Euro-Raum Content: 1. <i>Warum die EZB-Geldpolitik glaubwürdig ist.</i> – 2. <i>EZB-Strategie – Stabilitätsgarant oder überkommenes Regelwerk?</i> – 3. <i>Stabilitätsrisiken der Osterweiterung.</i> – 4. <i>Zinspolitik der EZB in 2001 und 2002.</i>	17 April 2001

A.3. – ECB OBSERVER – *objectives and approach*

The objective of ECB OBSERVER is to analyse and comment on the conceptual and operational monetary policy of the European System of Central Banks (ESCB). ECB OBSERVER analyses focus on the potential consequences of past and current monetary policy actions for the future real and monetary environment in the euro area. The analyses aim to take into account insights from monetary policy theory, institutional economics and capital market theory and are supplemented by quantitative methods. The results of the analyses are made public to a broad audience with the aim of strengthening and improving interest in and understanding of ECB monetary policy. ECB publishes its analyses in written form on a semi-annual basis.

ECB OBSERVER – team members

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