



Is the European Central Bank Failing Its Price Stability Mandate?

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Inflation in the euro area is too low, just 0.9 percent year-on-year in December 2013, and inflation expectations, measured from inflation derivative contracts, have shifted lower, indicating that markets expect some small probability of deflation in 2014 and average inflation over the next five years in the 1.25 to 1.5 percent range. The European Central Bank (ECB), however, seems to be content with this outlook. Its current projections show a very slow economic recovery and inflation at just 1.3 percent in two years' time.¹ Yet the ECB describes the risks to inflation as balanced.² This puzzling assessment might be due to the fact that the ECB's definition of price stability is less precise than that employed by other central banks, and some ECB members may interpret the definition as setting a ceiling, rather than a target, for inflation at close to but below 2 percent. But

1. ECB, Introductory Statement to the Press Conference following the December 5, 2013, ECB meeting. Available at www.ecb.europa.eu/press/pressconf/2013/html/is131205.en.html.

2. ECB, Introductory Statement to the Press Conference following the January 9, 2014, ECB meeting. Available at www.ecb.europa.eu/press/pressconf/2014/html/is140109.en.html.

if one considers the ECB's self-assessment of success since its creation—achieving 2 percent inflation on average—its current inflation forecast of 1.3 percent would fall short of achieving its price stability mandate.

The asymmetry in the ECB's stance—a discontinuity between attitudes toward overly high and overly low inflation—appears to be worrisome and is reminiscent of the Bank of Japan (BoJ) during the 1990s and 2000s. After the burst of the Nikkei and real estate bubble, the BoJ eased policy but was always ready to react forcefully against possible upside inflation risks (similarly to the ECB's rate hikes in 2008 and in 2011) while appearing too casual and dismissive against downside

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risks. By accepting a long period of low inflation, the ECB is either revealing a new, deflationary bias or not fulfilling its price stability mandate.³ In either scenario, the reason would appear to be the increased politicization of the ECB, with an excessive focus on influencing economic policies in the euro area periphery countries and too much concern about domestic political pressure, especially from Germany. As a result, ECB Governing Council members have increasingly aligned their positions along national lines, with members from Germany and some other countries (including the Netherlands, Finland, Austria, and Luxembourg) typically questioning and even opposing further easing,⁴ exerting a disinflationary bias on ECB

3. Adam S. Posen highlights the ECB's failure to fulfill its mandate as it has diverted attention too much to the budget politics of member states. See Adam S. Posen, testimony before the House Financial Services Committee Subcommittee on Monetary Policy and Trade hearing "What Is Central About Central Banking?: A Study of International Models," November 13, 2013. Available at www.piie.com/publications/testimony/posen20131113.pdf.

4. This started with Bundesbank President Axel Weber's opposition to asset purchases in 2010, which broke the consensus hitherto common in ECB

policies. Contrary to the traditional fear in the central banking literature, the excessive focus on politics is threatening to cause inflation to be too low, not too high.

This Policy Brief discusses the price stability outlook in the euro area and the challenges the ECB faces to fulfill its mandate. The evidence clearly shows that, with an inflation rate that is already too low, the risks to inflation are on the downside: The output gap (the amount of slack available in the economy) is large and will not close for several years, given the current growth forecast; wage growth is weak and likely to remain so, as the euro area periphery must take additional steps to regain competitiveness, and, once the taboo of nominal wage cuts has been broken, wage cuts are becoming widespread; the euro area core is running an inflation rate that is too low to allow the periphery to achieve needed disinflation at comfortable inflation rates; money and credit growth are extremely weak and will remain so for at least another year, and likely longer, while the banking sector continues its deleveraging and recapitalization process; the currency is overvalued and has appreciated significantly, tightening financial conditions; and inflation expectations have downshifted to a level clearly below 2 percent.

The ECB has always said that there is only one needle in its compass, and that is price stability. Therefore, because price stability is clearly being compromised to the downside, further easing is in order and should include three elements: (1) a clarification that the definition of price stability is inflation at 2 percent, with an explicit statement that deviations above and below this objective will be treated equally, in order to eliminate ambiguities and protect against political interference, strengthen the anti-deflation stance, and help push inflation expectations back towards 2 percent; (2) a program of quantitative easing (QE) implemented via purchases of GDP-weighted baskets of government bonds, to reduce risk premia along the yield curve and help reduce both the level and the dispersion of private lending rates; and (3) a targeted program of medium- to long-term lending to small and medium enterprises (SMEs) that reduces their credit restrictions and facilitates longer-term borrowing. These three actions, together with a clear and unanimous message that the ECB stands ready to ease as much as needed to achieve its mandate, will help the ECB achieve price

decisions; it was followed with Jürgen Stark's frequent clashes with fellow executive board members on asset purchases, which led to his resignation; and it has continued with Executive Board member Jörg Asmussen's opposition to rate cuts, justified at times by the damage that low interest rates could create for German savers. See Lorenzo Bini Smaghi, "The ECB should keep a lid on dissent," *Financial Times*, September 4, 2012, available at blogs.ft.com/the-a-list/2012/09/04/the-ecb-should-keep-a-lid-on-dissent/#axzz2qhGWvC9j; and David Marsh, "German duo show tactical voting," commentary on the website of the Official Monetary and Financial Institutions Forum, May 7, 2013, available at www.omfif.org/intelligence/the-commentary/2013/may/german-duo-show-tactical-voting/.

stability and contain the decline in potential growth and the increase in structural unemployment in the euro area. There is nothing revolutionary in this proposal. It would simply align the ECB with the practices of the other major central banks.

There is a clear lesson from this crisis for central bankers: Monetary policy is asymmetric, hesitant, and does too little too late when the task is to prevent inflation from being too low. Despite all the inflationary fears about the monetary expansions of the last few years, inflation has turned out to be too low. At the zero bound (when interest rates are zero or at very low levels), the political pressure, at least in the United States and the European Union, has been towards doing less rather than more.⁵ Therefore, central banks must improve their institutional setting to increase their independence and better fight deflation. This Policy Brief proposes three ideas: (1) increase central banks' capital to eliminate the fear of losses resulting from asset purchases; (2) provide more public explanation about the central banks' reaction function (i.e., the policy interest rate as a function of growth and inflation)—there should also be more explanation about the range of instruments available to adopt the optimal monetary policy and address the political pressures that have tried to limit the use of nonconventional tools, including quantitative easing; (3) and aim for a somewhat higher level of inflation in normal times (say 3 percent) to reduce the odds of reaching the zero lower bound and thus minimize the asymmetry.

WHAT IS THE ECB'S MANDATE?

The ECB's mandate is defined in the Article 127(1) of the Treaty of the Functioning of the European Union: "The primary objective of the European System of Central Banks (hereinafter referred to as 'the ESCB') shall be to maintain price stability. Without prejudice to the objective of price stability, the ESCB shall support the general economic policies in the Union with a view to contributing to the achievement of the objectives of the Union."⁶

5. Witness the strong criticism in the United States towards quantitative easing and the accusations of debasing the dollar, perhaps best represented by Ron Paul's "End the Fed" campaign, and the debate on the "cost" of QE due to the potential future losses for the Fed (see *Bloomberg*, "Fed Faces Explaining Billion-Dollar Losses in QE Exit Stress," February 26, 2013, available at www.bloomberg.com/news/2013-02-26/fed-faces-explaining-billion-dollar-losses-in-stress-of-qe3-exit.html). In the euro area, the best example is the fierce campaign against the ECB's policies launched by Hans Werner Sinn in Germany (see Hans-Werner Sinn, "The ECB's stealth bailout," *VOX*, June 1, 2011, available at www.voxeu.org/article/ecb-s-stealth-bailout).

6. Treaty of the Functioning of the European Union. Available at eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2010:083:0047:0200:EN:PDF.

This mandate is among the most independent in the central banking world, because it can only be changed via modification to the Treaty, a process more complex than a change in a central bank law. The precise meaning of price stability, however, is not defined in the Treaty. The ECB has defined its objective of price stability as “a year on year increase in the harmonized index of consumer prices (HICP) for the euro area of below 2 percent.”⁷ This initial definition was later clarified as aiming to “maintain inflation rates below, but close to, 2 percent over the medium term.”⁸

The problem with this definition is that it is not precise. It could be interpreted as inflation in the 0 to 1.99 range but closer to 1.99 than to 0 and thus centered around 1 to 1.25 percent, or it could be interpreted as inflation as close as possible to but below 2 percent and thus centered around 1.8 to 1.9 percent. To avoid speculation, this Policy Brief adopts what is understood to be the ECB’s definition of success, namely achieving 2 percent inflation on average. In the words of former ECB President Jean-Claude Trichet, “like actions, numbers speak louder than words. Let me mention one number: 2.01 percent, the average inflation rate in the euro area since 1999 until today, over a period of almost 13 years during which oil prices have soared.”⁹

As a protection against critics pressing the ECB to do more to support growth and emulate the US Federal Reserve’s dual mandate, the ECB has been very explicit about its price stability mandate. Again in the words of Trichet: “We have one needle in our compass, and that is price stability.” This makes the ECB’s policy strategy very simple: When price stability is assured, there is no need to change policy. When price stability is at risk, in either direction, policy should be changed to fulfill the mandate.

Having clarified the ECB’s mandate and strategy, this Policy Brief evaluates the price stability outlook for the euro area using the ECB’s methodology, looking at both the economic (growth, economic slack, and wages) and monetary (money and credit) pillars, and comparing it with the mandate of achieving an average inflation rate of 2 percent over the medium term.

7. The ECB’s definition of price stability is available at www.ecb.europa.eu/mopo/strategy/pricestab/html/index.en.html.

8. This is the most extreme form of central bank independence, where the central bank defines both the objective and the instruments to achieve the objective. In many other cases, such as in the United Kingdom, the government defines the objective.

9. Jean-Claude Trichet, Introductory Statement at the Hearing at the Committee on Economic and Monetary Affairs of the European Parliament, Brussels, October 4, 2011. Available at www.ecb.europa.eu/press/key/date/2011/html/sp111004.en.html.

ASSESSMENT OF THE INFLATION OUTLOOK: THE ECONOMIC PILLAR

In December 2013, HICP annual inflation was 0.8 percent. Excluding energy, food, alcohol, and tobacco, it was 0.7 percent. And the trend is clearly downwards (figure 1). Inflation could be low because of transitory factors, but the evolution of goods versus services inflation suggests otherwise (figure 2). Services inflation is a good proxy for underlying inflation, and it is also at record lows, just 1 percent year-on-year, and markedly lower than during the period of price stability.

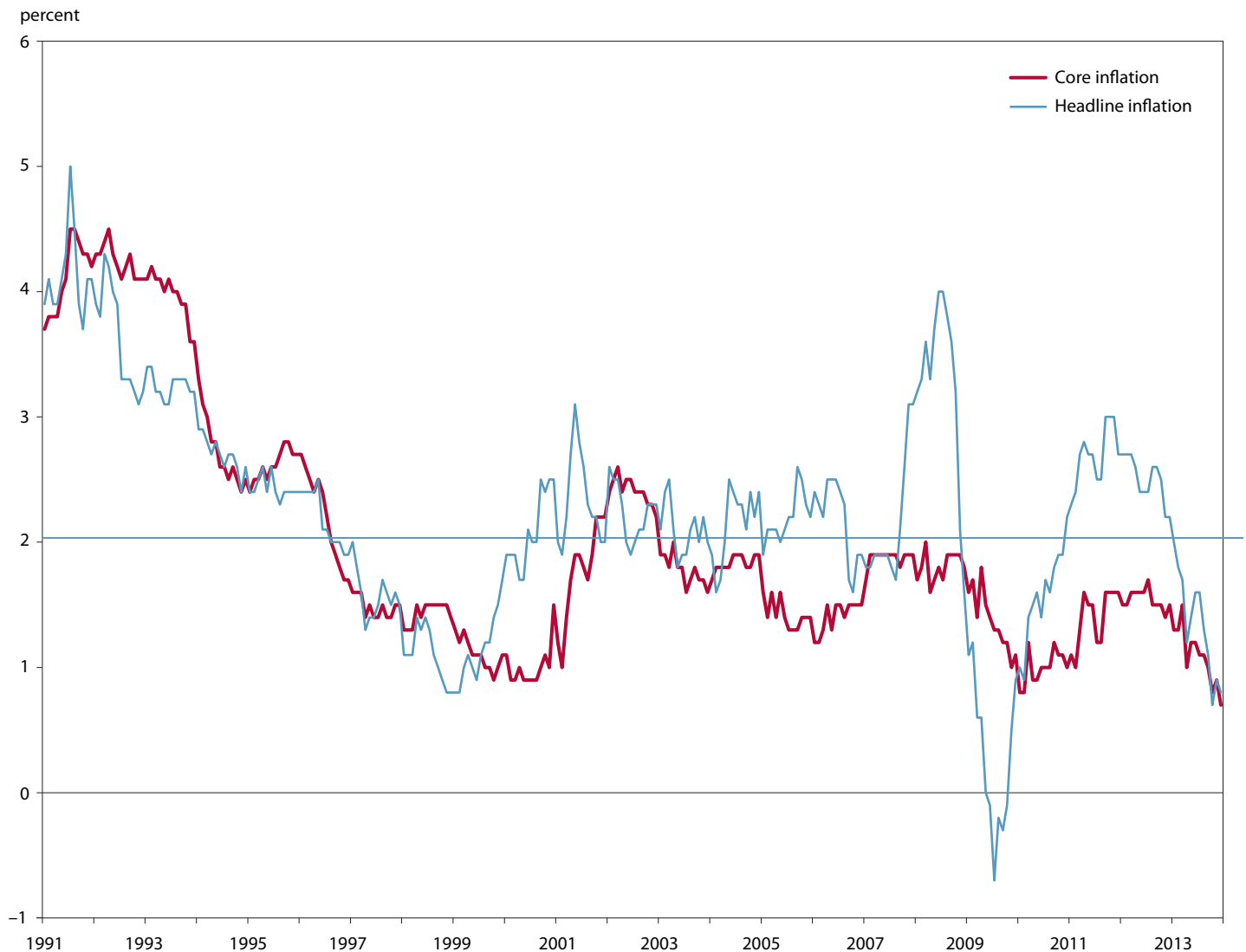
This low inflation level is not surprising—the disinflationary pressures in the euro area have been strong as a result of a very large increase in slack. After the longest recession since its creation, the euro area presents a large output gap (a bit over –2 percent, as estimated by the Organization for Economic Cooperation and Development [OECD], or close to –3 percent, as estimated by the International Monetary Fund [IMF]) that is unlikely to close before 2018 under current growth forecasts.¹⁰ The unemployment rate, at 12.1 percent, is the highest recorded since the unemployment rate series started in 1990.

In addition, the crisis management strategy put in place by euro area leaders, who were focused on generating an internal devaluation in the troubled countries via reductions in wages and prices, has contributed to disinflation (figure 3). Wage growth has been flat or negative in the euro area periphery for a couple of years now. As a result, euro area wage growth is at or near the lowest level since the euro was introduced. Note that wage growth in the 2 to 2.5 percent range was compatible with inflation near 2 percent, while now the growth of negotiated wages is barely in the 1.5 percent range. Note also that the nominal wage cuts executed in the periphery in recent years (mostly in the public sector but becoming common in the private sector as well) have broken the resistance to lowering wages, and the recent reforms aimed at increasing labor market flexibility are likely to strengthen this bias toward lower wages.

The ECB’s mandate is to maintain price stability for the euro area as a whole, and therefore this Policy Brief avoids entering into the debate of the specific problems of individual countries. But there is valuable information in the evolution of inflation across euro area countries in terms of assessing the future path of euro area inflation. After all, euro area inflation is calculated as the weighted average of the inflation rates of the euro area member countries.¹¹

10. These output gap estimates are likely very conservative (too small) because of the nature of the estimation techniques, which typically suffer from end-point biases (allocating most of the recent decline in growth to potential rather than cyclical causes), especially at the zero bound when demand policies are constrained.

11. The weights represent relative weights of household consumption and cur-

Figure 1 Euro area inflation, year-on-year, 1991–2013

Source: Bloomberg.

Figure 4 shows that the current low level of inflation is not a distortion generated by one or two countries. Inflation is low everywhere. Only three countries—Estonia, Austria, and Finland—have inflation near 2 percent, while as many as 10 countries have inflation below 1 percent, and two countries are in outright deflation.

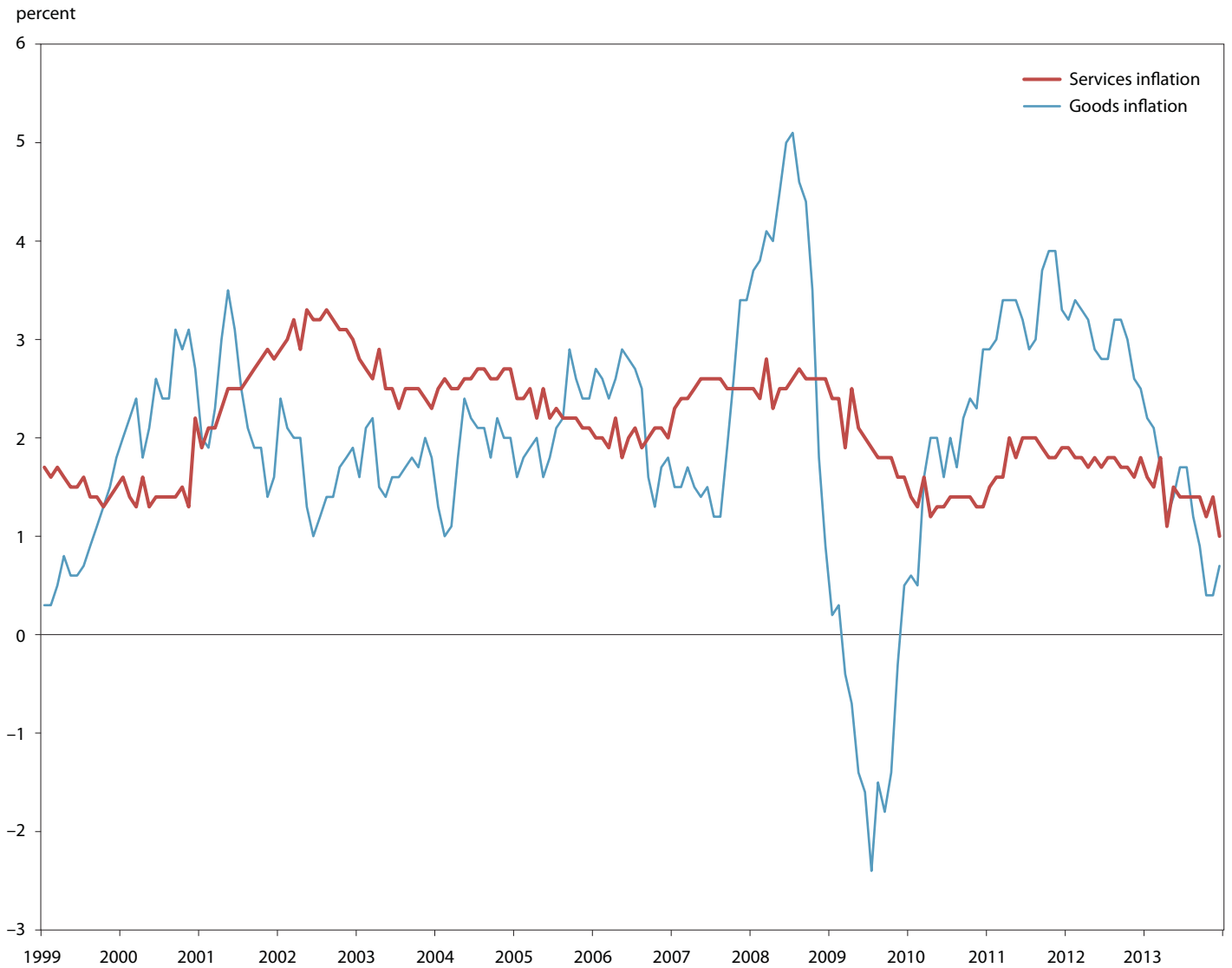
The comparison between Germany and Spain over time is illustrative (figure 5). During 1998–2007, the period of price stability, Spain’s inflation rate was about 200 basis points higher

than in Germany. At that time Germany was adjusting via wage moderation to the competitiveness loss that followed German unification, and higher growth and inflation in the rest of the euro area contributed positively to a smooth disinflation in Germany.¹² Now the situation has reversed. It is Spain’s turn to adjust, but because German inflation remains at low levels, Spain’s (and the rest of the periphery’s) disinflation needs to be very close to zero. The euro area periphery facilitated the German

rently are, in percent: Belgium (3.5), Germany (26.9), Estonia (0.2), Ireland (1.3), Greece (2.9), Spain (12.4), France (20.5), Italy (18.2), Cyprus (0.2), Luxembourg (0.3), Malta (0.1), the Netherlands (4.9), Austria (3.4), Portugal (2.3), Slovenia (0.4), Slovakia (0.7), and Finland (1.8).

12. I discuss this issue in Ubide (2013a) in the context of the end of political solidarity in the euro area.

Figure 2 Euro area goods and services inflation, year-on-year, 1999–2013



Source: Bloomberg.

adjustment, but Germany is not reciprocating now.¹³ This drags the euro area inflation rate lower on a permanent basis.

Table 1 divides euro area countries into two groups: the “adjusters,” the countries that still need to adjust via disinflation (Spain, France, Italy, Portugal, Greece, Cyprus, and Ireland, representing about 58 percent of euro area GDP), and the “surplusers” (the rest of euro area countries), who do not have a competitiveness problem now. Precrisis, during the period of

price stability, it shows a picture similar to the Spain-versus-Germany figure: Adjusters were running an inflation rate of about 2.5 percent per year, while surplusers were running an inflation rate of about 1.8 percent per year. This allowed the euro area to generate an inflation rate of 1.9 percent per year, in line with the ECB’s mandate of price stability. Today’s starting point, however, is different. The adjusters are running an average inflation rate of 0.6 percent per year, while surplusers are running an average inflation rate of about 1.5 percent per year.

Note that the period 2010–13 is very misleading, as the inflation of the “adjusters” in 2010–13 became temporarily higher due to the impact of indirect tax hikes implemented

13. Note that this is not a plea for a loss of competitiveness in Germany. Germany can contribute by boosting growth via the liberalization of the banking and services sector, to help correct Germany’s chronic underinvestment.

Figure 3 Indicators of euro area wage growth, year-on-year, 1996Q1–2013Q2



Source: Bloomberg.

as part of deficit reduction plans.¹⁴ Once the impact of these tax hikes faded away, the “true” lower underlying inflation rate appeared.

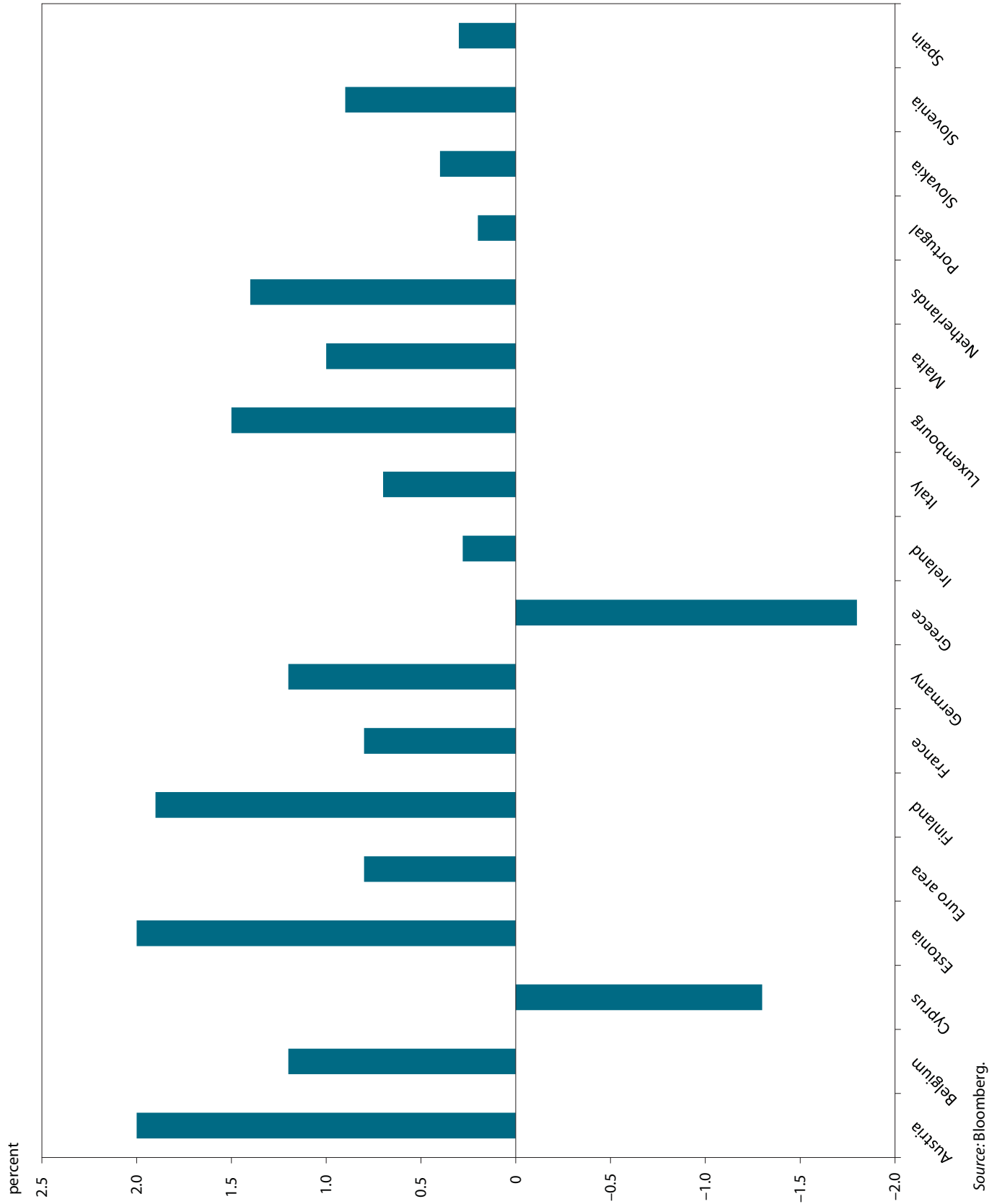
Table 1 provides different possible scenarios for both groups. Because the adjusters still have some room to go in terms of regaining competitiveness,¹⁵ unless the surplusers boost their inflation rate, the odds of euro area inflation moving back towards 2 percent are slim. If adjusters were to stabilize their

14. The period 2008–09 has been “ignored,” as it was subject to wild fluctuations driven by the swings in oil prices.

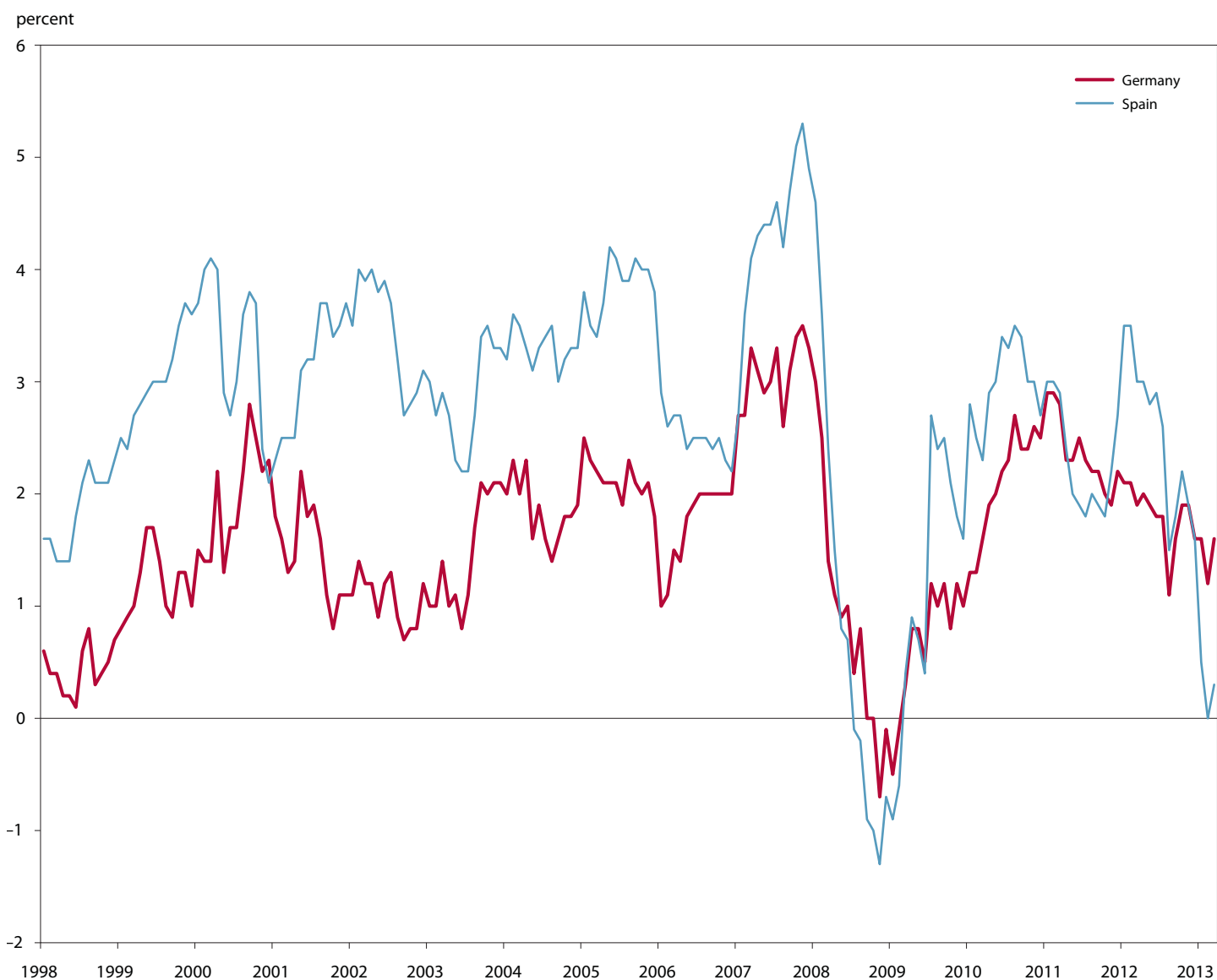
15. The ECB’s harmonized competitiveness indicators, a unit-labor-cost-based measure that takes into account both intra- and extra-euro area trade, shows that the competitiveness gap versus adjusters and surplusers has barely closed.

inflation rate to around 1 percent—an optimistic scenario, as it is almost double their current rate—the surplusers would have to run an inflation rate of about 3.2 percent for the euro area to reach 1.9 percent and thus meet its mandate. The problem is that 3.2 percent inflation would be almost double the inflation rate that the surplusers achieved during the first decade of the euro, when growth was robust and commodity prices were booming, and thus not very realistic. However, note that core inflation in the Federal Republic of Germany during the 1980–95 period, under the Bundesbank tenure, averaged very close to 3 percent. Therefore it would not be extraordinary to return to similar inflation levels in order to facilitate the euro area adjustment. If we assume that the surplusers will run an

Figure 4 Euro area annual inflation, December 2013



Source: Bloomberg.

Figure 5 Inflation in Spain and Germany, year-on-year, 1998–2013

Source: Bloomberg.

inflation rate similar to that of the first decade of the euro, around 1.8 percent, and the adjusters run a rate of 1 percent, then the euro area will achieve a meager 1.3 percent inflation rate. This is not compatible with price stability.

ASSESSMENT OF THE INFLATION OUTLOOK: THE MONETARY PILLAR

The analysis of the evolution of money and credit (the monetary pillar) has been a hallmark of the ECB's strategy. This strategy was hailed as the continuation of the Bundesbank tradition, and

the rate hiking cycle of 2005 was justified by the acceleration of money and credit growth, which occurred before growth and inflation were showing any visible upside. The monetary pillar has been controversial in the academic and central banking debate, and during the ECB's 2005 review of its monetary policy strategy, it was somewhat downgraded—it moved from first to second place in the ordering of the analysis of the information for the inflation outlook in the ECB post-meeting statements—with a strong debate about the stability of money demand and the information content of the monetary pillar for inflation forecasting purposes. Reichlin et al. (2006) provide a thorough

Table 1 Euro area average inflation of adjusters compared to surplusers, 1998–2013, with future scenarios (percent)

Date	Adjusters	Spain	Surplusers	Germany	Euro Area
1998–2007	2.5	3.0	1.8	1.4	1.9
2010–13	2.1		2.3		2.1
December 2013	0.6		1.5		0.9
2014–16, scenarios	1.0		1.4		1.2
	1.0		1.4		1.2
	1.0		1.8		1.3
	1.0		2.0		1.4
	1.0		2.5		1.6
	1.0		3.2		1.9
	1.4		1.4		1.4
	1.4		1.6		1.5
	1.4		1.8		1.6
	1.4		2.0		1.7
	1.4		2.5		1.9

Note: Adjusters include Spain, France, Italy, Portugal, Greece, Cyprus, and Ireland; surplusers include the rest of euro area countries.

Source: Eurostat and author's calculations.

discussion of the ECB's approach to monetary analysis and the surrounding debate, with two conclusions: Monetary variables help improve the accuracy of inflation forecasts, especially over the medium term, and nonmonetary-based forecasts and monetary-based forecasts have biases of opposite signs, complementing each other and minimizing the odds of large mistakes, especially missing financial bubbles. Thus monetary variables were seen as the best instrument to forecast medium-term trend inflation via its impact on inflation expectations.

With this in mind, it is surprising the monetary pillar is largely being ignored now (figure 6). The rate of growth of money supply (M3) has collapsed to a paltry 1.5 percent, well below the 4.5 percent reference value.¹⁶ The behavior of its most important component, credit growth, is even more worrisome, as it is in clear negative territory: Loans to nonfinancial corporates contracted at –3.8 percent year-on-year in November 2013, while the growth of loans to households has been flat for more than a year. Looking forward, the upcoming Asset Quality Review (AQR), balance sheet assessment, and stress tests will continue to put downward pressure on money and credit growth during the next several quarters, as banks will very likely intensify the deleveraging (selling of assets) in order to pass the tests. This deleveraging will likely further curtail lending growth (Ubide 2013b).

16. The ECB's strategy defined 4.5 percent growth in the money supply (M3) as compatible with achieving 2 percent inflation over the medium term.

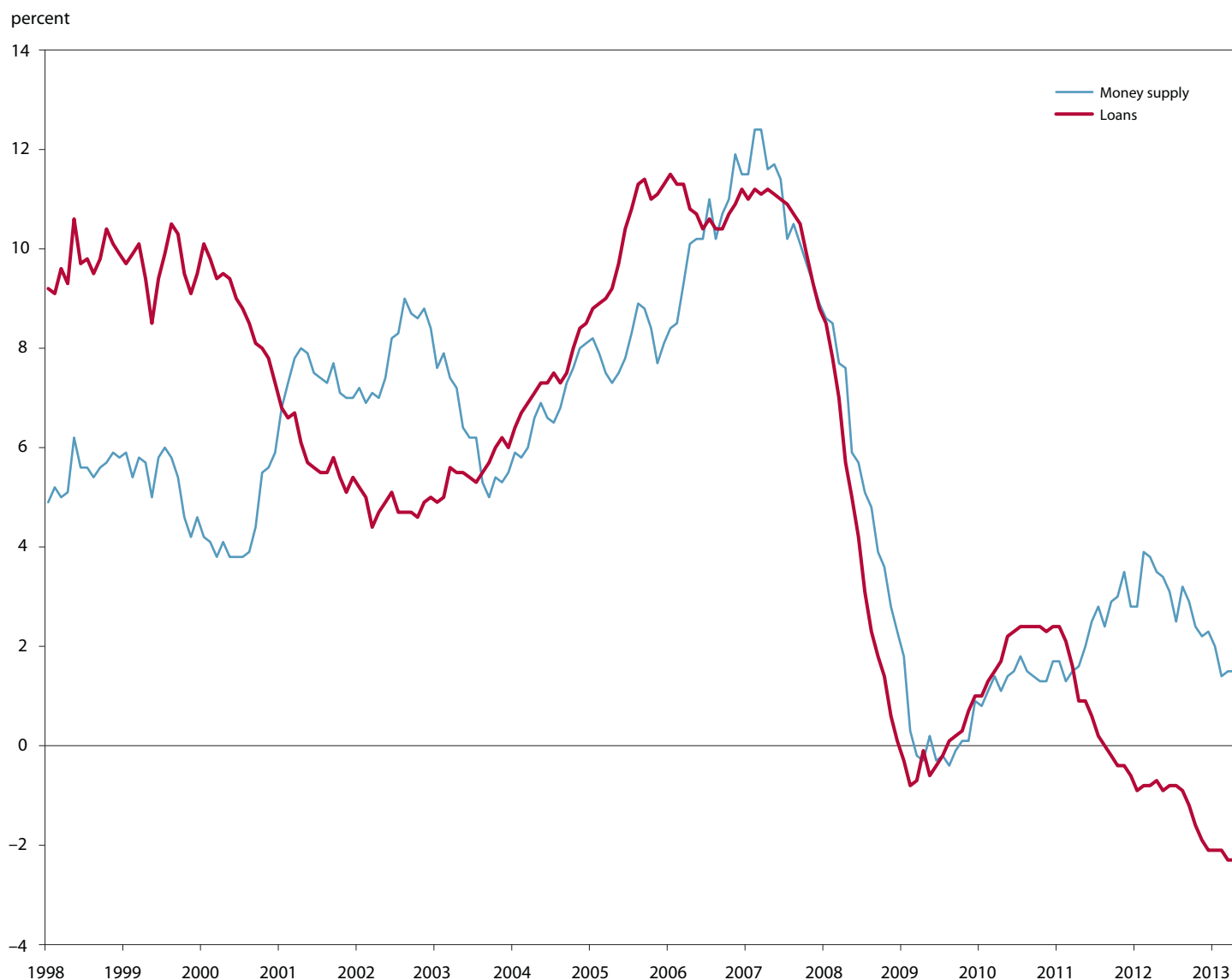
As discussed above, the monetary pillar was justified to protect against financial bubbles—the narrow focus on 2-year-ahead inflation could mask the development of credit excesses. Today the ECB faces a situation of a negative bubble, and the 2-year-ahead inflation forecast could be masking a heightened downside risk. If one takes the monetary analysis at face value, it is flagging very strong downside risks to medium- and longer-term inflation. As I discuss below, the behavior of inflation expectations is also starting to show these downside risks.

Cross-checking the information of the economic and the monetary pillar, and taking into account the low level of inflation today as a starting point, the ECB methodology should conclude that the risks to price stability are strongly to the downside, and the case for further easing is very strong.

THE STANCE OF POLICY AND THE CASE FOR FURTHER EASING

Since my earlier analysis of the need for the ECB to act forcefully to avert the risk of deflation in the euro area,¹⁷ the situation has only worsened. Last summer the ECB introduced a soft form of forward guidance—stating that interest rates would be on hold or lower for an extended period of time—to be followed by a rate cut in November 2013. Unfortunately, it was not very

17. Angel Ubide, "The ECB Should Act to Avert the Risk of Deflation in the Euro Area," RealTime Economic Issues Watch blog, May 23, 2013. Available at blogs.piie.com/realtime/?p=3582.

Figure 6 Money supply and credit growth in the euro area, year-on-year, 1998–2013

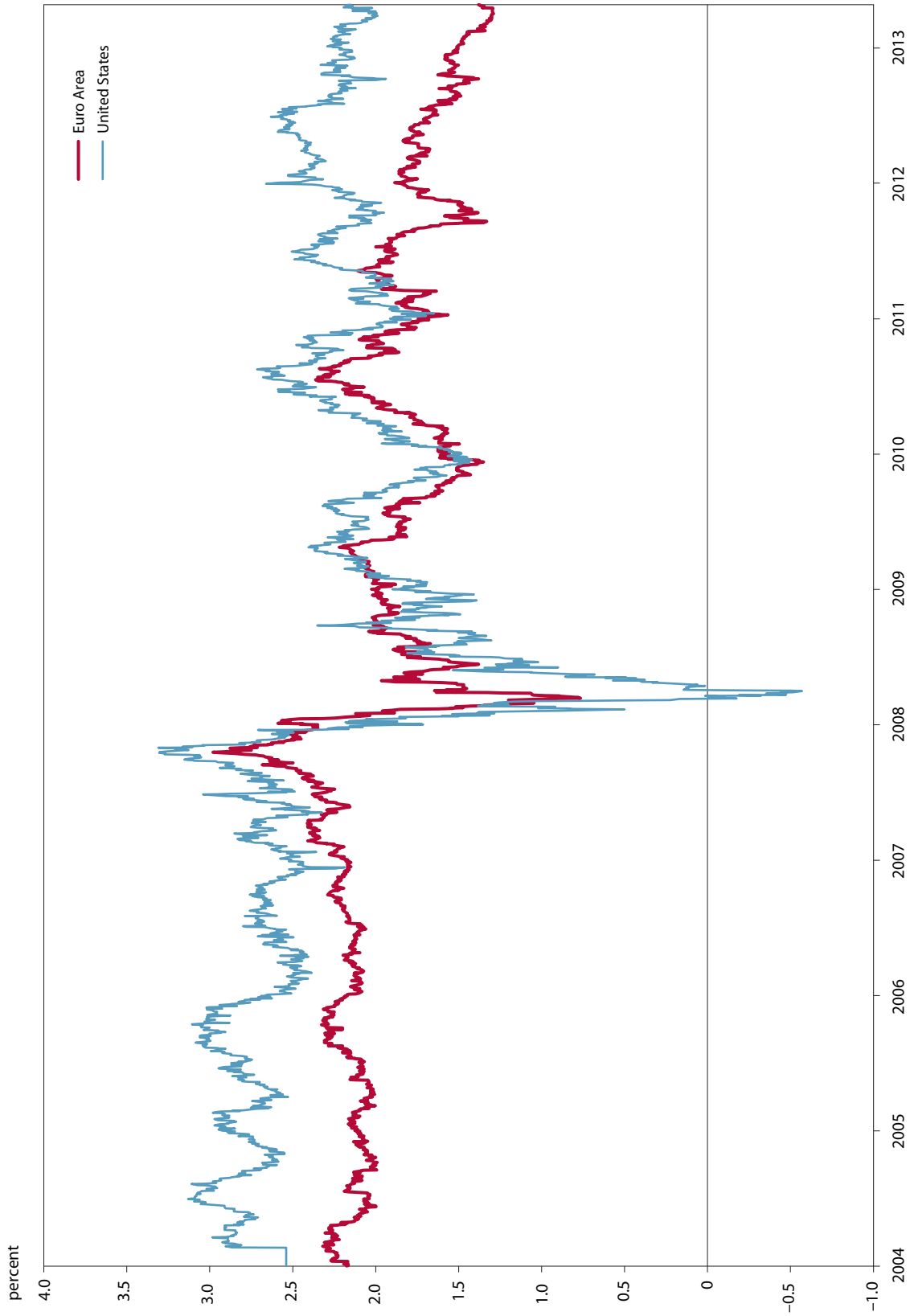
effective—the forward guidance and the rate cut merely offset the increase in money market rates generated by the increase in global interest rates and the euro area banks’ steady repayment of ECB liquidity loans. As a result 2-year interest rates have remained stable rather than declining. In addition, the euro has continued to appreciate, pushing the real effective exchange rate back to the levels of late 2011. In sum, combining the evolution of interest rates and the exchange rate, the stance of monetary policy has tightened in the last few months.

The tightness of the monetary policy stance is reflected in the downshift in inflation expectations. Figure 7 shows the evolution of 5-year inflation swaps (financial derivatives

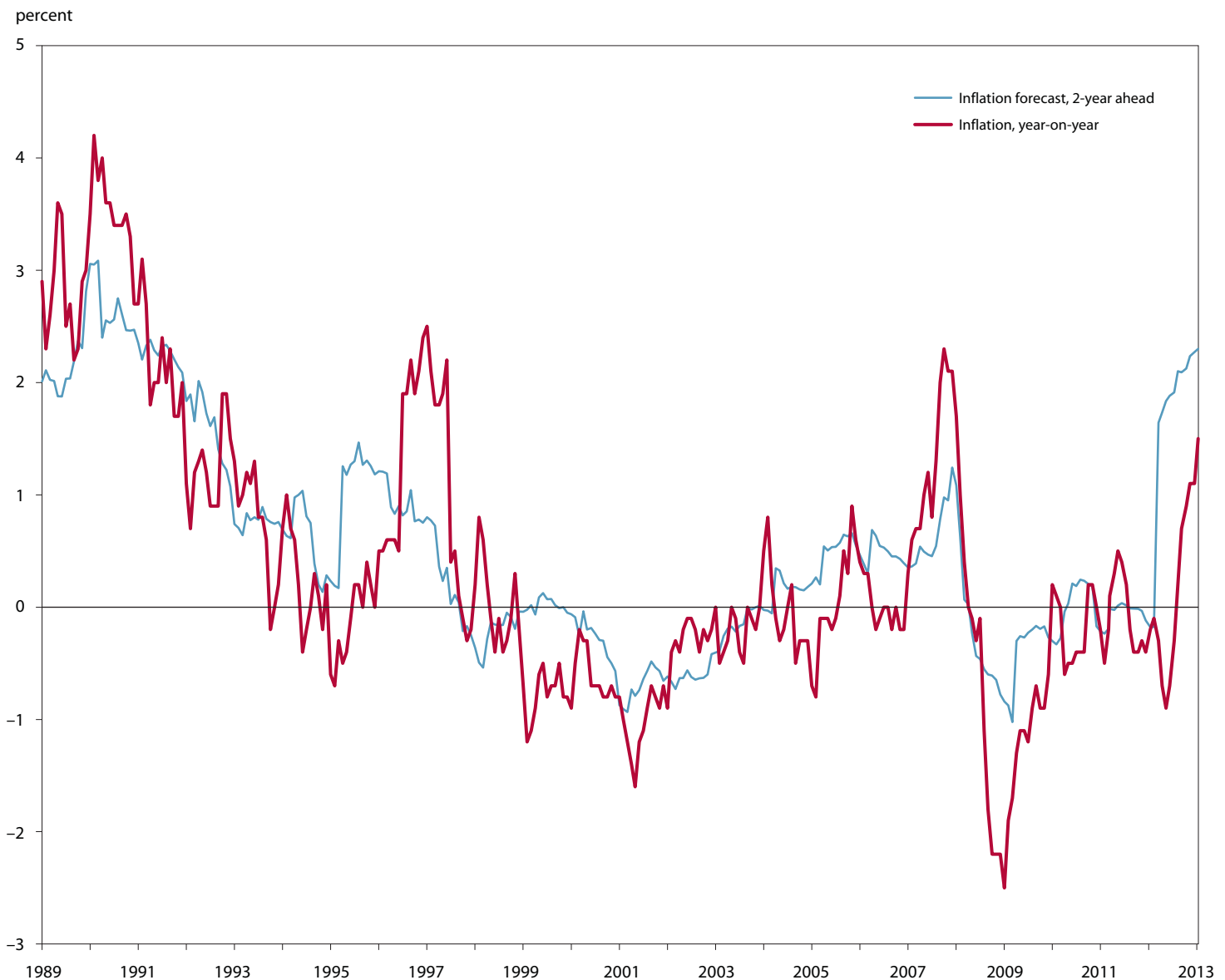
whose prices depend on average inflation over the subsequent 5 years). It shows that 5-year inflation swaps in the 2 to 2.25 percent range were compatible with the ECB meeting its price stability mandate during the precrisis period. This calculation seems realistic: If price stability implied an average inflation of around 1.8 percent, adding some positive term premium would yield 5-year expected inflation in the 2 to 2.25 percent range. However, since the crisis, inflation expectations have drifted to a lower level—the new range for 5-year inflation swaps seems to be 1.5 to 2 percent—and it is now at the bottom of that range.¹⁸

18. Note that inflation expectations have remained stable in the United States,

Figure 7 Five-year inflation breakevens, year-on-year, 2004–13



Source: Bloomberg.

Figure 8 Japan: Inflation expectations are adaptive (1989–2013)

Sources: Bloomberg and Consensus Economics.

Therefore, the market is forecasting average inflation in the euro area over the next five years in the 1.25 to 1.5 percent range, with a probability that inflation will be at or below 1 percent in five years' time at about 40 percent.¹⁹

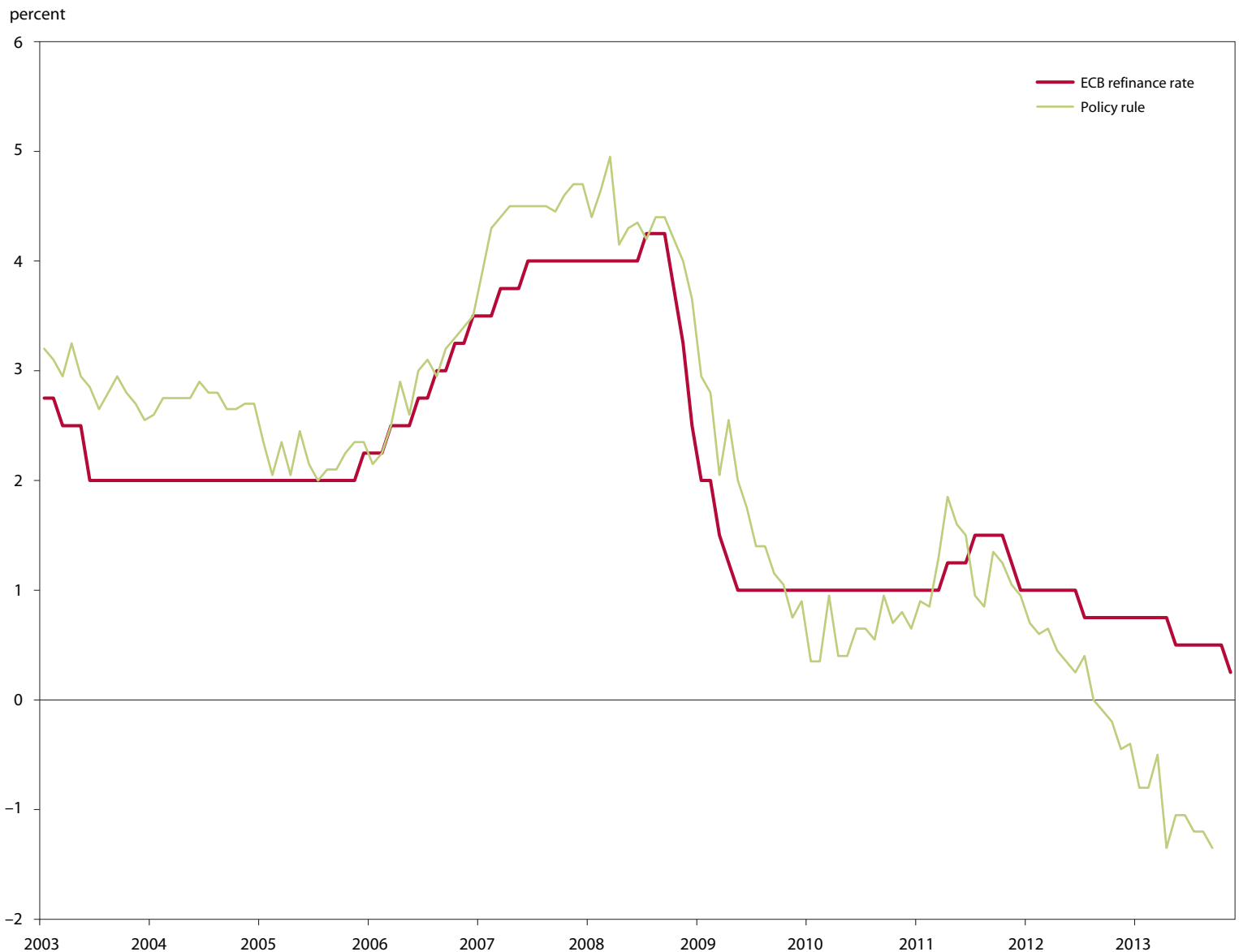
Despite this evidence, ECB officials argue that consensus medium-term inflation forecasts have remained stable and thus

despite the fact that the United States also currently has a very low inflation level, which makes clear that central banks do have the tools to stabilize expectations at the zero bound—they just need to use them.

19. See a discussion of the options implicit pricing in “Preserving a Safety Margin against Deflationary Risks,” Barclays Economic Research, November 22, 2013.

that inflation expectations are well anchored. The problem with this argument is that inflation expectations are always a mix of forward-looking and adaptive expectations, and even the ECB’s research shows that inflation forecasts are heavily influenced by past average inflation (ECB 2013). In fact, the experience in Japan shows that inflation forecasts were always lagging actual developments and reacted to actual inflation (as actual inflation was declining, 2-year-ahead inflation forecasts were declining as well, and the same happened to longer term inflation forecasts), especially when the BoJ was perceived as not doing enough (see figure 8). Therefore, the combination of low actual inflation plus lower market implicit inflation expectations suggest a

Figure 9 ECB refinance rate and policy rule, 2003–13



ECB = European Central Bank

Sources: Bloomberg and author's calculations.

strong risk that consensus inflation forecasts will steadily drift lower over time.

The tightness of the policy stance is also apparent by looking at a monetary policy rule. Figure 9 estimates the interest rate that the central bank should adopt, using the lagged policy rate, the deviation of core inflation from 2 percent, and an estimate of the unemployment gap as the measure of slack. This rule suggests that the current ECB interest rate is tight and that interest rates should be around -1.25 percent. Considering the

possibility that the neutral interest rate may have dropped in recent years, this policy rate estimate is likely to be an upper bound.

The persistent nature of inflation makes this overly tight policy stance very dangerous. The slope of the Phillips curve is very flat (ECB 2012, 2013)—in other words, a relatively large movement in the degree of slack is needed to significantly affect inflation. This is a welcome property during good times—it means that if inflation expectations are well anchored

around the target, all the central bank needs to do is respond to the deviations in the output gap and ensure that there are no second-round effects from wages. But this could become a problem during periods when inflation is too low and/or expectations become unhinged, as the needed response from the central bank becomes large.

The ECB has been alert to ensure that such a situation would not develop when the risks were to the upside. In fact, the ECB adopted a very hawkish rhetoric and even hiked rates in 2008 in the midst of the global financial crisis to ensure that

Current inflation is very low, inflation expectations have shifted lower, and wage growth has shifted lower as well, setting up a scenario of second-round effects to the downside—and yet the ECB is not reacting strongly against it....

the spike in headline inflation resulting from the acceleration in commodity prices would not generate second-round effects or lead to higher inflation expectations. Today we are observing a repetition of the same scenario but to the downside. Current inflation is very low, inflation expectations have shifted lower, and wage growth has shifted lower as well, setting up a scenario of second-round effects to the downside—and yet the ECB is not reacting strongly against it, highlighting the asymmetry in the ECB's strategy.

The flatness of the Phillips curve when inflation is too low presents two very important problems for the central bank: It must boost demand much more to achieve the same change in inflation, and it must do something to move inflation expectations higher. This highlights the risks of running too low an inflation rate for too long—were an unexpected negative shock to happen, it would push inflation in the euro area into negative territory, and the flatness of the Phillips curve would make it much more difficult for the ECB to restore price stability. This is exactly what happened to the BoJ during the last two decades. After the disinflation that followed the bubble burst in the late 1980s and early 1990s, rather than trying to achieve 2 percent inflation, the BoJ was content with achieving zero inflation. Then the 1997 crisis hit, and the negative shock sank Japan into deflation. Again, the same mistake was repeated. The BoJ adopted a policy strategy aimed only at restoring positive inflation rather than being more aggressive and trying to achieve 2 percent inflation. It had barely managed to achieve zero inflation when the 2007 crisis occurred, thus pushing Japan again

into deflation. The BoJ finally learned the lesson in 2013, and it is now aiming at 2 percent inflation in an aggressive way with its quantitative and qualitative easing strategy. A key part of this strategy is to push inflation expectations higher—in other words, increase the intercept of the Phillips curve, which declined steadily over the last two decades—so that they can achieve 2 percent inflation when the output gap is zero.²⁰

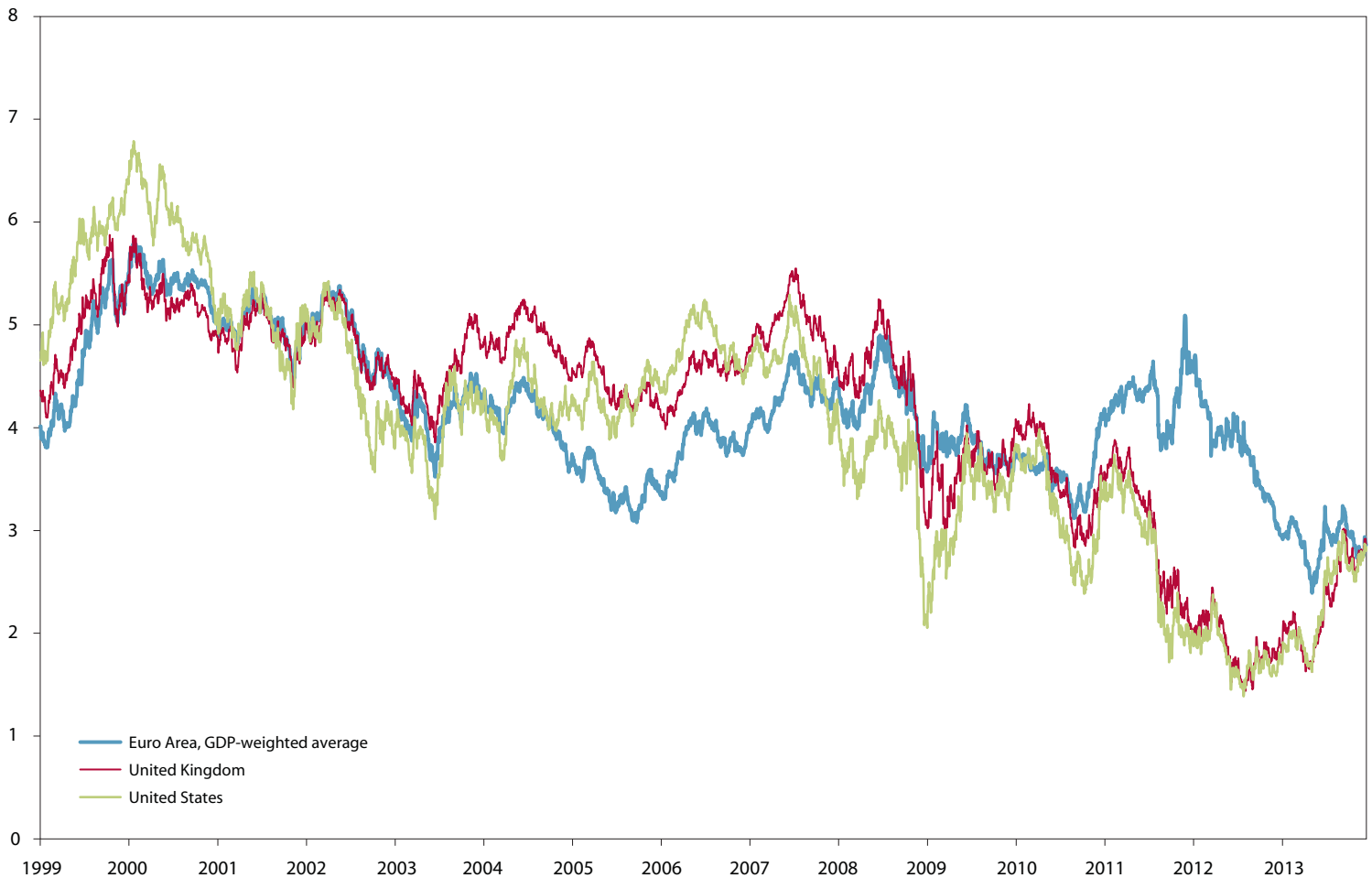
Some ECB officials have tried to justify the current ECB stance by arguing that a slower than usual return to the inflation target is warranted by the ongoing structural adjustments the euro area is undergoing.²¹ The opposite is in fact true. The flatness of the Phillips curve shows that in terms of inflation the cost of closing the output gap at a faster pace is very low—and lower than in the past—and this favorable inflation-unemployment trade-off should be exploited.²² Using optimal control simulations, Bill English, David Lopez Salido, and Robert Tetlock (2013) show that, in the current context of very low inflation, an easier policy setting (in the US case, keeping rates on hold for longer) that achieves a faster than usual return to the inflation target is welfare improving, unless there is a risk of creating financial market excesses. The ECB does not face that risk. On the contrary, asset prices in the euro area remain depressed, banks are still engaged in balance sheet repair and deleveraging, and risk aversion is high.

The benefits of a faster return to the inflation target are even higher when there are risks of hysteresis in the labor market (see Reifschneider, Wascher, and Wilcox 2013)—something quite likely in the euro area due to the sharp increase in long-term and youth unemployment. The ECB (2012) quantifies the potential extent of hysteresis effects, estimating that about 25 percent of the increase in the euro area unemployment rate would become permanent during the first year, and this effect increases more than proportionally during sharp downturns. It also shows, based on survey data, that about 50 percent of the increase in the unemployment rate becomes permanent as it becomes embedded in the 5-year-ahead unemployment forecast and thus becomes self-fulfilling—corporates become gloomier about the outlook and thus hire less, and workers become gloomier and detach themselves from the labor force and lower

20. A speech by BoJ Governor Kuroda explains this focus on the Phillips curve. Available at www.boj.or.jp/en/announcements/press/koen_2013/data/ko130920a1.pdf.

21. Interview with Benoit Coeure, member of the Executive Board of the ECB, January 15, 2014. Available at www.ecb.europa.eu/press/key/date/2014/html/sp140116.en.html.

22. The low inflation cost of a faster decline in unemployment is reinforced by the positive dynamics of the euro area labor supply—the sensitivity of labor force participation to the downturn has declined with respect to prior recessions, likely due to past pension reforms that have made it more attractive to remain in employment (ECB 2012).

Figure 10 Comparison of 10-year sovereign rate for the euro area, the United States, and the United Kingdom, 1999–2013

Note: Euro area countries included here are Austria, Belgium, France, Finland, Germany, Greece, Ireland, Italy, the Netherlands, Spain, and Portugal.

Source: Bloomberg.

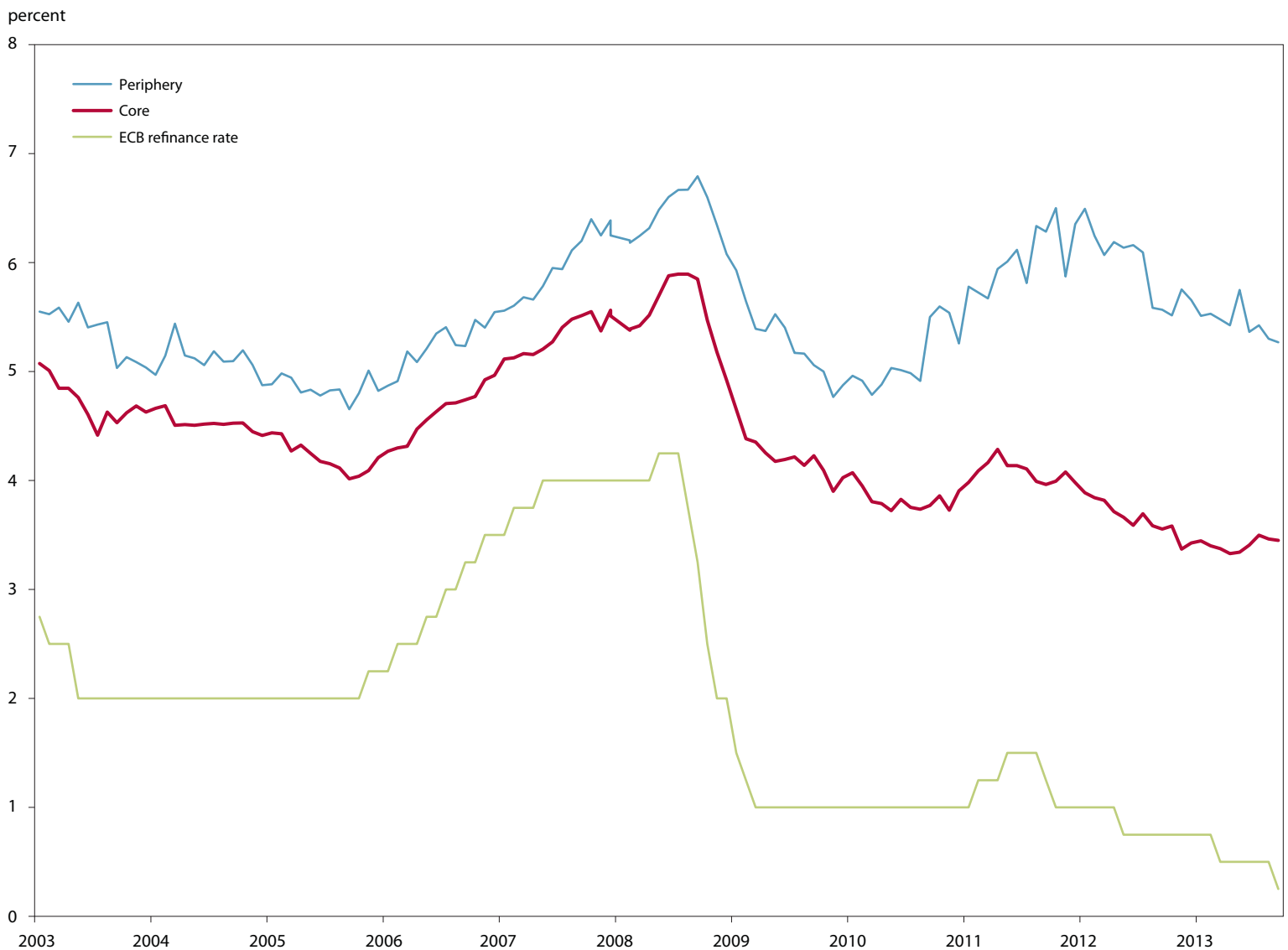
their search intensity. Combined with the decline in investment caused in part by the tightness of financial conditions, these hysteresis effects lower potential growth. Aggressive monetary policy easing can be a useful complement to structural reforms in order to reverse some of this decline.²³

It is striking that euro area 10-year rates (a weighted average of the 10-year rates of the different euro area countries) are at the same level as those in the United States and the United Kingdom (see figure 10), even though the US cycle—in its fifth year of recovery and with the level of GDP above the previous peak—is much more advanced, and UK growth is much more robust and inflation higher. This high level of euro area long-

term rates is happening because euro area money markets are fragmented. Although the ECB cut rates to 0.25 percent, euro area periphery interest rates remain very high—Italy and Spain still face 10-year rates near 4 percent—which also translate into much higher private lending rates (see figure 11).²⁴ This fragmentation of euro area monetary policy affects SMEs disproportionately. Interest rates charged for small loans are higher than those charged for large loans, and ECB surveys show that lending conditions, which are tighter than elsewhere, are much worse for SMEs than for large companies.

23. This is not questioning the need for reforms—rather, both reforms and demand stimulus are needed to prevent a decline in potential growth. The discussion in the euro area typically overlooks the demand element.

24. Research at the European Commission (EC 2013) and the IMF (Al-Eyd and Berkmen 2013) shows that funding costs, credit risk (both influenced by sovereign spreads), and leverage have become important determinants of lending rates in the euro area periphery.

Figure 11 Euro area corporate lending rates, 2003–13

Source: European Central Bank.

Not only are euro area long-term rates too high from a cyclical perspective, they are too high from a debt sustainability perspective. High levels of public debt make it critical for monetary policy to ensure that the growth rate stays above interest rates to avoid a worsening of the debt sustainability outlook regardless of the fiscal consolidation efforts.²⁵ This has been true for the United States, the United Kingdom, and Japan, but not for the euro area—it has been true for Germany, though, contributing to its better fiscal performance. The recent

25. The evolution of the debt-to-GDP ratio depends on both the primary balance and the spread between the growth rate of the economy and the interest rate paid on the debt.

increases in debt-to-GDP ratios in the euro area periphery, despite strong deficit reductions, reflect this necessity.²⁶

WHAT SHOULD THE ECB DO?

The analysis above leads to the conclusion that policy easing must therefore both raise inflation expectations and boost growth to close the output gap and boost inflation faster, and it needs to affect both sovereign rates and the transmission of sovereign rates into private lending rates. There is a constellation

26. The IMF report on the 2012 Article IV (IMF 2013b) consultation for Italy makes clear that the increase in the debt-to-GDP ratio is mostly due to weaker than expected growth.

of policy actions that would address these issues—all of which are versions of tools already implemented by other central banks and thus far from revolutionary.

First, the ECB should update the definition of price stability as inflation at 2 percent over 2 to 3 years. This would eliminate the ambiguity over the inflation objective and make clear that the ECB cares equally about upside and downside deviations from the 2 percent target. This stronger commitment would enhance the forward guidance on interest rates, help boost inflation expectations, and reduce real interest rates. It would also shield the ECB from the current focus on German domestic needs that exert a deflationary impact on the euro area as a whole.²⁷

...[T]he ECB should update the definition of price stability as inflation at 2 percent over 2 to 3 years.

Second, the ECB should act forcefully to reduce risk premia in the yield curve via a program of QE, or bond purchases. The steepness of the euro area yield curve is excessive, and the ECB could successfully ease financial conditions by removing duration from the markets—essentially announcing a program of purchases of a GDP-weighted basket of sovereign bonds.²⁸ To avoid confusion and make clear that this is a monetary policy operation and thus legal under the Maastricht Treaty, such a step should be clearly separated from the ECB's program of Outright Monetary Transactions (OMT) program. The OMT program was a crisis management tool that should be kept in case of future crises; by contrast, a QE program would be a standard monetary policy action. Such a QE program should be established in an open-ended fashion, similar to the US Federal Reserve and BoJ programs, where the ECB commits to buying

27. The ECB has been the only major central that has not updated its framework during the crisis. Both the US Federal Reserve and the BoJ have issued statements in this regard, and the UK Treasury modified the remit of the BoE. In all cases, the modifications have been towards enhancing the ability of the central bank to support the recovery and, if necessary, tolerating a higher level of inflation for some time. See Federal Reserve press release "Federal Reserve issues FOMC statement of longer-run goals and policy strategy," January 25, 2012 (available at www.federalreserve.gov/newsevents/press/monetary/20120125c.htm); Bank of Japan "Price Stability Target" of 2 Percent and "Quantitative and Qualitative Monetary Easing," 2013 (available at www.boj.or.jp/en/mopo/outline/qqe.html); and UK Treasury "Remit for the Monetary Policy Committee," March 20, 2013 (available at www.bankofengland.co.uk/monetarypolicy/Documents/pdf/chancellorletter130320r.pdf).

28. This is a superior alternative to cutting the deposit rate to negative levels, as it avoids potential market functioning problems while potentially exerting a similar downward pressure on the exchange rate.

a monthly amount of assets until price stability is restored. Such a QE program will reduce long-term rates in a manner proportional to the existing risk premium, reduce private lending rates, and ease funding constraints for the ailing euro area banking sector.²⁹

Third, the ECB should ease the quantitative credit shortages to SMEs via a well-designed lending program, offering long-term funds at the policy rate to banks who lend to SMEs—say up to five years, so that it finances investment, not just working capital, and also serves to lower rates at the front end of the yield curve. To enhance participation, some credit risk should be absorbed via lower haircuts and/or some first-loss insurance from the European Stability Mechanism (ESM) and/or the European Investment Bank. This would be a very effective way of employing fiscal resources and tackle the quantity credit restrictions that are hampering investment growth. Other central banks have successfully implemented similarly targeted programs in the past—the Federal Reserve's Term Asset Backed Loan Facility (TALF) for the housing market, the BoJ's program for lending for "productive activities," and the BoE's "Funding for Lending" scheme.

These three actions, combined with a clear message that the ECB stands ready to do whatever it takes to achieve its price stability mandate, would suppress the current cacophony of messages that cast doubt about the ECB's convictions. The forthcoming publication of the minutes of the ECB Governing Council meetings, if they contain a detailed explanation of the reasons driving the ECB decisions, should contribute to improving the messaging.

A legitimate question arises: If the case is so overwhelming, why isn't the ECB easing further? Yves Mersch, ECB Executive Board member, says it clearly in a recent speech: In his view, all the available options present problems. He discussed the option of quantitative easing but dismissed it, arguing that it presents "immense economic, legal and political problems."³⁰ It is difficult to understand the economic problems—there is plenty of research on the QE operations undertaken by the Federal Reserve, the BoE, and the BOJ showing that QE is effective in reducing term premia, lowering interest rates, and eliminating tail risks (see the in-depth review in IMF 2013), showing that the cumulative effect of bond purchasing programs has reduced long-term rates between 90 and 200 basis points and has boosted GDP growth about 2 percentage points. The legal problems are

29. The concern among some ECB members that a QE program would lower the incentives of the banking sector to restructure and recapitalize should be over by now, as the date of the assessment of balance sheets for the Asset Quality Review, December 31, 2013, is now past.

30. Speech by Yves Mersch, Member of the Executive Board of the ECB, Frankfurt December 9, 2013. Available at www.ecb.europa.eu/press/key/date/2013/html/sp131209.en.html.

also difficult to understand: It is well known that the ECB can buy government bonds in the secondary market in the course of the implementation of monetary policy (the BoE is subject to the same Treaty restrictions and yet has implemented several rounds of QE). In fact, in a recent letter written by several German economists opposing the OMT program, they implicitly admit that QE would be perfectly legal: “While a purchase of bonds in secondary markets is permitted, it must serve monetary policy goals...”³¹ It is therefore the “political” concerns that seem to be stopping the ECB from aggressively easing policy and meeting its price stability mandate. The uproar in Germany following the recent interest rate cut, claiming that it hurt German savers, is a clear example.³² The fact that a member of the ECB Executive Board cites political problems as a reason not to ease is a clear example of the increased politicization and diminished independence of the ECB and the disinflationary pressure that this generates.

Delivering these proposed easing actions as a package would have a very positive impact, as the measures are complementary. The ECB’s bank lending survey makes clear that concerns about the inflation outlook are as important for the tightening of lending standards to enterprises as the higher cost of capital or the risk on collateral demand (ECB 2013b). If this easing creates a problem in a specific area, such as German housing, macroprudential tools should be used to offset it, as has become the norm in many countries. For example, during the first decade of the euro, Spain had to put countercyclical provisioning in place, because ECB policy rates—set mostly to accommodate the German post-unification adjustment—were too low for Spain. The ECB (2013) suggests that, during that decade, the tightening of monetary policy had little impact on bank lending in countries experiencing housing and lending booms, such as Spain (Roberto A. De Santis and Paolo Surico

[2013]). In the words of the ECB paper, “the limited impact of interest rates on bank lending in Spain suggests that in a monetary union country-specific excessive growth of credit should be counteracted with instruments that limit the fall in lending standards during boom times.” Therefore, the mild increase in house price inflation in Germany³³ should not become an impediment to further monetary easing in the euro area.

CONCLUSION: THE ASYMMETRY OF MONETARY POLICY MUST BE CORRECTED

Inflation in the euro area is too low, and the ECB is at risk of missing its price stability mandate.³⁴ The ECB must show that it has a symmetric approach to price stability and that it is ready to act forcefully to push inflation higher towards the target. The package of actions outlined here would restore price stability and generate an environment conducive to sustainable growth. These measures are not revolutionary, by any means; they will just put the ECB on par with other central banks. The ECB’s strategy of LTROs (long-term repurchasing operations, the provision of long-term liquidity on demand to the banking sector to ensure that no bank will fail due to funding problems) is no longer adequate. In the current environment banks do not want more unconditional liquidity, especially as they are being punished for it in the AQR exercise. The feature of the LTROs that the ECB used to highlight—that they are self-absorbing and thus pose no upside inflation risk—has now become their major drawback, as the stigma associated with participating in the LTROs has led to an endogenous tightening of financial conditions at the wrong time. The LTROs have been “passive easing” (liquidity on demand to offset increases in market interest rates due to solvency concerns), and the ECB needs to shift now into “active easing” (reducing risk premia via asset purchases).

One lesson we can extract from the crisis is that the fear that QE will generate runaway inflation has no basis when implemented during a period of very large output gaps.³⁵ If anything, the lesson is that central banks become too timid

31. This quote from the letter that 136 German professors of economics published last year, criticizing the ECB’s OMT program, makes it very clear: “We—136 German professors of economics—consider the European Central Bank’s program to buy government bonds unlawful and economically amiss. Article 123 Treaty of Lisbon forbids the ECB the direct ‘purchase of debt instruments’ from governments of Member States. The article clarifies that monetary finance of governments is inadmissible. *While a purchase of bonds in secondary markets is permitted, it must serve monetary policy goals* (e.g. short-run money market balance) not government finance. *If monetary policy were its focus, the ECB would buy the representative bond portfolio, including sovereign or private debt from all member states* [author’s emphasis]. But this is not the policy. Instead the ECB concentrates on buying the bonds of over-indebted member states. This is money finance of governments.” (*Wall Street Journal* Real Time Economics blog, “Economists Call ECB’s Bond Buying Plan Unlawful,” September 11, 2013. Available at blogs.wsj.com/economics/2013/09/11/economists-call-ecbs-bond-buying-plan-unlawful/.)

32. “Near zero: ECB Interest Rate Cuts Hit Savings Hard,” *Der Spiegel*, November 20, 2013. Available at www.spiegel.de/international/business/germans-worried-as-low-ecb-interest-rates-hit-savings-a-934240.html.

33. This increase should be welcome, as house prices in Germany remain clearly undervalued, both against income and against rents. See “Global House Prices,” *Economist*, January 2, 2014. Available at www.economist.com/blogs/dailychart/2011/11/global-house-prices.

34. This should not be confused with the risk of a deflationary spiral, which is likely absent in the euro area, especially if the AQR is executed properly. But this does not liberate the ECB from addressing downside risks to price stability.

35. “Volcker Says Quantitative Easing May Create Inflation in the Future,” *Bloomberg*, November 2, 2010. Available at www.bloomberg.com/news/2010-11-02/fed-s-quantitative-easing-program-may-create-inflation-surge-volcker-says.html.

when they reach the zero bound and have to try new tools, and they do not ease enough for fear of unintended consequences. The worry about the costs of QE has become a major impediment to the adoption of optimal policy settings, creating an implicit asymmetry: Central banks are strongly convinced they can tame high inflation but doubt their ability to lift inflation that is too low.

With QE induced inflation fears proven wrong, now would be the time to aim for an inflation rate higher than 2 percent.

There are a few consequences from this asymmetry. First, there is a need to strengthen the institutional setting of central banks so that they can operate more effectively at the zero bound. Capital levels must be raised (either de facto or in a forward-looking manner by setting up automatic recapitalization schemes via an accord) to remove concern about the political fallout if losses are incurred as a result of monetary policy actions.³⁶ Second, central banks must be more explicit about their reaction functions to protect themselves from political pressures—the current vogue of forward guidance goes in that direction. Transparency is the best shield against political pressure, and forward guidance is a way to enhance independence when at the zero bound.

Finally, a strong case can be made for aiming for somewhat higher rates of inflation—say 3 percent rather than 2 percent—in the steady state (a similar idea was first proposed by Olivier Blanchard, Paolo Mauro and Giovannie Dell’Arricia [2010]). The debate in the late 1990s that set the current consensus of 2 percent inflation targets was anchored in the experience of the Great Moderation—the period of steady growth and stable inflation in the 1990s and early 2000s. Econometric exercises suggested that 2 percent inflation provided enough cushion against deflation. But these exercises were calibrated on the available history, which contained only mild recessions. This is why the recession triggered by the recent crisis was thought “impossible” based on the simulations generated with models fed with data up to 2007. A higher level of steady state inflation would provide a more adequate cushion against larger shocks.

36. We believe that central banks, in theory, do not need capital to operate. But in practice they behave as if they want to avoid near-term losses for fear of political costs, as witnessed by the US debate over the cost of QE. Thus the call for a bigger capital cushion to avoid political costs is a self-imposed restraint.

With QE induced inflation fears proven wrong, now would be the time to aim for an inflation rate higher than 2 percent.

The ECB is, by statute, the most independent central bank in the world. But over the last few years it has reached into areas that have put this independence at risk, focusing too much on influencing economic policies in specific euro area countries and putting too much weight on the specific political concerns of Germany. This was partly driven by the fact that the ECB was the only European institution that had a strong balance sheet that could be deployed quickly at a time of an existential crisis and thus led the ECB to perform a role that went beyond that of central banking (this is best shown by the ECB’s questionable decision to become a part of the troika—the European Union, the ECB, and the IMF). But recall that the primary mandate of the ECB is price stability, and fostering the general policies of the euro area comes only second to price stability. The acute phase of the crisis is over, and it is time for the ECB to return to its roots and become only a central bank in pursuit of its price stability mandate.

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