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The ECB has reached its political limits. Its consequences in eight charts

Ashoka Mody 11 February 2019

In this post, Ashoka Mody documents the costs of ECB timidity, which, he argues, arises from the political limits on its actions.

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Hélène Rey, a professor at London Business School, argues that the US Federal Reserve determines global monetary policy [5]. The Fed determines the interest rate for the use of the world's most dominant currency, the US dollar. Fed policy decisions, therefore, trigger the 'global financial cycle', which causes global capital to slosh around the world, placing severe constraints on national monetary policies.

Some, however, insist that all central banks are equally effective (or ineffective). Claudio Borio of the Bank of International Settlements contends that central bank policies are powerless to move inflation rates [6]. International competition keeps global inflation low, and central banks, in a misguided effort to prevent deflation, reduce interest rates to very low levels. Central banks thus encourage speculative investments, which eventually trigger financial crises. Raghuram Rajan, the University of Chicago economist, falls in this camp. [7]

Others believe the opposite, tarring all central banks of unwarranted timidity after the onset of the global financial crisis. Such critics claim that all central banks "failed even to lift inflation to their target [8]" because they did not use their full stimulus capacity.

Rey is correct that the Fed is the world's powerful central bank, but this is so not only for the reason she emphasises. The Fed is also the world's most credible central bank, which makes it hugely influential domestically and not just internationally. The Fed did raise the US inflation rate to its 2% target. Early and aggressive Fed actions helped propel the US economy to a quicker recovery; that same boldness prevented inflation expectations from falling. In contrast, the Bank of Japan (BOJ) and the ECB, having allowed inflation rates to fall too low, proved unable to lift them back again.

Commentators do sometimes exclude the BOJ from equivalence with other central banks, presumably because it has failed, despite massive efforts, to pull inflation out of the doldrums. Many, most prominently Paul Krugman [9], have told the story of the BOJ's past timidity, which caused investors and consumers to lose faith that the BOJ will continue its stimulative policies.

Expressing that perspective, Mohamed El-Erian, chief economic advisor of Allianz, recently described the Fed and the ECB [10] as "the two most systemically important central banks." But is the clubbing of the Fed and the ECB appropriate? In this post, I document the costs of ECB timidity, which, I argue, arises from the political limits on its actions and which renders the ECB, by at least one metric, even less effective than the BOJ.

The ECB's delay in quantitative easing

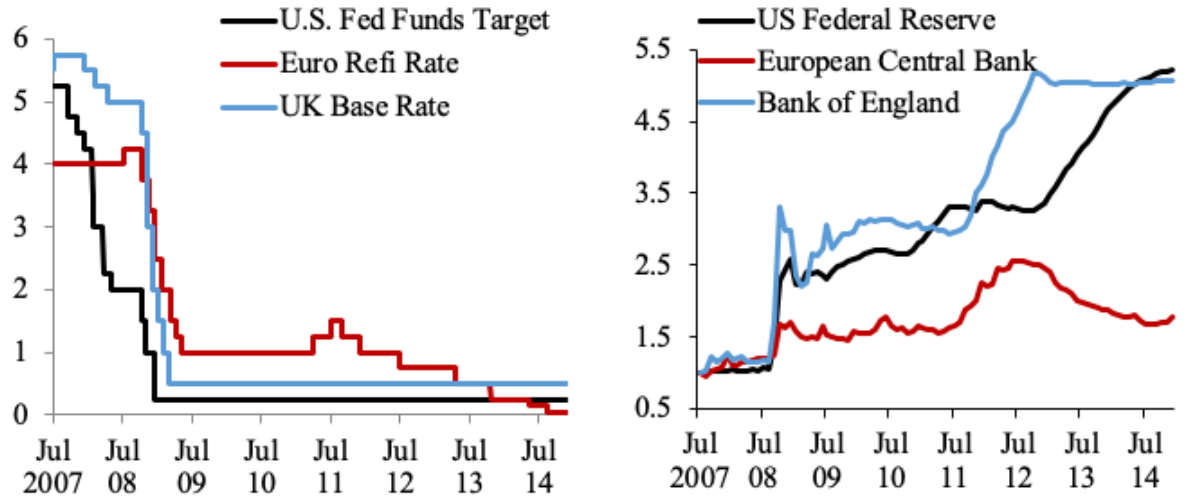
The ECB is intensely averse to inflation but is more tolerant of deflationary tendencies. This asymmetric predisposition is not the result of its mandate of achieving price stability. The ECB has chosen to interpret this mandate asymmetrically. It has focused on keeping inflation below 2% but has downplayed the goal of maintaining inflation close to 2%.

In periods of inflationary pressure, ideological commitment to 'price stability' causes the ECB to maintain tight monetary policy. The ideology was manifest between 2001 and 2003. Although the pace of economic deceleration and inflation rates were similar on both sides of the Atlantic, the ECB lowered its interest rates only slowly and grudgingly while the Fed drastically cut rates. The ECB paid greater heed to inflation than to the economic slowdown. When national leaders badgered ECB president Wim Duisenberg to ease monetary policy, he famously responded, "I hear but I do not listen." Similarly, after the start of the global financial crisis, the ECB's first action was to raise its interest rate in July 2008; more seriously, the ECB raised rates in April and July 2011, setting off financial panic and pushing the euro area into prolonged recessionary conditions. In each of these cases, the ECB was fighting the threat of a phantom inflation, not recognising that the ongoing economic slowdown would moderate inflation.

The ideological unity in raising the interest rate was such that even Mario Draghi, often viewed as more balanced than his zealous colleagues on the ECB's Governing Council, publicly defended the rationale for the egregious July 2011 rate hike, both before [11] and after [12] the decision.

While ideology unified the Governing Council in the fight against inflation, divergence of national interests held it back in countering deflation. The divergent interests became evident towards the end of 2012. In the US, where the inflation rate was much the same as in the eurozone, the Fed under Chairman Ben Bernanke stepped up bond purchases under its QE programs (Figure 1).

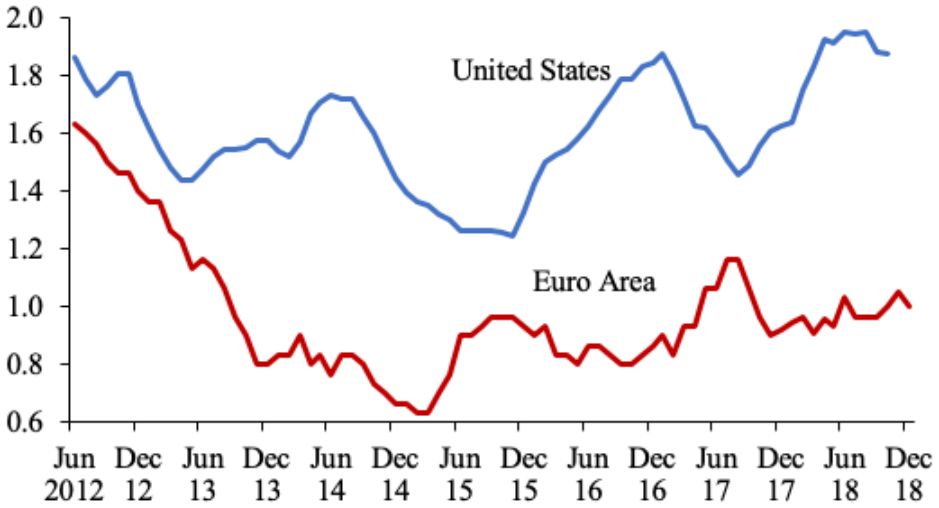
Figure 1 The ECB was tardy in fighting deflationary tendencies
(Policy rates, left, percent; central banks' assets, right, ratio relative to the level of assets in July 2007)



Sources: Left panel - Federal Reserve Bank of New York, "Federal Funds Data Historical Search"; European Central Bank, "Main Refinancing Operations," fixed-rate tenders; Bank of England, https://www.bankofengland.co.uk/boeapps/database/Bank-Rate.asp [13]; Right panel - Federal Reserve Bank of St. Louis, codes ECBASSETS for the ECB, WALCL for the U.S. Fed. UKASSETS and code RPQB75A of the Bank of England for BoE.

By thus helping to bring down long-term interest rates, the Fed sought to induce greater spending and thereby prevent a recession and deflation. In contrast, the ECB stood virtually still. The euro area's inflation rate began to fall steadily below the US inflation rate (Figure 2).

Figure 2 Euro area inflation rate began dropping in mid-2013, inflicting the lowflation wound
(Three-month moving average of "core" annual inflation rates, percent)



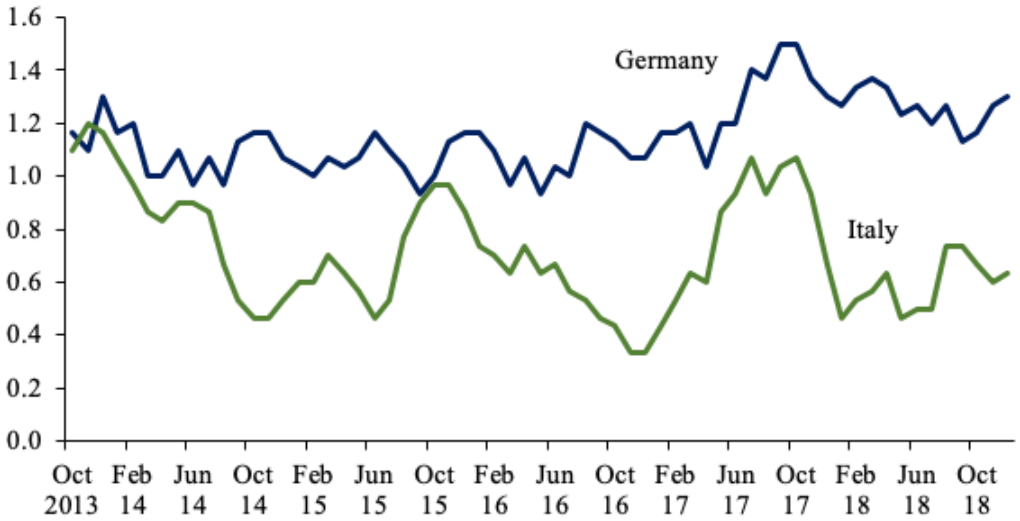
Sources: Eurostat: "HICP—All Items Excluding Energy and Food"; St. Louis Fed, FRED: "Personal Consumption Expenditures Excluding Food and Energy (Chain-Type Price Index)."
Note: December 2018 value for the Euro Area is an estimate.

ECB leadership initially dismissed the decline in the eurozone inflation rate as temporary. In place of a major QE initiative, Draghi offered cheap talk. In November 2013, he said that the ECB had "a whole range of instruments [14]," which it would deploy "if needed." In April 2014, he did acknowledge that ECB projections of a rise in inflation had proved incorrect "a few times [15]." He insisted, however, that the ECB would respond only if inflation remained low for "too prolonged" a period. Such deliberately vague phraseology was an unmistakable—and therefore unsuccessful – attempt to camouflage the tensions within the Governing Council. Northern member states, with Bundesbank president Jens Weidman in the lead, publicly opposed QE.

The consequences of delayed QE

The ECB finally initiated QE in January 2015, but only after lowflation – persistently low inflation rates – had set in. But not only was the euro area's average inflation rate stuck at near 1%, a troubling divergence in inflation rates was manifest. The inflation rate in Germany was well above 1%, while in Italy it was well below 1% (Figure 3). This was predictable. Monetary policy was particularly tight for Italy, the weaker economy. That pushed the Italian inflation rate down, which kept the Italian real interest rate (the interest rate adjusted for inflation) much higher than Germany's. Thus, tight monetary policy reinforced economic divergence within the euro area.

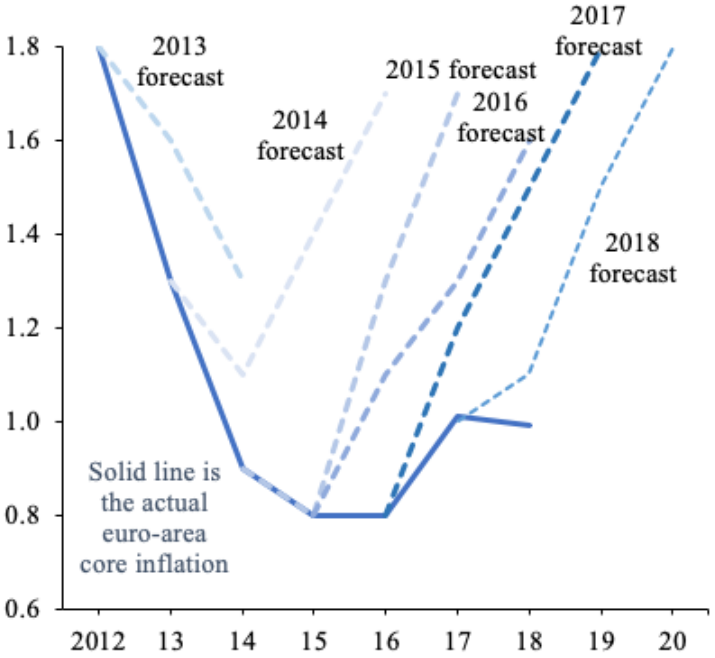
Figure 3 The euro area problem: a single monetary policy causes inflation divergence and Italy's lowflation problem
(Annual core inflation, three-month moving average, percent)



Source: Eurostat. Notes: Core inflation is the annual percentage change in the Harmonized Index of Consumer Prices excluding energy, food, alcohol, and tobacco. December 2018 figures are Eurostat estimates.

The ECB continued to forecast that inflation would rise, but average inflation refused to budge (Figure 4).

Figure 4 The ECB kept forecasting a rise in euro area inflation, but inflation remained stubbornly low

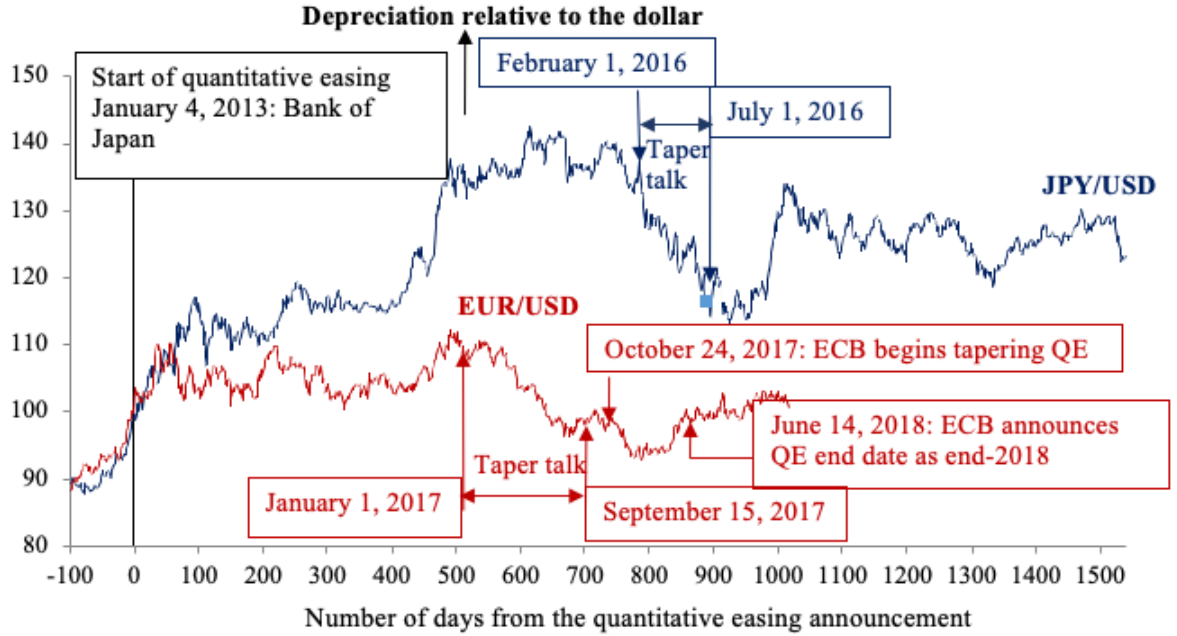


Sources: ECB's Macroeconomic Projections made in March of the year. https://www.ecb.europa.eu/pub/projections/html/index.en.html [16].
Note: 2018 core inflation is the average of months January to December 2018. December 2018 is a Eurostat estimate.

The ECB also remained unable to deliver a significantly weaker exchange rate to help boost growth and inflation. Normally, a QE-led decline in interest rates should cause the currency value to depreciate. Figure 5 aligns at time "0" the QEs initiated by the BOJ and the ECB. The yen depreciated substantially and remained weaker than at the BOJ's QE starting point. The euro did depreciate in anticipation to the ECB's QE, but at least some part of this was due to the Fed's QE withdrawal in the final months of 2014. After the ECB began QE, the euro depreciated only briefly and then slowly reverted to its starting level. Thus, overall, the euro barely depreciated against the dollar.

The lack of euro depreciation against the dollar was due to the ECB's threat as early as January 2017 that it planned to slow down its pace of bond purchases. In October 2017, Draghi delivered partially on that threat. He announced that, starting in January 2018, the ECB would halve its monthly purchases to €30 billion. Markets, therefore, had good reason to believe that the ECB would withdraw QE early, which kept the exchange rate buoyed in anticipation of the program's end.

Figure 5 The ECB, even more than the Bank of Japan, lacked commitment to bond purchases



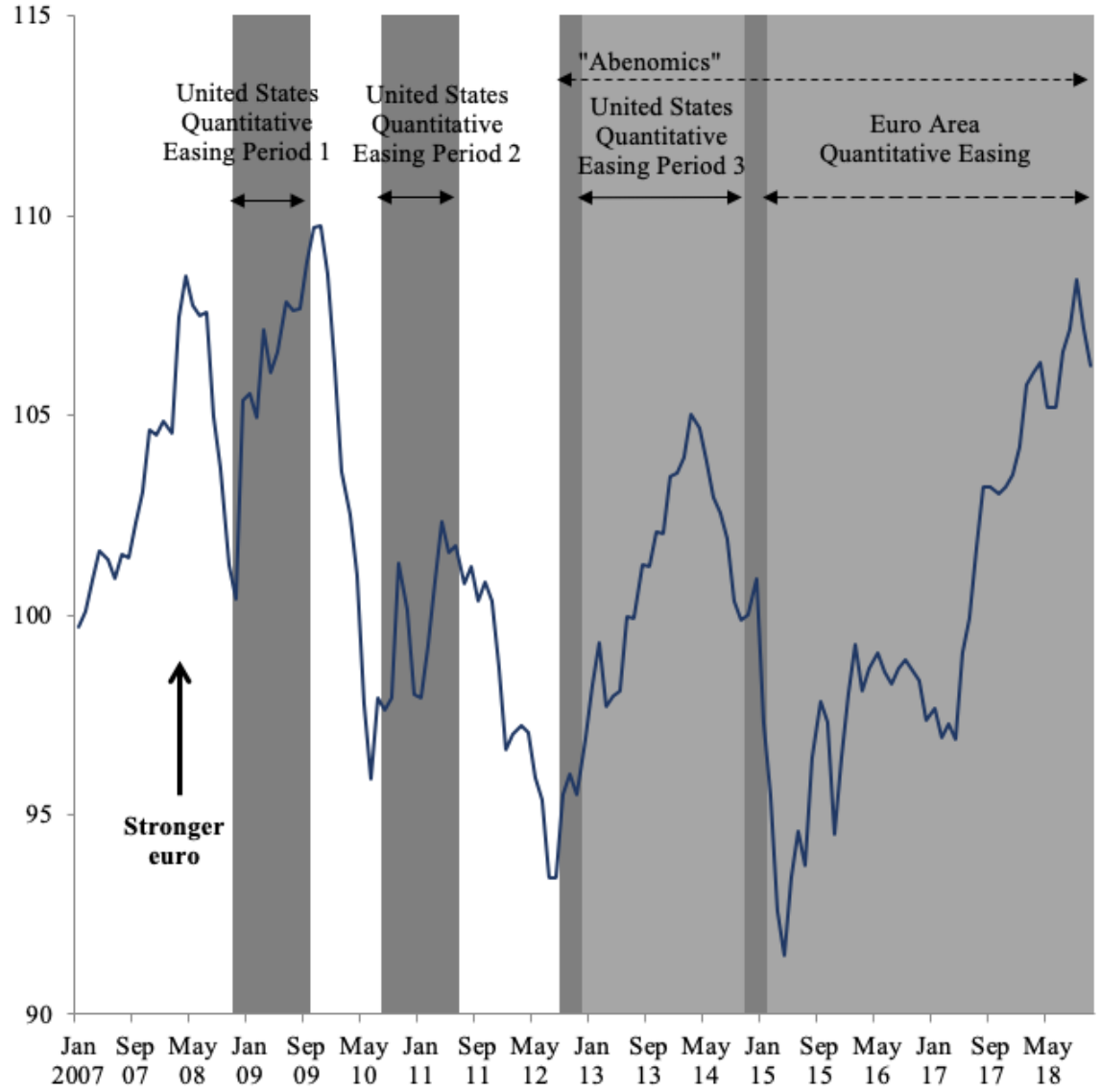
Note: Exchange rate for JPY/USD equals 100 on January 4, 2013 (date of the announcement of QE by the Bank of Japan) and exchange rate for EUR/USD equals 100 on January 22, 2015 (date of the announcement of QE by the ECB).
Source: For USD and Japanese yen, https://www.investing.com/currencies [17]; for USD and Euro rates, ECB, https://sdw.ecb.europa.eu/quickview.do?SERIES_KEY=120.EXR.D.USD.EUR.SP00.A&periodSortOrder=ASC [18].

In June 2018, Draghi announced that the ECB was ready to wind QE down. The Governing Council, he declared [19], had "concluded that progress towards a sustained adjustment in inflation has been substantial so far". This was a startling declaration. The core inflation rate was about 1 percent, where it has been for nearly three years. By September, the euro area's growth slowdown had become manifest, and the ECB revised its growth

forecasts down a tick. But Draghi continued to insist [20] that the outlook for growth and inflation remained favourable. At his December press conference, when announcing the end of QE, Draghi presented [21] a bright economic assessment. “The underlying strength of domestic demand,” he said, “continues to underpin the euro area expansion and gradually rising inflation pressures. This supports our confidence that the sustained convergence of inflation to our aim will proceed and will be maintained even after the end of our net asset purchases.” The assessment was disturbingly at odds with the data – with Germany and Italy in near-recessionary condition.

Given this pattern of denials, delays, and half measures, it is not surprising that the ECB’s actions failed to move the euro’s exchange rate against the US dollar. In this manner, the eurozone failed to gain the one benefit of QE that both the US and Japan had received (Figure 6). Indeed, since the dollar appreciated against other currencies starting in early 2015 as the Fed began a gradual withdrawal of its QE bond purchases, the trade-weighted effective euro exchange rate perversely appreciated after the introduction of the ECB’s QE. Little wonder, then, that the ECB’s QE did little for growth.

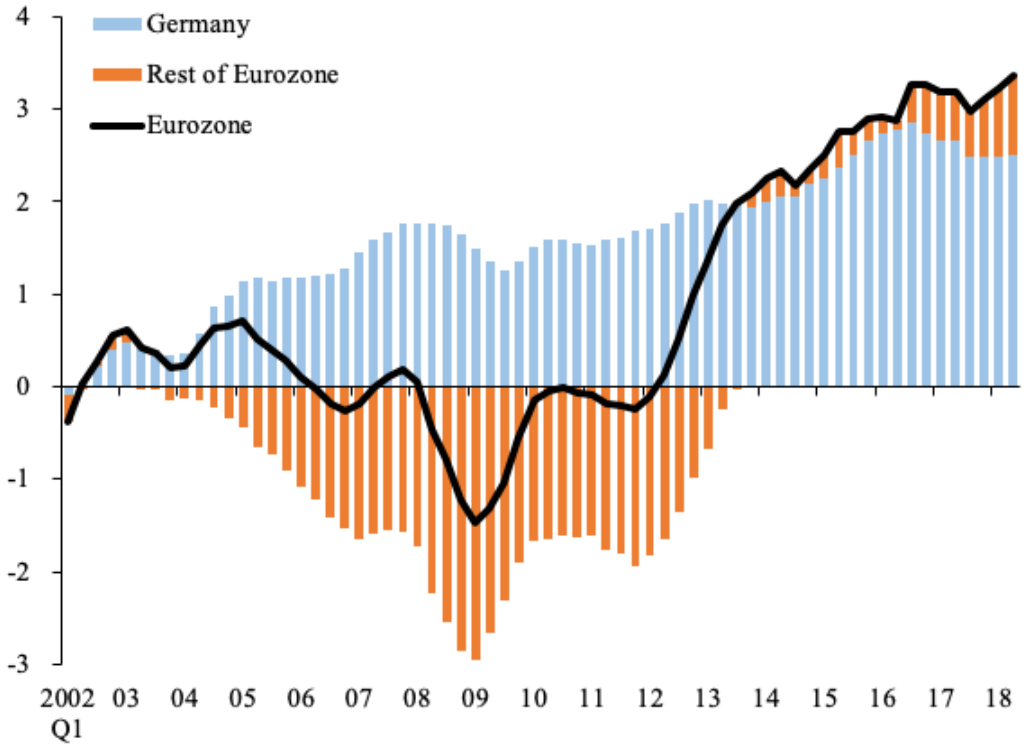
Figure 6 US and Japanese quantitative easing caused the euro to strengthen, as the ECB waited and lost credibility
(euro nominal effective exchange rate, index 2010 = 100)



Sources: Bank for International Settlements, "Effective exchange rate indices, Narrow indices, Nominal"; Board of Governors of the Federal Reserve System press releases November 25, 2008, September 23, 2009, August 10, 2010, June 22, 2011, September 13, 2012, September 17, 2014; Ben Bernanke, 2013, "The Economic Outlook," testimony before the Joint Economic Committee, US Congress, Washington, D.C., May 22; Shinzo Abe, 2013, "Press Conference by Prime Minister Shinzo Abe," Prime Minister of Japan and His Cabinet, January 4; ECB press release: January 22, 2015.

The euro area is in a macroeconomic trap. The lack of significant growth momentum during and following the prolonged global financial and eurozone crises caused a compression of imports. The import compression led to a swing from current account deficit to surplus in countries worst hit by the crisis (Figure 7). That surplus propped up the euro's exchange value, which, in turn, created a further restraint on growth.

Figure 7 Deflationary monetary policy has contributed to the euro area's current account surplus
(percent of GDP, 4-quarter moving average)



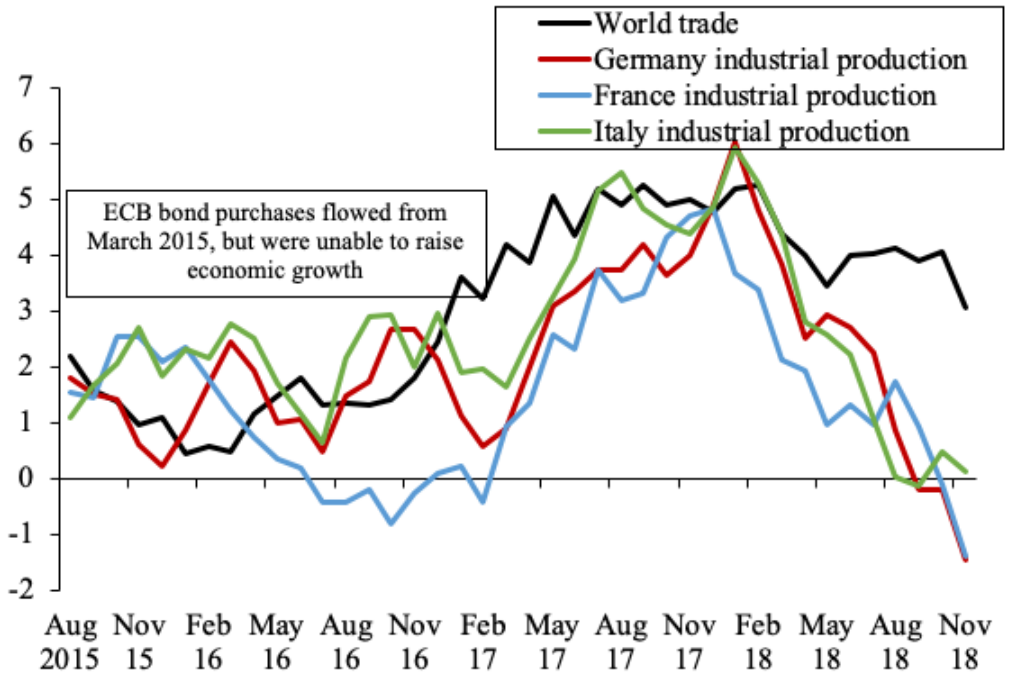
Source: Euro area GDP, Eurostat code namq_10_gdp; Balance of payment, Eurostat code bop_c6_q; Euro area current account, ECB code DD.Q.I8.BP_CU.PGDP.4F_N.

Euro area growth is driven by world trade

Draghi asserts [21] that the ECB's "QE has been the only driver of this [euro area] recovery." To the contrary, the evidence is that QE has made little difference to bolstering euro area growth.

Growth in the euro area remained in the doldrums in the first two years after the ECB initiated QE. In these two years – 2015 and 2016 – world trade grew at an annual rate of around 3% or less. Because European countries are highly dependent on trade, the anaemic pace of world trade growth placed a lid on euro area growth (Figure 8).

Figure 8 World trade, rather than ECB's bond purchases, moves euro area growth
(annual growth rates, percent; three-month moving averages)



Sources: For world trade growth data, World Trade Monitor, https://www.cpb.nl/en/data [22]; for the industrial production of Germany, Destatis, https://www-genesis.destatis.de/genesis/online/logon?sequenz=tabelleErgebnis&selectionname=42153-0001&sachmerkmal=WERTE9&sachschluessel=X12ARIMAASB&leerzeilen=false&language=en [23]; for France, INSEE, https://www.insee.fr/en/statistiques/3690022#titre-bloc-6; for Italy, Istat, http://dati.istat.it/?lang=en# [24].
Note: Growth rate computed as the latest three-months over the same three months in the previous year.

Starting in early 2017, Chinese authorities injected significant stimulus to rev up their economy. As has been true in the past couple of decades, rapid growth in China accelerated the pace of world trade growth through stepped-up Chinese imports and greater activity spurred by Chinese firms in global value-added chains. Higher world trade growth, which reached a peak of over 5% in late 2017, predictably spurred euro area growth. Although it is tempting to attribute the higher euro area growth to a delayed benefit of QE, in reality world trade was doing all the work. Thus, when the Chinese authorities pulled back on their stimulus for fear of aggravating the already alarming domestic financial vulnerabilities, world trade growth slowed and so did the euro area. Throughout, QE remained a sideshow.

The ECB's loss of influence has consequences

Hélène Rey is right. The Fed, in effect, sets global monetary policy. The BOJ remains unable to move inflation. While the ECB's defenders often argue that "things might have been worse" absent its QE programme, judged by the benchmarks of other central banks and even those set by its own management, the ECB's QE has no apparent impact on either inflation, the euro exchange rate, or euro area growth.

Unlike the Fed, the other central banks have lost the 'expectations game'. In June 2018, at Sintra, the Portuguese resort town, Fed chairman Jerome Powell noted, [25] "Today policy makers have a greater appreciation of the role expectations play in inflation dynamics." BOJ's Governor Haruhiko Kuroda bemoaned that Japanese consumers have come to expect that prices will remain relatively stable, which has made businesses hesitant to

raise their prices. Five years of ambitious QE, he helplessly concluded, have failed to dislodge the “tenacious deflationary mind-set” rooted in the Japanese psyche.

As John Williams, president of the New York Federal Reserve, has also emphasized, once inflation falls, it is extraordinarily hard to get it “back up to where we want it to be.”

The ECB’s political limits to monetary stimulus have prevented it from getting inflation back where it should be. The result: much of the euro area has fallen into a ‘lowflation’ trap. Although no euro area country is facing outright deflation, lowflation raises the real interest rate, which causes consumers and investors to hold back on purchases, which holds back growth, which validates the expectation that inflation will remain low, which causes consumers to continue holding back on purchases.

Among central banks, the Fed stands out because its commitments are the most credible, allowing it to influence expectations most effectively. In the latest crisis, the Fed began early and did not equivocate until 2013. Thus, the Fed engineered large depreciation of the dollar through QE and slowly but surely brought inflation back to 2%. The BOJ undermined its own credibility in the 1990s, when it hesitated in fighting the deflation threat. That loss of credibility has continued to haunt Japan. Even in the latest QE round, despite its ambition, episodic hints of tapering have undermined the BOJ’s efforts. The BOJ, therefore, has been only partially successful: some yen depreciation but little traction on prices.

The ECB has lost the expectations battle and, hence, the ability to raise inflation. Even more so than the BOJ, the ECB is unable to engineer an exchange rate depreciation.

Now, amid a sharp economic slowdown and persistent low inflation, the ECB’s decision to halt its asset purchases renews afresh its cycle of denials, delays, and half measures. Some ECB officials, led by Benoît Cœuré, take comfort in their view that the large stock of past bond purchases will continue to exercise a stimulative effect [26]. This is a strange claim. The marginal transaction, not the stock held, influences the bond’s price and, hence, its yield. Hence, with stoppage of ECB’s new purchases, bond prices will fall and the yield will increase.

That expectation of a rise in euro area interest rates keeps the euro-dollar exchange rate bound in a narrow range even though the Fed has already raised its policy rate [27] from a target range of 0 to 0.25% in December 2016 to a range of 2.25% to 2.5% as of December 2018.

A rise in euro area interest rates could prove unbearable in many euro area countries. Their real interest rates are already rather high, productivity growth rates are very low, and the effective euro exchange rate, stronger than at the start of QE, could become even stronger.

The ECB has reiterated that it could resume QE. At his December 2018 press conference [21], in response to a question on whether the ECB could “deal with the next economic slowdown,” Draghi responded, “we have instruments.” These are the same words he used when the ECB postponed QE in the crucial 2013-2014 period, allowing lowflation to set in. If euro area growth remains weak, a hesitant effort to renew QE – amid discordant voices from the Governing Council – will be met with deserved scepticism. It could all be rather unpleasant.

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