

Policy Wounds Leave Scars

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Based on *EuroTragedy: A Drama in Nine Acts*, New York: Oxford University Press, June 2018.

A euro that the French desperately wanted, on German terms



- Chancellor Helmut Kohl pushed the euro, despite deep public opposition to giving up the deutsche mark
- In seeking the Bundestag's authorization on April 24, 1998, he twice said:
- “According to the treaty rules, the community shall not be liable for the commitments of the member states and there are no additional financial transfers.” *Translation: Germany will not pay the bills of other member countries.*
- The euro would ensure Europe's peace, he added.

Kohl was talking about the Maastricht Treaty

- The Maastricht “contract” was founded on Germany’s “*stability*” ideology.
 - This way or no way.
- The quirky budget deficit limit of 3 percent of GDP was quickly decried as economically illiterate by virtually every Anglo-Saxon economist.
- Even European Commission president Jacques Delors pushed back to the very end:
 - But the “super-orthodox” Germans, he later said, had their way.
- Less controversial: independent central bank with price stability as sole mandate:
 - But French didn’t like it. President François Mitterrand in September 1992 run up to French referendum on the treaty said, “I hear it said everywhere that this ECB will be master of its decisions! That is not true!” The European Council he said, would determine monetary policy; the ECB would only implement it.
 - Bundesbank president Helmut Schlesinger declined to comment with the excuse that his French was not good enough to understand it!

But Anglo-Saxon critics also warned about the design of the proposed European Central Bank. In 1997, Paul Volcker, then former U.S. Federal Reserve chairman, warned:

- ECB's hyper-independence would undermine accountability.
- A central bank, he said, "must be able to justify its policies to the general public and to political leaders."

In 1998, Franco Modigliani (also an Anglo-Saxon, being at MIT) and his colleague Robert Solow, both economic Nobel laureates, predicted ECB's price-stability mandate would create obsessive focus on low inflation:

- Interest rates, therefore, would be too high.
- A monetary policy that overemphasized price stability would make the Europe's endemic unemployment problem worse.
- They recommended that the ECB follow the Fed and adopt a "dual" mandate: greater employment be "on an equal footing" with the price-stability goal.
- They were "confident" that the ECB could do more to alleviate Europe's employment problem "without renouncing or sacrificing its commitment against inflation."

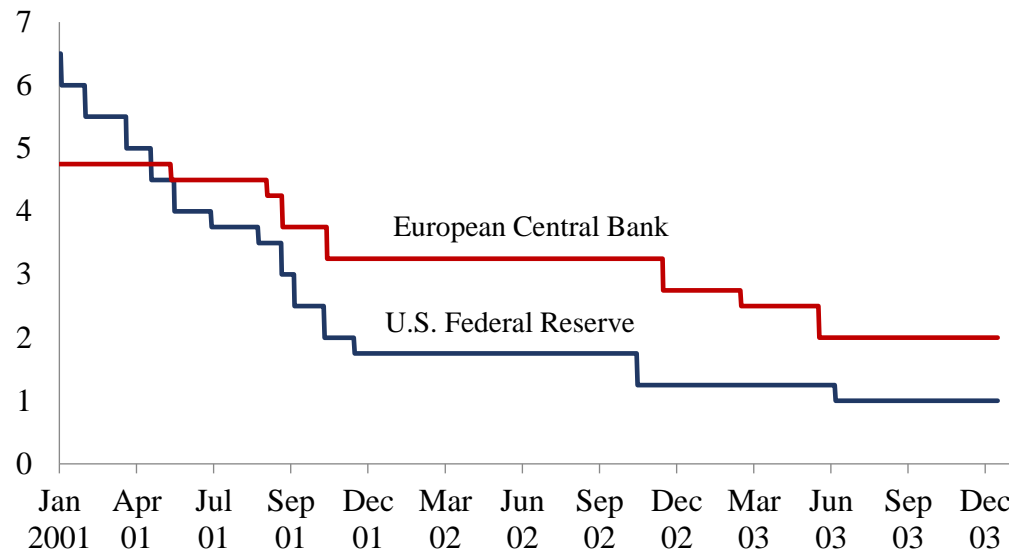
The ECB's first test...

The U.S. Federal Reserve leads, the European Central Bank follows

Greenspan: January 2001, economy in the position of a person falling off the 30th floor, blissfully passing the 10th floor. *Risk management required preventing the crash, because you don't bounce back from a crash.*

Duisenberg: "I hear but I don't listen." [First sign of ECB's ideological internalization.]

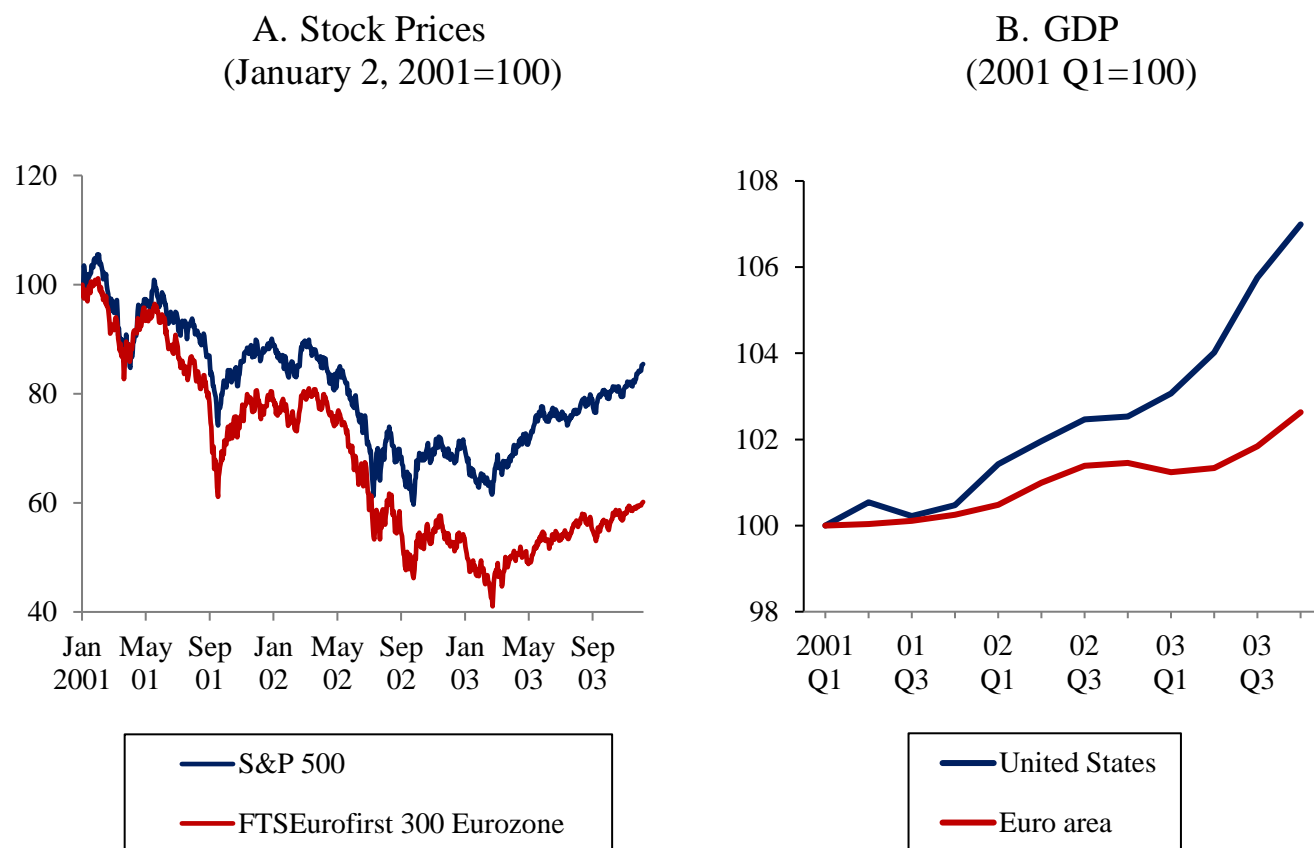
(Policy interest rates, percent)



Sources: Federal Reserve Bank of New York "Federal Funds Data Historical Search"

<https://apps.newyorkfed.org/markets/autorates/fed-funds-search-page>. European Central Bank Main Refinancing Operations," variable rate tenders, https://www.ecb.europa.eu/stats/policy_and_exchange_rates/key_ecb_interest_rates/html/index.en.html.

The first wound: earlier U.S. recovery in stock prices and GDP.

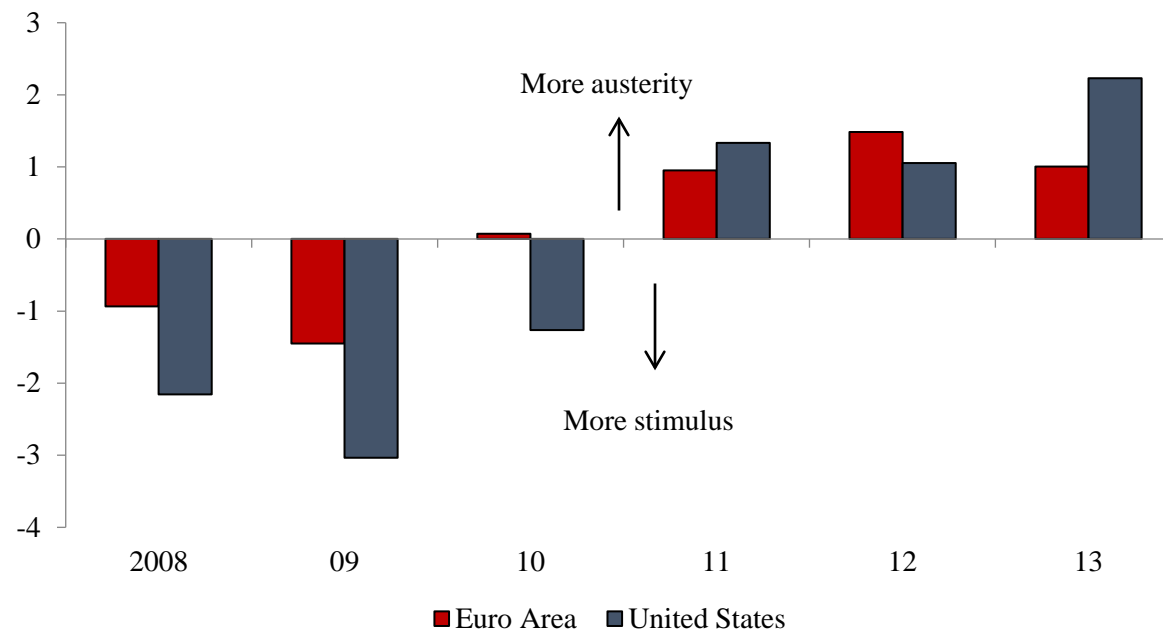


Sources: FTSEurofirst 300 Eurozone (FTEUEBL(PI)) from Datastream; S&P 500 (^GSPC), online at <https://finance.yahoo.com/q/hp?s=^GSPC&a=00&b=1&c=1999&d=11&e=31&f=2003&g=d>. For GDP, OECD Statistics, “B1_GE: Gross domestic product—expenditure approach; LNBQRSA: Millions of national currency, chained volume estimates, national reference year, quarterly levels, seasonally adjusted,” available from stats.oecd.org.

Between 2008 and 2010, significantly more fiscal stimulus in the United States than in the euro area.

- Euro area austerity after 2010 [German preference, by now European identity]
- Accompanied tight monetary policy [also Europe's "stability identity"]

(Change in structural balance as a percentage of potential GDP)



Source: International Monetary Fund, World Economic Outlook Database.

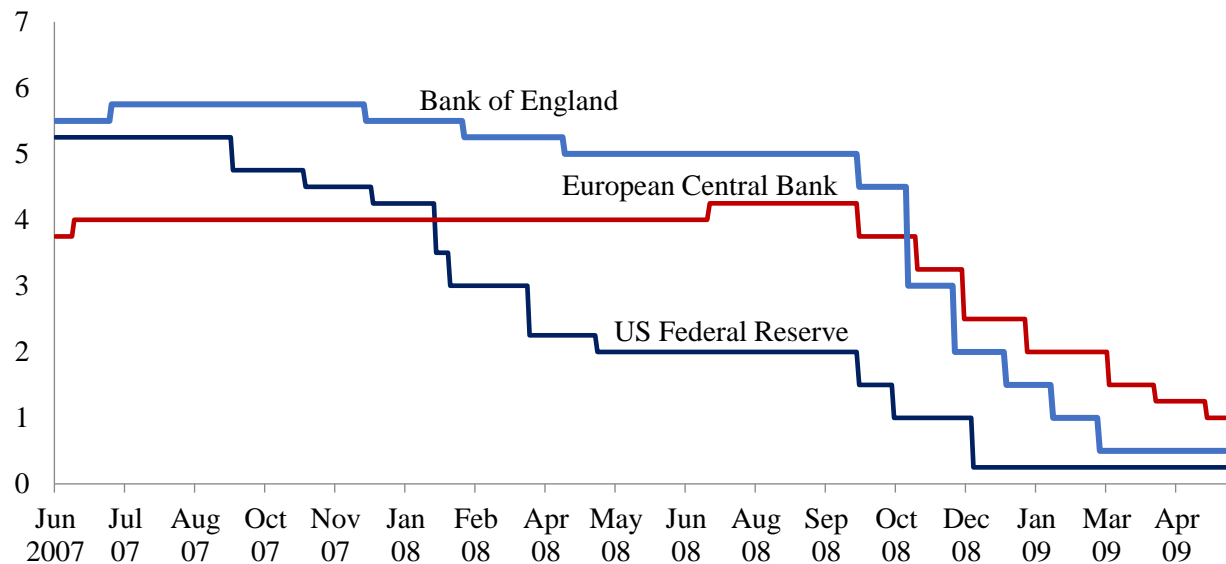
Note: A decrease in the structural fiscal balance represents a fiscal stimulus.

The ECB's second test...

Federal Reserve leads, Bank of England follows, and ECB lags

Janet Yellen, September 2007, again the risk-management principle: “I honestly don’t know what the risks are,” but financial disruptions could generate “negative, non-linear dynamics.” *Translation: things could get ugly, quickly.*

(Policy interest rates, percent)



Sources: Federal Reserve Bank of New York, “Federal Funds Data Historical Search”; European Central Bank, “Main Refinancing Operations,” fixed rate tenders; Bank of England, <http://www.bankofengland.co.uk/boeapps/iadb/Repo.asp>.

...in June 2008, at the euro's tenth anniversary celebrations, Jean-Claude Trichet:

“This relatively short period of time [the euro's first decade] has been rich in successes.”

He repeated: “The euro has been a remarkable success.”

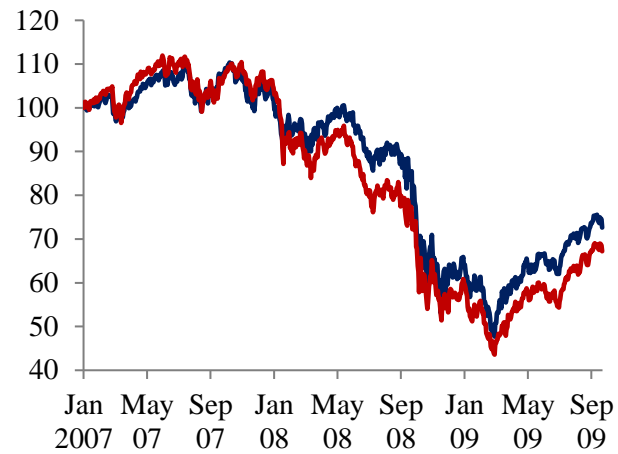
Then, trying hard to contain his elation, Trichet said he did not want to “name and shame” those who had predicted that the euro would fail.

Instead, he breathlessly concluded by once again saying, “A success indeed.”

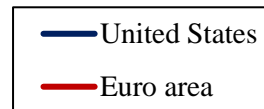
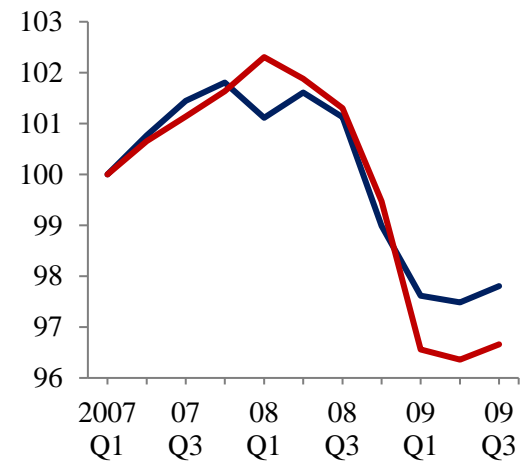
- As George Orwell might have written, Trichet was narrating history “not as it happened, but it ought to have happened.
- In July 2008, the ECB raised (*yes, raised*) its policy interest rate, its first action since the start of the crisis, even as eurozone industrial production was falling.

More wounds: the euro area falls behind by early 2009.

A. Stock prices
(January 1, 2007=100)



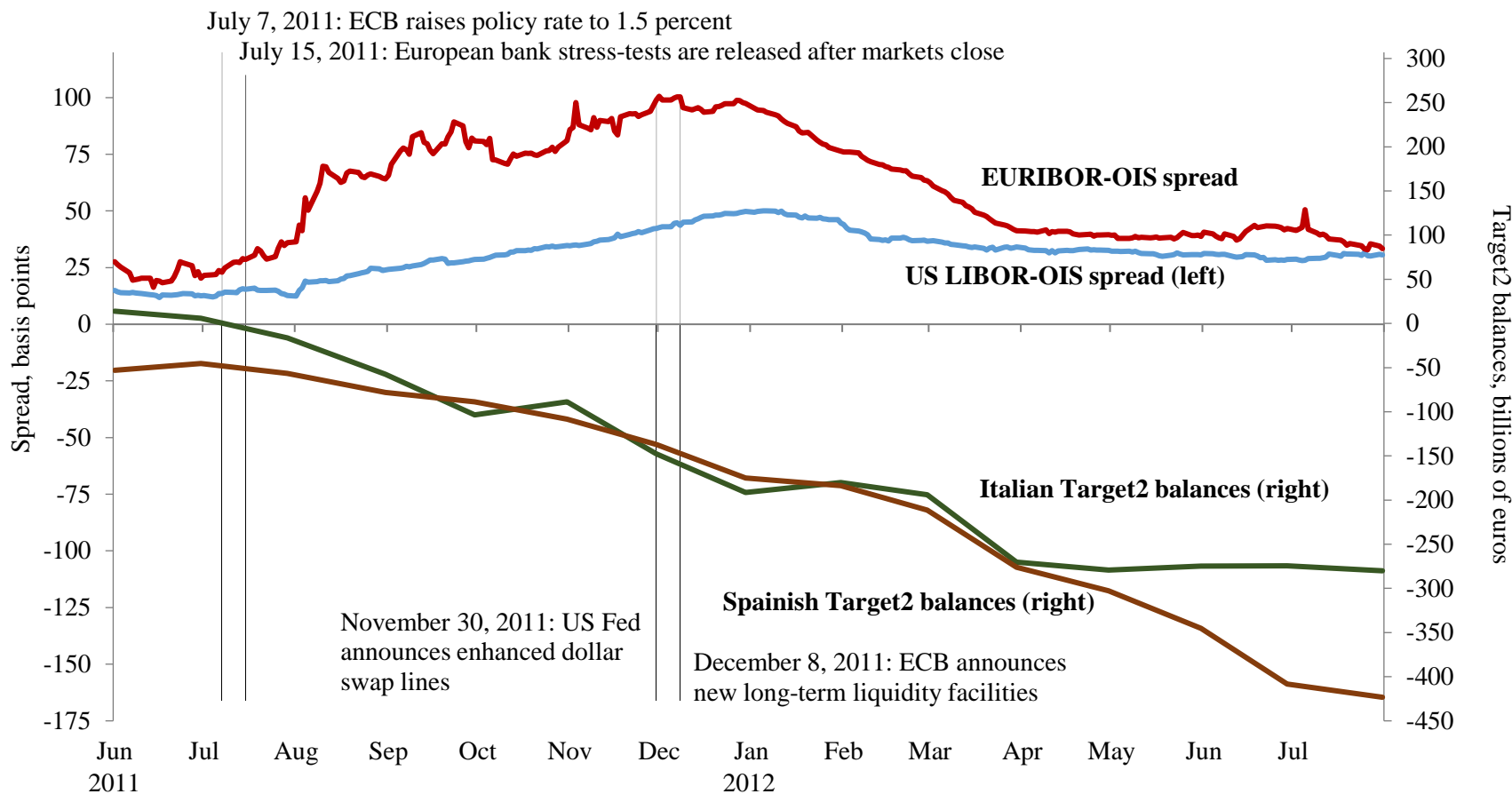
B. GDP
(2007 Q1=100)



Source: Datastream.

Third Test, and the big wound:

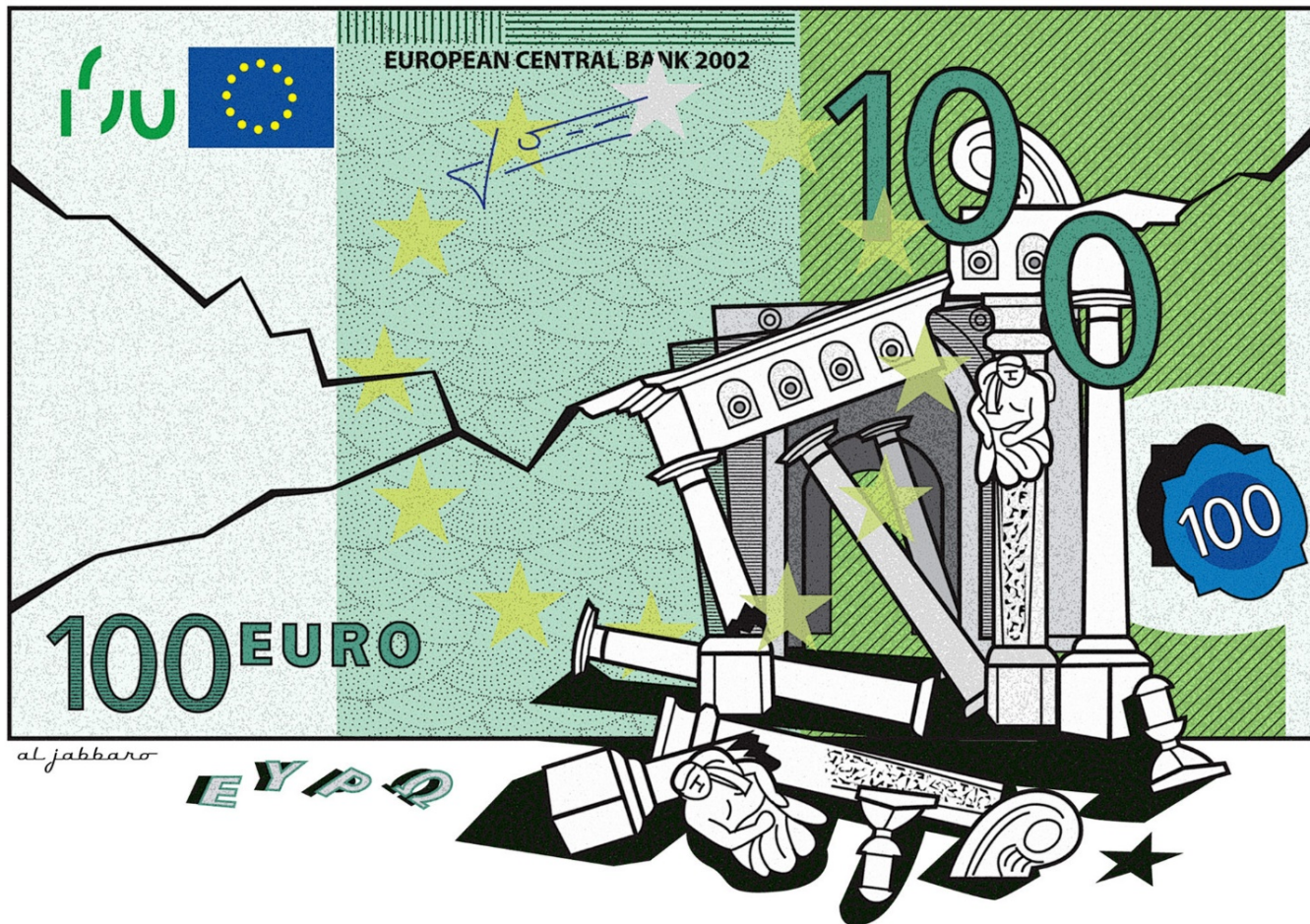
Market panic after July 7 interest-rate hike and farcical bank stress tests.



Sources: US LIBOR-OIS spread: Bloomberg, US0003M Index—USSOC Curncy; EURIBOR-OIS spread: Bloomberg, EUR003M Index—EUSWEC Curncy; Target2 balances are end-of-month position from ECB Statistical Data Warehouse.

Note: One hundred basis points equals 1 percentage point.

By January 2012: an existential crisis



Fourth Test: Draghi-Merkel alliance to save the euro

Draghi's July 2012 makes "whatever it takes" announcement

Crucial assist from Merkel, who overruled her Bundesbank chief Jens Weidman



CartoonStock.com

Merkel was unwilling to let the euro collapse, but did not want to burden German taxpayer.

Outright Monetary Transactions (OMTs) approved in September 2012.

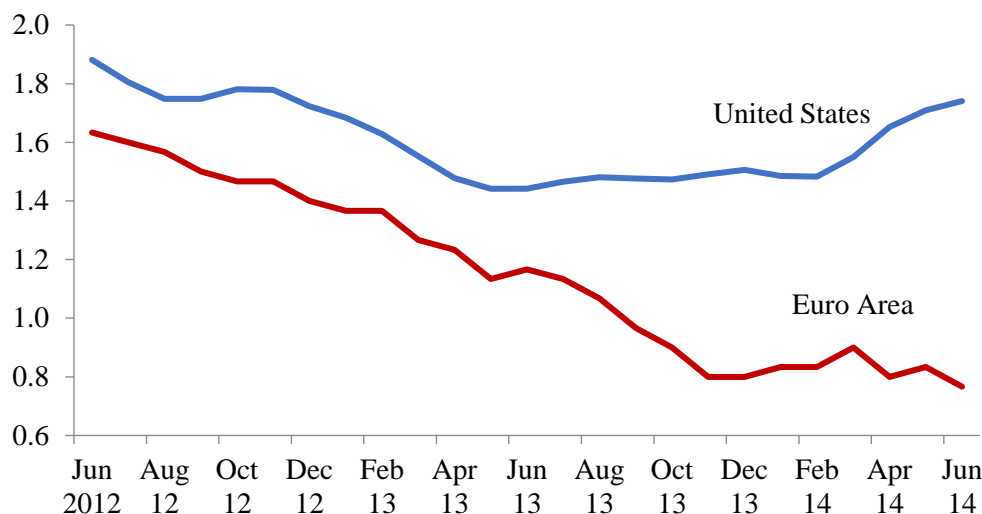
But OMTs only partially undid the ECB's July 2011 error.

German and other "northern" Governing Council members held ECB back from aggressive monetary stimulus through end-2014: real interest rates remained high.

Long-Term Refinancing Operations (LTROs) do not count: passive monetary policy, ease credit supply; do not put money in people's pockets (do not create demand); funds used by banks to buy sovereign debt, aggravating the sovereign-bank "doom loop."

Euro-area inflation rate started dropping in mid-2013: the lowflation wound.

(Three-month moving average of "core" annual inflation rates, percent)



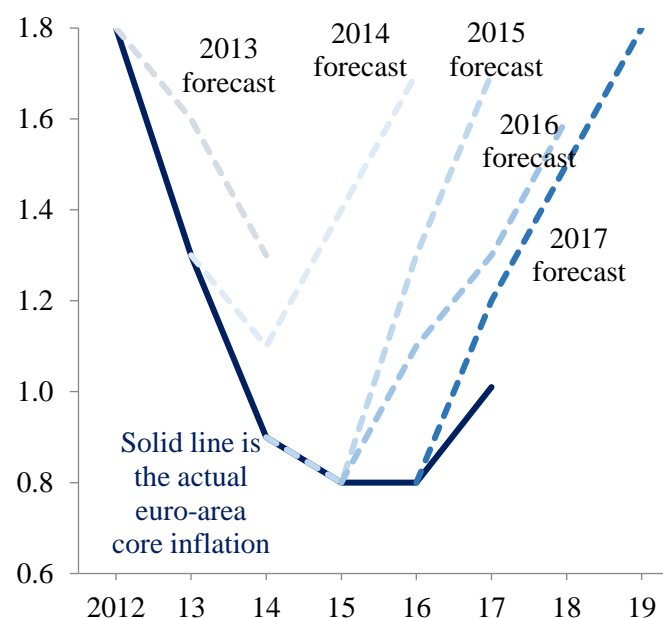
Source: Eurostat: "HICP—All Items Excluding Energy and Food"; St. Louis Fed, FRED: "Personal Consumption Expenditures Excluding Food and Energy (Chain-Type Price Index)."

Fifth Test: ECB's delayed quantitative easing, lowflation settles in.

The ECB's balance sheet (left-hand scale, trillion euros) increased rapidly, but the annual inflation rate (right-hand scale) remained low



Despite ECB forecasts of rise in inflation, inflation remained at a low level



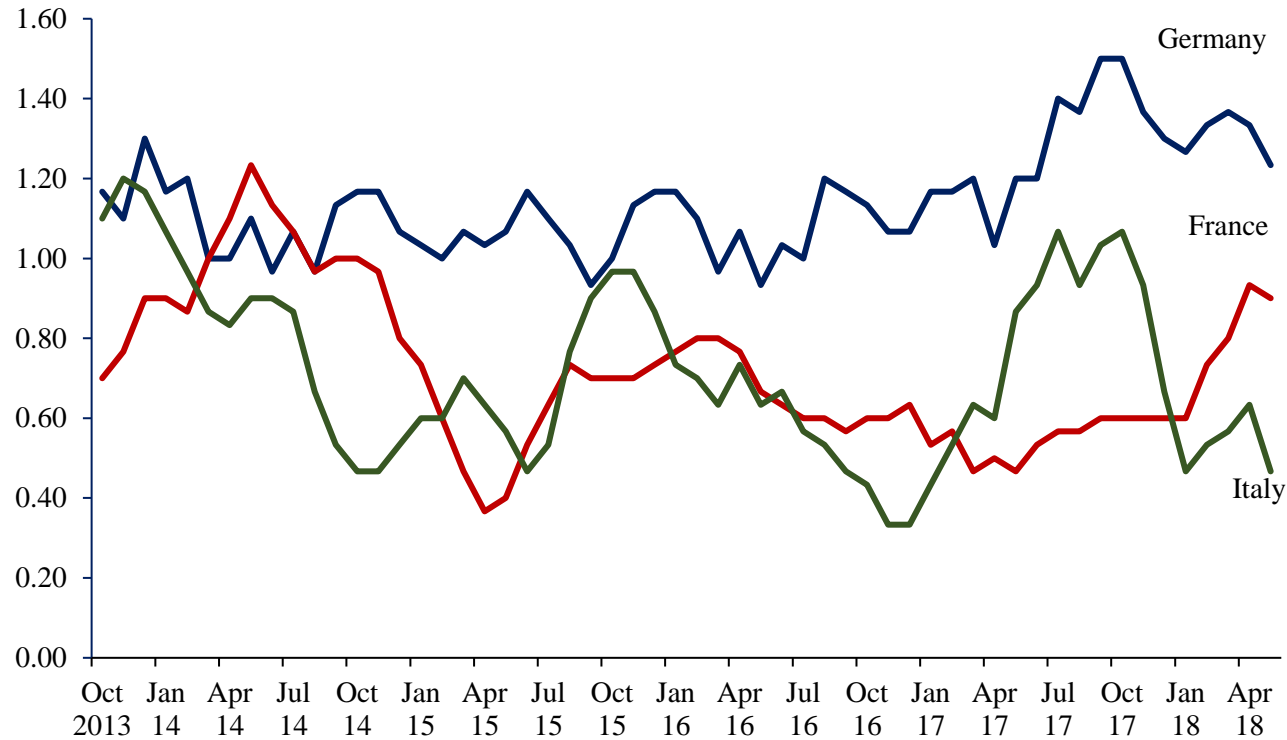
Sources: Left panel: ECB Balance Sheet, Bloomberg's weekly "EBBSTOTA Index" at weekly frequency; inflation expectations are measured by Bloomberg's daily FWISEU55 index (five-year, five-year inflation swaps); core inflation is the three-month moving average of Eurostat's annual change in the monthly "HICP—All-items excluding energy, food, alcohol and tobacco" index. Right panel: ECB's Macroeconomic Projections made in March of the year, <https://www.ecb.europa.eu/pub/projections/html/index.en.html>.

Note: The ECB's balance sheet and inflation expectations are plotted at weekly frequency; the core inflation rate for the week is the same as the year-on-year monthly inflation during the month in which the week falls.

Single monetary policy will create inflation divergence, and it did.

Lowflation a more serious problem in the south, especially Italy

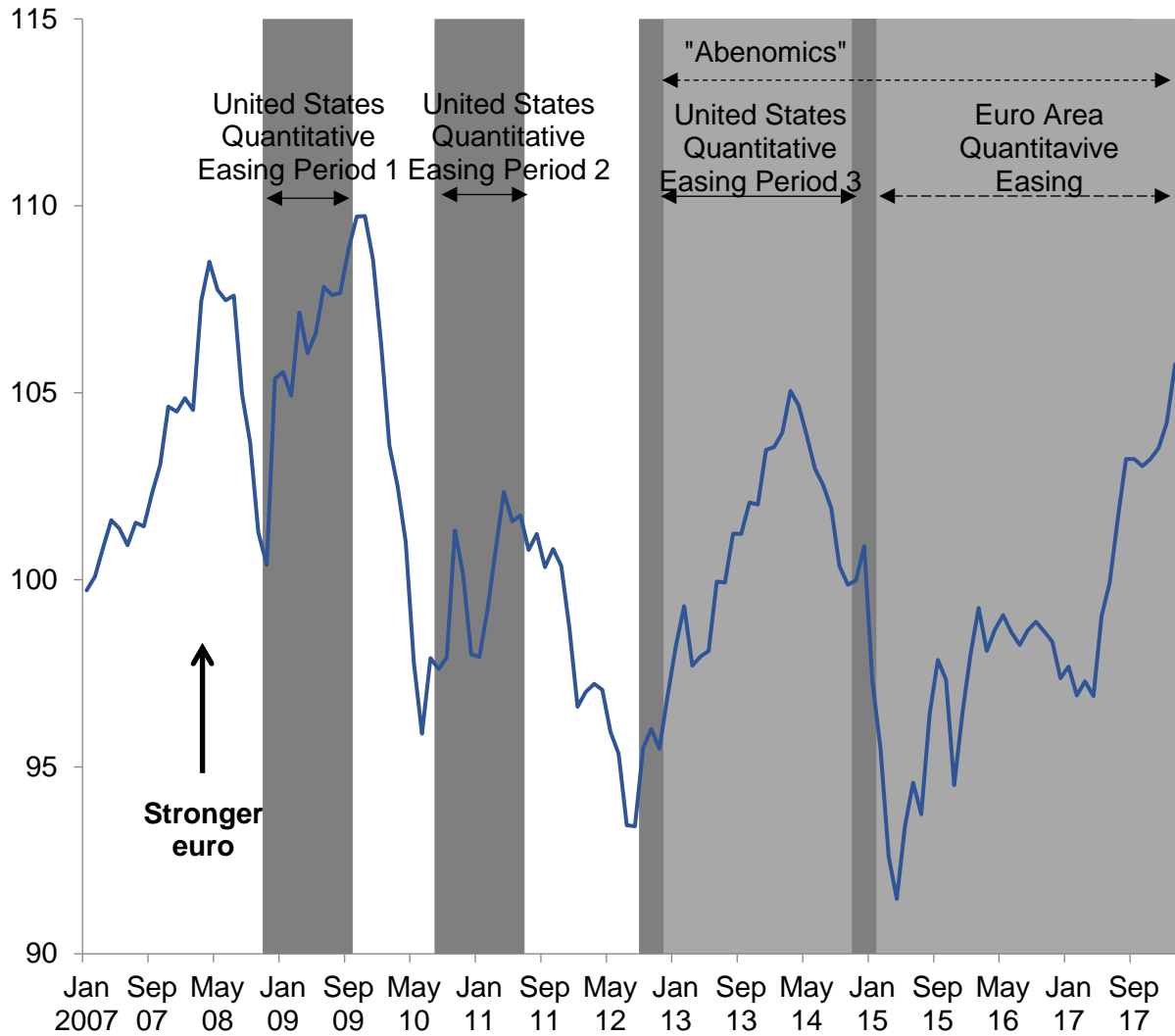
(Annual core inflation, three-month moving average, percent)



Source: Eurostat. Note: Core inflation is the annual percentage change in the Harmonized Index of Consumer Prices excluding energy, tobacco and unprocessed food.

U.S. and Japanese quantitative easing caused the euro to strengthen, as ECB waited and lost credibility

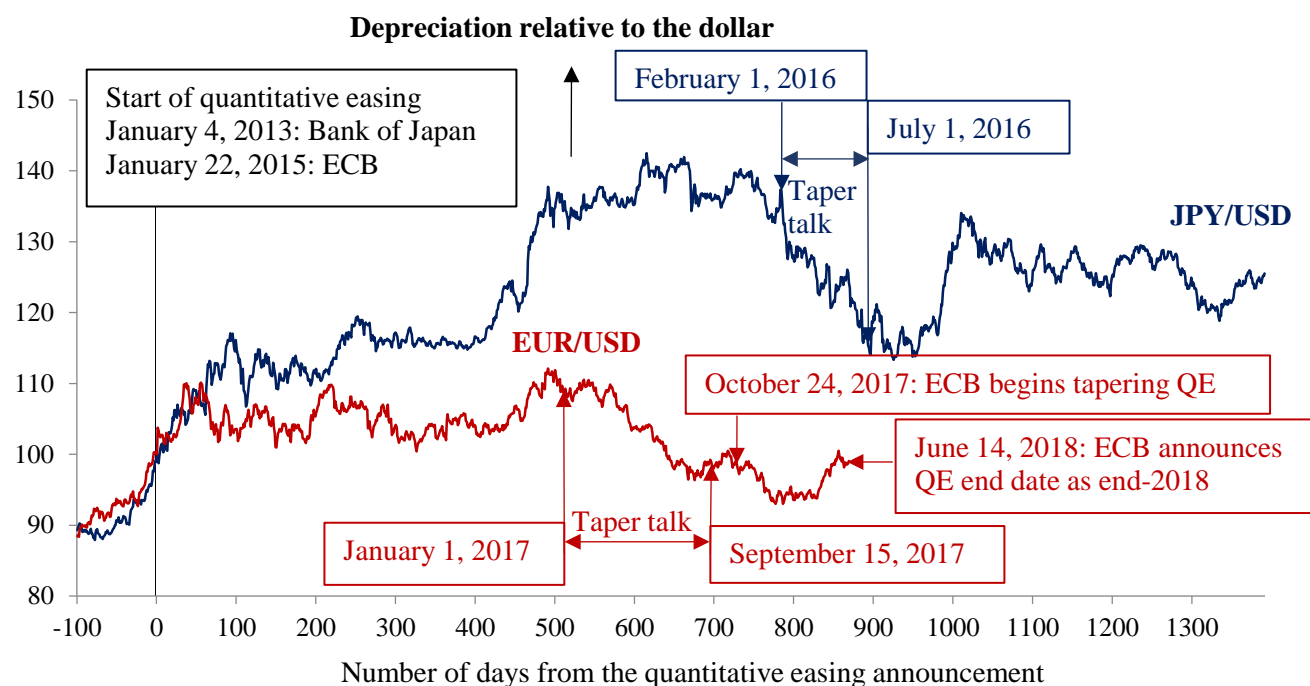
(Euro nominal effective exchange rate, index 2010 = 100)



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 cumulative effect of tight money: ECB credibility even lower than BOJ's in maintaining sustained monetary policy easing.

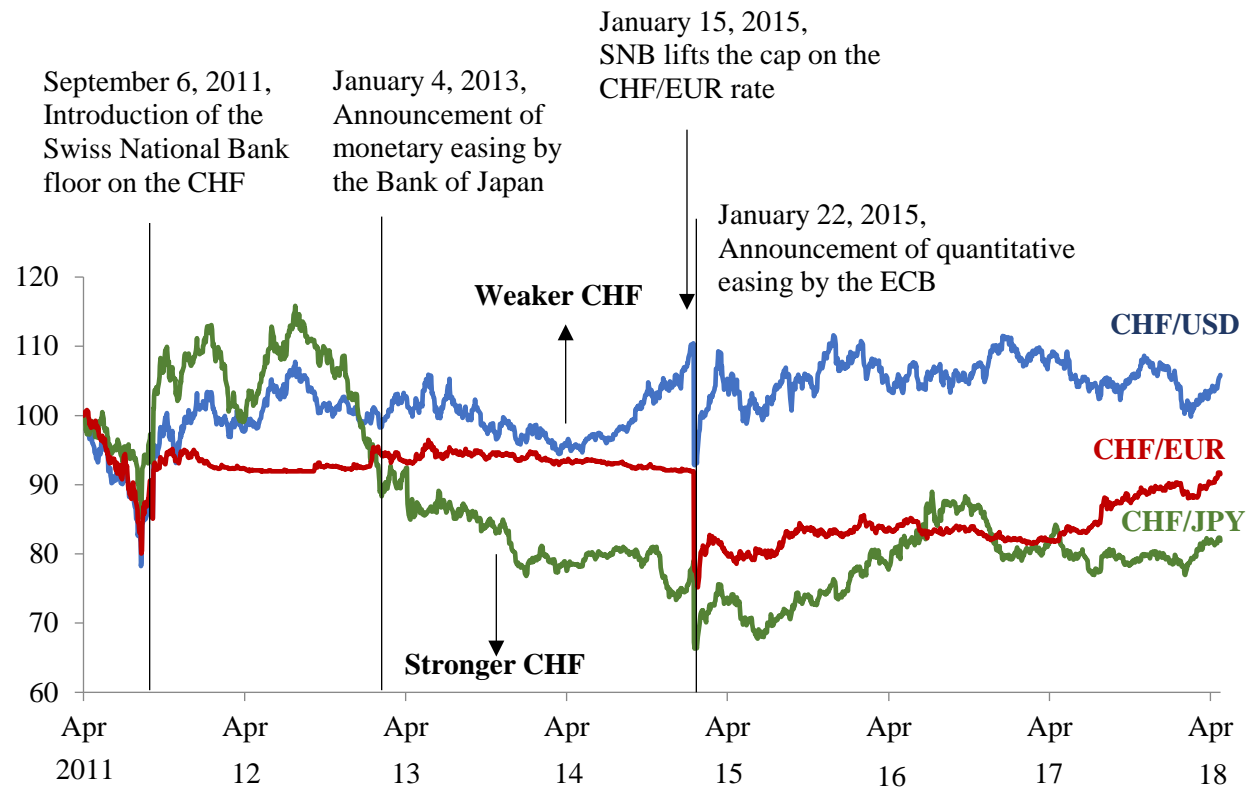
ECB QE did little to weaken the euro to boost demand and inflation.



Note: Exchange rate for JPY/USD equals 100 on January 4, 2013 (date of the announcement of quantitative easing by the Bank of Japan) and exchange rate for EUR/USD equals 100 on January 22, 2015 (date of the announcement of quantitative easing by the ECB).

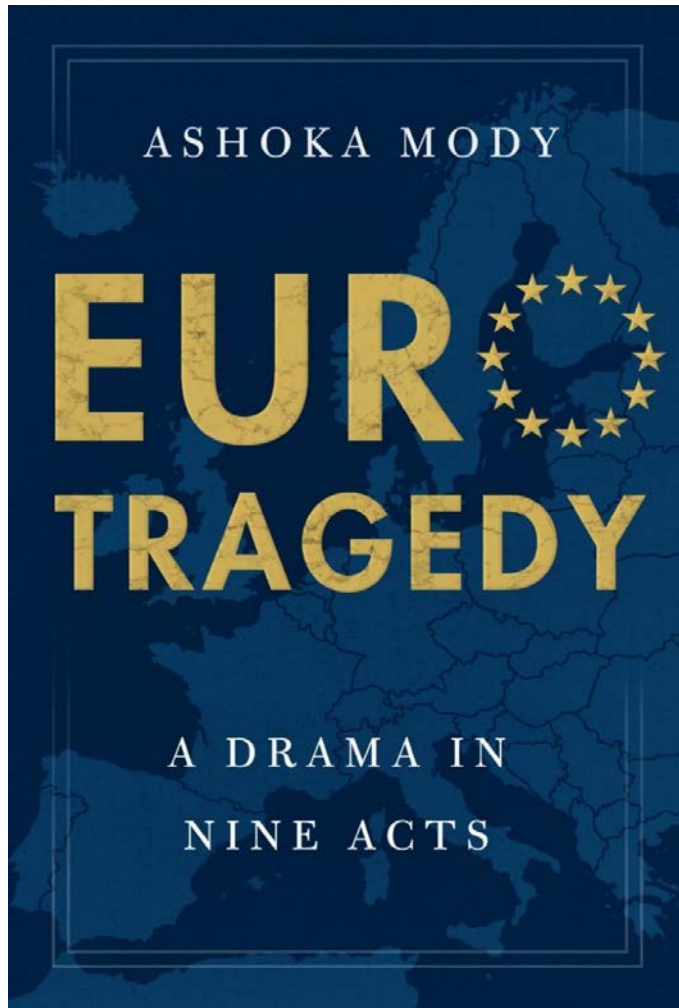
Source: For USD and Japanese Yen, <https://www.investing.com/currencies>, for USD and Euro rates ECB, https://sdw.ecb.europa.eu/quickview.do?SERIES_KEY=120.EXR.D.USD.EUR.SP00.A&periodSortOrder=ASC.

Another view of the ECB's strong euro problem.



Source: For Swiss Franc to USD and Japanese Yen, <https://www.investing.com/currencies>, for Swiss Franc to Euro rates ECB, https://www.ecb.europa.eu/stats/policy_and_exchange_rates/euro_reference_exchange_rates/html/eurofxref-graph-chf.en.html.

The scars



- Unaccountable ECB: no reasoned explanation of its errors and delays
- Loss of ECB recession- and deflation-fighting credibility
 - question will remain, as with BOJ, whether the ECB will:
 - act in time, and will
 - follow through
- Hence
 - Continued hysteresis in output: reduced potential GDP growth
 - Lowflation: further damage to potential GDP growth and increased debt burdens
 - Strong euro: reduced competitiveness of countries that need a jump start.