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EASY MONEY THROUGH THE BACK DOOR: THE MARKETS VS. THE ECB

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This brief assesses the experiences of Europe's policy regime in the two years since the introduction of the euro in 1999, particularly the performance of the European Central Bank (ECB), the institution in charge of conducting monetary policy for the euro area. Conventional accounts of European growth, price, and labor market performance over recent years focus on labor market institutions and wage trends. By contrast, the interpretation offered here assigns a key role to demand-side factors as the driving force behind the recovery in output and employment growth. It is argued that the euro's plunge essentially resumed the trend of deutsche mark weakness that had started in 1996 and that currency depreciation amounted to a significant easing of monetary conditions.

In this way, "easy money" was introduced "through the back door" of the European fortress of stability-oriented policies and contributed decisively to the export-demand stimulus that lifted Euroland out of the dol- financial market participants and by playing against the markets. The result was that any attempt to prop up the euro by narrowing the current interest rate spread vis-à-vis the dollar would fail if perceived by the markets as from a very low level to well above the ECB's declared tolerance level.

After discussing some issues in assessing the ECB's performance, the convergence process of the 1990s is examined. The ECB's performance is discussed next, with a focus on its ongoing communication problem and the impact on financial markets. The analysis then turns to the ECB's interest rate decisions and their effects on the exchange rate and monetary conditions.

Some Issues in Assessing the ECB's Performance

The ECB has declared from the beginning that it wishes its performance to be judged only in terms of medium-term price developments in Euroland. That is, it should be judged in terms of meeting its primary objective of price stability, defined by the ECB as a yearly increase in the Harmonized Index of Consumer Prices (HICP) of less than 2 percent over an unspecified medium-term horizon. Assessing the ECB's performance on the basis of this standard of (ex post) evaluation raises some problems.

One problem is that no such medium-term record is yet available. Given that the lag between monetary policy measures and prices is commonly held to be around one and a half to two years, an assessment of the ECB's performance on the price front would have to focus only on developments since the latter half of 2000 and inflation prospects over the next few years.

In addition, given that the consensus view among economists is that monetary policy affects real variables, such as output and employment, in the short run, it may be misguided to focus solely on medium-term price developments.

transmitting monetary policy, policy success hinges on how well the central bank guides market expectations and perceptions. Currency markets are especially important in this respect, given that the effects of exchange rate changes are reflected relatively quickly in both economic activity and prices. Accordingly, communication failures concentrated in currency markets may quite easily disrupt monetary policy and impose a monetary stance different from the one intended by the central bank. These considerations move the euro exchange rate into the spotlight of the analysis.

Preconditioning the Euro's Slump: The Legacies of the 1990s

The ECB started out from a rather difficult position at the euro's inauguration. The few years preceding the formation of the Economic and Monetary Union (EMU) were expected to improve and harmonize economic conditions among countries so that the new currency could be launched against the backdrop of a stable economic environment. However, immediately in 1999, and then again in the spring of 2001, divergence became a serious issue for monetary policy. Among the EU economies, Germany seemed to be in particularly deep trouble in spring 1999, and this was widely seen as the prime force behind the euro's plunge. Given that the conduct of EU-wide monetary policy is strongly influenced by German views and the ECB is modeled on Bundesbank standards, this is a worrisome issue. But there is also the question of why the euro was launched at a rate that was immediately perceived by the markets as inappropriately high.

Boasting the biggest economy in the EU, Germany has been the predominant influence not only in EU policy making, but also in economic performance. The striking fact is that effects of the excessively restrictive fiscal stance adopted in 1992. As economic theory would predict, this had glaring real consequences. Capacity utilization dropped sharply in the 1992–93 recession and remained at severely depressed levels for most of the 1990s.Employment kept on falling and unemployment continued to soar until the end of 1997. Depressed domestic demand reflected the severity of the tight monetary and fiscal policies (Bibow 2001a, b).

Another consequence of the ill-conceived policy mix was that Germany became extremely reliant on export demand. External developments had strongly stimulating effects when, in spring 1996, a process of monetary easing began through currency depreciation. The deutsche mark's decline reinforced the export-driven recovery that started in autumn 1996 owing to the acceleration in U.S. and world economic growth. The external boost enabled Germany to meet the Maastricht fiscal criteria and be admitted to participate in the EMU.

But reliance on external growth to compensate for deflationary conditions at home is a risky strategy, as developments over 1998–99 showed. The export demand shock that arose in the wake of the Asian and Russian crises was bound to take its toll on Germany and the rest of Euroland. Most remarkably, however, monetary conditions even tightened significantly after mid 1998. This monetary tightening was due to the Bundesbank's idiosyncratic response to the international crises. The Bundesbank failed to cut interest rates in a timely way as had other central banks (for instance, the Federal Reserve and the Bank of England) to avoid risks to economic stability. In addition, public statements by top Bundesbank officials downplayed the risks posed by the external shocks, thus inviting the deutsche mark's appreciation. Apart from choking growth in Germany, this had the

external competitiveness within the EU—at Germany's expense. Interest rate convergence was another key factor. The fall in interest rates toward the German level in the second half of the 1990s bestowed a domestic demand stimulus on traditional high-interest countries. Not surprisingly, Spain was in a better position than Germany to weather the international crises of the late 1990s. Spain exemplifies a point of—to varying degrees—general validity in Europe over the 1990s: ultratight money in the early years of the decade and very easy money later go a long way toward explaining trends in macroeconomic performance.

The international crises of 1998–99 had a negative impact on all countries, but the situation within the euro area diverged starkly in terms of countries' exposure to the shock and strength of domestic demand. While some countries had achieved a state of balanced and sustainable growth, others, especially Germany, were relying solely on export demand. Hence the consequences of the external shock were asymmetrical across countries and the existing degree of divergence was further reinforced. The very country where relief was probably most needed, Germany, faced both a tightening of monetary conditions and an especially sharp fall in export demand.

The history of divergence repeated itself by the turn of 2000–01, when relatively higher inflation in some faster-growing economies was a major factor behind the ECB's decision to not cut interest rates in the face of a slowdown in external growth, while Germany was once again hardest hit due to its free-riding strategy of relying on external growth. However, before discussing the ECB's conduct in 2000–01, its response to the euro's plunge, which started immediately after the new currency's inauguration in January 1999, must be analyzed.

conditions. The precariousness of the overall situation was heightened by the Bundesbank's blunders on the eve of EMU, setting the scene for things to come: the euro was launched from what became seen as an unsustainably high level. The new currency thus started on a distinctly negative note, and immediately zoomed in on the deutsche mark's (only briefly interrupted) downward trend that had started in 1996.

It is probably not controversial that the two key issues in monetary policy in 1999–2000 were pronounced euro weakness and the ECB's ongoing difficulties in communicating effectively and coherently with the outside world. These two issues might have been more closely and deeply related than many observers seem to appreciate. The ECB's conduct is first analyzed within its own policy-making framework, the "two-pillar strategy" (ECB 1999). Its interest rate decisions are then analyzed to determine if they gave rise to a time-inconsistency problem, which effectively imposed the market's, rather than the ECB's, stance.

The first pillar of ECB strategy, the setting of a "reference value" for money-supply growth, gave rise to confusion among analysts and market participants. One reason was that the actual growth in money supply was significantly and consistently above the reference value, ever since the euro's inauguration. Another was the contradiction with the signals provided by the second pillar of ECB strategy. Because few observers seem convinced of either the usefulness of the reference value for money growth or its systematic role in the ECB's strategy, it may be most fruitful to focus on the second pillar: the ECB's broadly based assessment of the outlook for price stability in the medium term.

This assessment has been the primary source of communi-

When the euro fell decisively below U.S. dollar parity (1 euro = 1 dollar) in early 2000, the ECB supplemented its "open mouth" operations (emphasizing the "potential upside" of the euro) by using a series of interest rate hikes to bolster the sagging euro. These were complicated by the fact that the first rate hike, in early February 2000, occurred the day after the Federal Reserve had raised interest rates, and was thus perceived by the markets as a panicky move that did little to build up the ECB's already blemished market reputation.

Finally, on September 22, the ECB organized concerted foreign exchange market interventions in which it was joined by the Federal Reserve and other G7 central banks. Their success in bolstering the euro proved rather temporary because ECB President Wim Duisenberg committed another communication blunder shortly afterward (an incident that led to the most serious crisis so far in his presidency).

The ECB's failure to clarify the role of the exchange rate at the outset was a first-rate policy blunder in itself. Wavering between the appearance of benign neglect and panicky policy moves in response to exchange rate changes and interest rate decisions abroad, the markets were left with a wide range of possibilities to choose from. This uncertainty in turn complicated the communication of the ECB's own interest rate decisions. Despite its huge foreign exchange reserves, the ECB seemed all along unable to establish a credible threat to intervene in foreign exchange markets, a threat that would break market psychology and end what apparently presented a one-way bet situation against the euro.

The verdict that the ECB's communication with the outside world has some scope for improvement is not really controversial. What is emphasized here is that effective communication of monetary policy to financial market participants is

Time-Inconsistent Policy, the Euro's Plunge, and the Consequences

In addition to the ongoing irritations caused in currency markets by the ECB's incoherent behavior, another deeper layer exists in the relationship between the pronounced euro weakness and the ECB's communication problems. Just as Germany's poor economic growth had been behind the deutsche mark's plunge since 1996, the pronounced growth differential between the eurozone and the United States was the basis for the time-inconsistency problem faced by the ECB. It is widely recognized that economic growth has represented the primary theme in financial markets over recent years (Corsetti and Pesenti 1999).

Acting in this "progrowth" environment, the ECB has failed to grasp that attempts to support the euro by narrowing the current interest rate differential vis-à-vis the U.S. dollar may be counterproductive if they are perceived as risking a widening (rather than narrowing) of the growth differential ultimately underlying any sustainable path of future interest rate differentials. This hypothesis offers an explanation for the paradoxical result that interest rate hikes by the Federal Reserve tended to be good news for the euro, while rate hikes by the ECB were detrimental.

Faced with a booming U.S. economy and a Federal Reserve determined to slow it down, the ECB had to choose between containing the euro–dollar interest rate differential in the short-run (which, due to growth risks, might be perceived as unsustainable) or strengthening its position through improved growth prospects, which would give them a more sustainable basis for tighter monetary policy in the longer run. The latter strategy would involve a medium-term orientation of waiting until the Federal Reserve achieved its intended slowdown in U.S. growth and stimulating the rather than lower, inflation through facilitating currency weakness, which runs against the central bank's primary concern. Even worse, by posing risks to growth and economic prosperity (society's primary concerns), the central bank's myopic behavior may have detrimental long-run effects—an especially disturbing prospect since rising inflation may forestall any interest rate cuts in the event of a slowdown.

In line with the time-inconsistency problem hypothesized, it took confirmation of U.S. weakness to reverse the euro's decline in November 2000. By the turn of the year, the euro had strengthened significantly, but, soon afterward, the time-inconsistency scenario reaffirmed itself—in reverse gear. As U.S. gloom became global, the markets increasingly perceived the Federal Reserve's (forward-looking) quick easing approach as more appropriate than the ECB's (backward-looking) "wait and see" inertia. The Federal Reserve's interest rate cuts proved good news for the dollar while the ECB's reluctance to cut was bad news for the euro. The euro weakened again. Despite Euroland's relatively more favorable short-term outlook, the ECB once again mobilized market forces unanimously against itself. Its behavior was curiously reminiscent of 1998, when the Bundesbank proclaimed that international crises would not have an adverse impact on the German economy.

No doubt, some of the consequences of the short run of (market-imposed) "easy money through the back door" are highly desirable: employment grew at an impressive pace and unemployment fell markedly. This is a crucial blow to the conventional wisdom that European unemployment is all structural in nature. If the ECB, and not the markets, were in charge of policy, unemployment would have remained unchanged; this would be in line with the conduct of its supposed model—the Bundesbank.

Part of the problem was that even though overall monetary conditions were easy over the recent past, the balance of stimuli was suboptimal: the euro's plunge reinforced the bias of externally driven growth, while the ECB's interest rate hikes constrained domestic demand. With world growth slowing markedly, the old problems of dwindling growth prospects and divergence reemerged with new force.

Conclusion

The euro's plunge in 1999–2000 and the problems this presented to the ECB had important earlier roots that offer some exoneration to the ECB, which, due to these unenviable legacies, found itself in a difficult position right from the start.

But the ECB's policies were highly inappropriate and acted as twofold propagation mechanisms of the euro's plunge. First, its ongoing communication problem brought market psychology up against the new currency and established conditions akin to a one-way bet situation. Second, by misreading the progrowth environment in which it was acting, the ECB ran into a time-inconsistency problem: its aggressive interest rate hikes in defense of the sliding currency weakened it further, as they were perceived by the markets as risking Euroland's growth prospects.

Interestingly, as the markets took over, overall monetary conditions became easier rather than tighter, imposing "easy money through the back door." One of the less desirable consequences was rising inflation. But the ECB is wrong to continue focusing on inflation alone. Certainly its vague mandate grants the ECB all the discretion it needs to take a more proactive attitude toward growth, which would have facilitated, not jeopardized, the maintenance of price stability over both the short and the medium term. Therefore the

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