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Assessing the ECB's Performance since the Global Slowdown
A Structural Policy Bias Coming Home to Roost?

by

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1. INTRODUCTION

Concern is growing about euroland's ongoing stagnation and fragility, which have become entrenched since the global slowdown in 2001. While recovery elsewhere in the world economy started in 2002 and has meanwhile gathered pace, Europe's economic heartland continues to drift along the sidelines. Policymakers in euroland blame their lot on external shocks and policies conducted elsewhere, which, they seem to realize, differ markedly from "stability oriented" policies at home. In particular, despite economic fragility, budgetary consolidation efforts remain a top priority. In addition, manifold reform of welfare systems (i.e., benefit cuts) and labor markets (i.e., withdrawals of job security) is under way, and wage inflation seems set to fall even further from current historic lows.

The analysis in this paper suggests that the prescribed medicine of budget deficit reduction, welfare reform, and wage deflation follows from mis-diagnosis, and may do more harm than good. A common mistake is to overlook the paramount role of the ECB in euroland's ongoing malaise. Thus, the aim of this paper is to correct this mistake by providing a comprehensive assessment of the ECB's performance since the global slowdown. It is shown that the bank's conduct was not only characterized by a series of grave policy blunders, but by errors that were systematically biased rather than randomly distributed. Furthermore, it is likely that both institutions and personalities will continue to err primarily in one direction, with dire consequences for growth, employment, and public finances in euroland and abroad.

Although an unusual amount of criticism has been leveled against the world's most independent central bank, most academic economists conclude that the bank's overall conduct of monetary policy has been quite in line with conventional wisdom and fairly appropriate. For instance, conventional Taylor rule assessment exercises seem to prove that the ECB has made no systematic mistakes and done nothing out of the ordinary. Furthermore, the inflation-targeting framework at the heart of conventional wisdom today seems to justify and approve of the ECB's record. Ex ante fears that the ECB might be too much of an inflation "hawk" and too keen to establish its anti-inflation credentials have apparently been proven wrong as inflation has exceeded 2 percent for much of the bank's life. One prominent ECB watcher concluded that: "Any simple charge of a deflationary bias in monetary policy is not justified" (CEPR 2002: xiv).

This conclusion contrasts starkly with a widespread perception, particularly in financial markets, that the ECB's reaction to the global slowdown exemplified "too little too late." The financial media typically uses the word "cautious" to describe the ECB. The point is that it may take no more than this kind of caution to inflict an anti-growth bias upon the system, especially since fiscal policy is geared at unconditional consolidation anyway. Taking no chances on inflation risks, which a cautious bank might perceive at any time, may be a fine thing. Or it may not, if caution in one direction implies taking enormous risks in another. Perhaps, then, academic economists are a little rash in dismissing market perceptions. After all, financial market players' perceptions supposedly drive their actions and have an impact on financial market prices.

My analysis shows that the ECB may have been far more consistent in both its words and deeds that many researchers believe. As a result of the ECB's *asymmetric* approach to monetary policy, euroland missed out on the opportunities and benefits of a very low inflation environment compared to countries with more symmetric central banks, and got stuck in protracted stagnation and fragility instead.

After pinpointing some key facts about euroland's performance since 1998, the analysis briefly revisits the euro's plunge in 1999-2000 in section 3. This event exemplified the force of market perceptions rather well and set the scene for developments in subsequent years. The ECB's performance since 2000 is divided into three phases in sections 4 through 6. The ECB's words and underlying economic doctrines are given further scrutiny in section 7, particularly with regard to its compatibility with inflation targeting. Section 8 critically assesses the validity of standard Taylor rule assessment exercises in terms of the bank's deeds. Section 9 concludes the analysis and offers some proposals for ECB reform.

2. PROTRACTED DOMESTIC DEMAND STAGNATION IS THE ISSUE

It is common to stress the *global* character of the 2001 growth slowdown, and a consensus view on the high degree of synchronicity has emerged among international authorities emphasizing increased international linkages on the one hand, and commonness of shocks on the other. For instance, the BIS's Annual Report (2002: 16) states: "On balance, it seems that the synchronized downturn in 2001 mainly represented the effects of common shocks, reinforced by the high trade

intensity of the demand components most severely affected."

Due reference to international linkages alerts us to the fact that euroland remains part of an ever more tightly integrated global economy. After all, euroland is three quarters the size of the U.S. economy — and thus quite big enough to pose serious risks to the rest of the world. Furthermore, there is no denying that euroland's brief span of prosperity during 1998-2000 owed much to U.S. growth in particular.[1] Thus, a U.S. slump was bound to have a significant impact on euroland — and policymakers should have been especially alert to this prospect.

Nor can the commonness factor of certain "shocks" be denied. The oil price surge since 1999, the IT bubble bursting and general stock market decline after March 2000, and monetary tightening feature as common shocks in the BIS's and IMF's account of causes of the global slowdown. As to the latter "common" shock, the IMF also identifies some differences though:

> As in previous business cycles, monetary policy in G-7 countries was tightened prior to the recent downturn. Given that inflation was relatively low toward the end of the previous expansion, central banks had to raise interest rates by less than usual, which is one factor behind the relatively mild recessions. Relatively low inflation going into the recessions also allowed central banks — especially in the United States, the United Kingdom, and Canada — to cut interest rates aggressively over the past year, helping to set the stage for recovery (IMF 2002, April WEO: 71).

The OECD too refers to "lagged effects of earlier monetary tightening" in its survey of the euro area of 2002, suggesting an interesting link between this factor and inflation and exchange rate developments that will be taken up again in section 3:

> The sharp hike in oil prices in 1999/2000 reduced purchasing power and squeezed profit margins, while the rise in underlying inflationary pressures led to a tightening of monetary policy by central banks, including the ECB. The continued weakness of the euro and strong monetary growth also added to concerns about the risk to price stability (OECD 2002a: 19).

It is of some curiosity that interest rates do not feature in the ECB's assessment of the

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[1]In fact, this is not only true for the recovery since mid 1999 the role of external growth and the euro's plunge in which the ECB appears to acknowledge in an article on the "characteristics of the euro area business cycle in the late 1990s": "When foreign demand picked up again in early 1999, extra-euro area exports improved and real GDP growth increased. The exceptionally strong cyclical upturn in extra-euro area exports in 1999 and 2000 benefited from an unusually sharp expansion in the world economy and from the rise in price competitiveness associated with a protracted depreciation of the effective euro exchange rate" (ECB 2002, July Monthly Bulletin [MB]: 48). Arguably, the start of a broad EMU would not have got off the ground in the first place without the external boost in 1996, stemming from the U.S.'s "new era" growth spur and strong dollar which allowed most countries to take the 3 percent Maastricht hurdle virtually in the last minute (cf. Bibow 2001a,b).

slowdown. Ex ante interest rate policies never seem to conflict with economic growth in ECB policy communications and assessments. And ex post economic developments do not appear to have been related to interest rate developments either. For instance, throughout the ECB's brisk tightening phase between November 1999 and October 2000, the ECB proclaimed that monetary tightening would not pose any risk to economic growth. Rather, by keeping inflation expectations in check, confidence in price stability would be sustained which, in turn, would stimulate growth, in the ECB's view (Bibow 2002b). In comparing the 1998 and 2001 slowdowns in the euro area (ECB 2002, June MB: 41-3), the ECB is conspicuously silent on the near doubling of its policy rates (225 basis points) in less than a year after October 1999. Another key monetary factor that receives no attention there is the interest rate conversion process and associated asset price surges since the mid 1990s; a one-off adjustment that significantly boosted domestic demand in the late 1990s in some EU countries, but had largely run its course by 2001-02.

Given that the ECB's published research on the transmission mechanism in the eurozone shows strong[2] (although allegedly "temporary") real effects of monetary policy, particularly "that investment is a main driving force, with a contribution of more than 80 percent to the total response of GDP after three years" (ECB 2002: 47), it would be surprising if these factors made no difference at all in recent years. The ECB's comparative study does not fail to observe though that in the context of the external demand shocks of 1997-98 domestic demand in the eurozone held up quite well, whereas domestic demand has plunged since the 2001 slowdown.

Indeed, the plunge in domestic demand in the 2001 slowdown and its protracted stagnation in subsequent years is the key issue here. Figure 1 captures the broad situation since 1998, showing (year-on-year) quarterly growth of real GDP, domestic demand, and exports at annual rates. In the late 1990s, following a long span of sub-par growth, domestic demand grew at 3% per year, slowing only mildly and temporarily in the course of 1999. A marked and protracted deceleration of both private consumption and investment then started in mid 2000,

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[2]A two-year increase of 100 basis points in policy-controlled interest rates is estimated to contract GDP by 0.2 to 0.4% in the first year and by up to 07% in years two and three (effects in later years are not reported). See ECB 2002: 45) as well as ECB 2000, Arestis and Sawyer 2002, and Kuttner and Mosser 2002.

pulling down imports along with them. By contrast, after recovering from the 1997-98 crises, exports grew briskly in 1999 and through 2000. Export growth then plunged in 2001, long after the domestic situation had markedly turned for the worse. While government consumption increased slightly over 2001-02, overall domestic demand growth turned negative in late 2001.

A look at the contributions to GDP growth shown in figure 2 is most revealing. Much in contrast to the U.S., where net exports have proved a significant and persistent negative drag on GDP growth since the mid 1990s, in euroland's case net exports not only added nicely to GDP growth in 2000, but then kept the land of the euro afloat and GDP from shrinking during 2001 and 2002 too. This situation only tipped over in 2003, following the euro's marked appreciation since April 2002. But the truly outstanding fact is that domestic demand continued to stagnate at depressed levels and, even four years later, has yet to recover. In Germany, euroland's supposed economic powerhouse and roughly one third the size of the total area, this problem has been most severe, though not altogether new. For in terms of stagnant domestic demand Germany has much resembled Japan since 1995. Today, however, stagnant domestic demand describes the situation not just in Germany but in most of euroland — the disease has spread.

In conclusion, blaming euroland's ongoing malaise on external developments is a nonstarter. In so far as "common shocks" were at work in the 2001 global slowdown, euroland's downturn after mid 2000, and failure to recover ever since, has helped to drag the world economy down; representing a cause and propagation mechanism of global fragility and imbalances rather than the opposite. Clearly, then, explanations for this uninspiring record have to focus on domestic factors, macroeconomic policymaking in particular. As the euro's plunge in 1999-2000 set the scene for subsequent developments, briefly revisiting that event will prepare us for assessing the ECB's conduct over the period of protracted economic weakness that has ensued.

3. 1999-2000: REVISITING THE EURO'S PLUNGE[3]

The supposed link between inflation and exchange rate developments on the one hand and monetary tightening by the ECB on the other — referred to in the OECD (2002) survey — warrants further attention. The point is that the ECB's approach, its aggressive tightening between November 1999 and October 2000 and subsequent reluctance to cut, may have been rather ill-guided all-round. Former economic advisor to the Reagan and G. Bush administrations David Malpass suggested a "more constructive path" was open to the bank:

> In 1999, the ECB could have softened the euro's collapse rather than fueling it with talk of benign neglect and the supposed silver lining in a competitive devaluation. In 2000, it could have held interest rates steady in response to global deflation, rather than carrying out six euro-weakening rate hikes. In 2001, the ECB could have safely cut interest rates in the almost certain knowledge that rate cuts would strengthen, not weaken, the euro and would thereby lower the inflation rate (Wall Street Journal Europe [WSJE], 21 October 2002).

Since interest rate hikes are central bankers' traditional weapon to defend the currency, referring to euro-*weakening* hikes might at first seem puzzling. And yet, it is a well-known phenomenon in currency crises that interest hikes may fail to bolster confidence, but may even trigger or accelerate the flight from the currency instead. In the euro's case the trouble was that market climate in the late 1990s was one of growth enthusiasm (Corsetti and Pesenti 1999, De Grauwe 2000). With inflation calm all round, the "growth theme" was key to market perceptions of monetary policy actions and communications, with peculiar consequences for exchange rates:

> The "time-inconsistency hypothesis" of the euro's plunge states that attempts to bolster the euro through narrowing the current interest rate spread vis-à-vis the U.S. dollar may be counter-productive if the narrowing of the current interest rate differential is perceived as risking a widening (rather than narrowing) of the growth differential ultimately underlying any sustainable path of future interest rate differential. Under such conditions, interest rate hikes might then weaken rather than strengthen the currency — and *vice versa* in a policy easing scenario (Bibow 2001b, 2002a).

Note that a communication failure is an essential part of the phenomenon. The central bank fails to anchor market expectations in line with policy intentions, it fails to persuade the markets that its desired policy stance represents a *sustainable* course of policy (Keynes 1936). For instance, if the markets perceived an intended monetary tightening as too aggressive, namely,

[3] Cf. Bibow 2001b, 2002a,b on the euro's plunge and the ECB's performance until mid 2001.

as causing growth risks, the intended tightening would appear unsustainable (involving the prospect of a future policy reversal, particularly if the markets went along with it). In this way, tighter money undermines itself by running into a time-inconsistency problem; while diminished growth prospects undermine the currency by making assets denominated in that currency less attractive to global finance.[4] In the prevailing market climate, the ECB's aggressive rate hikes were perceived by the markets as representing growth risks, which led to a general downgrading of euro-denominated assets and a faltering outlook for the euro's future external value. This backfired on the euro spot rate: the euro did not strengthen, but weakened.

Of course "market play" may quickly add to the plight as traders begin to perceive that their peers perceive the ECB's policies in the just described way. Each player will discount and try to anticipate the others' moves and their price impact, with such herding effects providing extra spin to the policy-driven downward trend (Keynes 1936). Suffice to mention that the ECB's idiosyncratic "price stability above all else" rhetoric was poorly attuned to the prevailing market climate and that Mr. Duisenberg's famous slips about benign neglect and prospects for forex interventions were unhelpful to say the least.[5] Market perceptions of a lack of policy credibility reinforced by market play effectively disrupted the implementation of the ECB's policy when the euro — puzzlingly, as it may have seemed to many academic economists — crashed.

The forces at work in this apparent puzzle did not remain unnoticed by some authorities. For instance, the European Commission was right on spot when it warned in its 2000 review that:

> To the extent that the depreciation in the euro is due to cyclical divergence between the euro area and the United States, a rise in interest rates in an attempt to support the currency could even backfire if it was perceived as stifling the euro-area recovery. The risk of creating an even more unbalanced growth pattern with weak domestic demand and higher export growth would be serious (EC 2000: 71).

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[4]In this context, the BIS (2000, 2001) and the IMF's May 2001 World Economic Outlook emphasized that sizable (net) portfolio and direct investment flows from Europe to the U.S. occurred at the time.

[5]Probably most famous is the incidence of 16 October 2000, which provoked the Economist's (2000: 24) following verdict on "Wim's whim": "unless Mr. Duisenberg is genuinely unconcerned by the euro's slide, it is hard to understand why he chose to speak out. And previous remarks he has made suggest that he is indeed concerned by the weakness of Europe's single currency, because it is helping to boost inflation, which is making the ECB raise its interest rates, which threatens to restrain or even terminate Western Europe's economic recovery."

Similarly, the BIS's Annual Report (2001: 89) observed that: "On balance, market participants may have considered the Eurosystem's monetary policy stance to be excessively tight inasmuch as it may have negatively influenced the outlook for euro area growth." And the OECD (2001: 106) referred to a "countervailing impact of interest rates on exchange rates via growth expectations" and an "unpleasant monetary policy dilemma" (118). In fact, the leading financial media's market commentary increasingly reflected and aided this theme in becoming the new orthodoxy — and exactly because growth enthusiasm was the only game in town at the time.

The economic consequences were as the Commission had feared. In the short run, the euro's plunge extended the DM's plunge and span of easy money through convergence of interest rates after 1995. Alas, aggregate demand was further skewed towards exports as the interest hikes took their toll on domestic demand. Heralding bad news for economic growth beyond the short run anyway, especially fateful proved that the euro's plunge pushed up inflation along the way: magnifying the impact of the oil price surge and other temporary factors on headline inflation.

With inflation *above* 2% a "cautious" ECB was stuck in a vicious circle. As the markets' growth theme was still intact, the time-inconsistency game simply played out in reverse[6] when the Fed embarked on its aggressive slashing of rates starting in January 2001 while the ECB sat tight — its inaction sustaining euro weakness and hence import price pressures. Box 1 summarizes the key role of the euro's plunge. The next section scrutinizes the ECB's misjudgements of both external developments as well as the onset of the slump in domestic demand in 2000-01.

4. 2000-01: MISJUDGING THE INCIPIENT SLUMP IN DOMESTIC DEMAND

In both euroland and the U.S. the turning point in domestic demand growth occurred in mid 2000. Despite indications of an imminent slowdown starting to emerge in spring 2000 the ECB continued hiking until October 2000. The euro's plunge was one pivotal factor behind all this, as seen in the previous section. Another was that the ECB thoroughly misjudged developments at

[6]The BIS's Annual Report (2002: 86) commented: "Repeating a pattern observed in 1999 and 2000, but in stark contrast to the 1980s and most of the 1990s, monetary policy decisions and interest rate differentials appeared to influence exchange rates mostly through their effect on growth expectations."

the domestic demand front in particular.

While Jean-Claude Trichet, on presenting the Bank de France's Annual Report, warned in June (FTD 30 June 2000) that Europe must take precautions against the sharp slowdown that he feared was hitting the U.S, it took considerable time for the ECB's official line to reflect any such concerns. The explanation given for the final "preemptive" rate hike in October focused on a perceived risk that rising headline inflation might feed through to inflation expectations:

> This risk is all the more relevant given the currently favourable outlook for economic growth in the euro area. In this respect, the decision to increase ECB interest rates on 5 October aimed at maintaining confidence in price stability over the medium term. This confidence should continue to guide the process of formation of wages and profits margins in the euro are (ECB 2000, October MB: 6).

In December 2000, as the U.S. economy was tanking and the euro rising sharply, the ECB then released its first staff projections for GDP growth, based on an unchanged monetary policy stance, of 2.6 to 3.6% and 2.5 to 3.5% for 2001-02. And in its Monthly Bulletins of December 2000 and January 2001, the ECB held that medium-term risks to price stability were on the upside.[7] The January Bulletin's editorial discussed the U.S. Fed's first 50 basis points cut of 3 January 2001 with reference to increasing uncertainty surrounding the economic growth performance in the U.S., but in February the ECB declared:

> While this deceleration will have some dampening effects on euro area net exports, the euro area is a large economy in which economic developments are determined mainly by domestic factors. Overall, the fundamentals in the euro area remain broadly favourable (ECB 2001, February MB: 5).

This assessment of the situation was confirmed in March[8] with the ECB stating that:

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[7]The ECB's upbeat assessments became increasingly challenged by financial markets and others. The IMF's Stanley Fischer saw room for interest cuts in late January (Financial Times Deutschland [FTD] 27 January 2001) and the Fund's head Horst Koehler reiterated that view in early April, adding that "through aggressive interest rate cuts, the U.S. has correctly demonstrated decisiveness" (Financial Times [FT] 2 April 2001, T. Barber). (Mr. Koehler's views are of particular interest — and will be referred to again further below — for the fact that he played a key role in the negotiations leading to the Maastricht Treaty; cf. Dyson and Featherstone 1999: 423-4.) Later that month the Fund's Chief Economist Michael Mussa urged that "it is time for the ECB to become part of the solution, not part of the problem, of slowing global growth" (quoted in FT.com 29 April 2001). Exemplifying the ECB's single-minded and backward-looking focus Mr. Duisenberg explained that "with inflation above the central goal, a move in interest rates in that context would not enhance the credibility of the ECB" (FT.com 30 April 2001).

[8]Similarly, at the Monetary Dialogue [MD] on 5 March 2001, Mr. Duisenberg explained that "Europe is overwhelmingly dependent on domestic demand, both investment and consumption. Therefore, to a large extent, Europe is isolated, but not entirely, I admit, from developments elsewhere," and he announced that "we expect economic growth to remain at close to 3% both in 2001 and 2002" (MD 5 March 2001).

> The general outlook for this year and next remains positive. Economic activity in the euro area is mainly determined by domestic factors. The conditions on the domestic side, as shown in long-term financing costs and real disposable income developments, for example, have remained favourable. ... This notwithstanding, an element of uncertainty with regard to the outlook for euro area growth continues to be the world economy and its potential impact on euro area developments. However, at this juncture, there are no signs that the slowdown in the U.S. economy is having significant and lasting spillover effects on the euro area (ECB 2001, March MB: 5).

Again upholding the view that U.S. growth was not all that important to economic performance in the eurozone, the ECB asserted in May 2001 that "economic growth, supported by domestic demand, will be broadly in line with estimates of potential growth in 2001" (ECB 2001, May MB: 5). Yet, an unexpected cut in its key policy rates by 25 basis points had occurred on May 10, stirring widespread confusion in financial markets.[9] The surprise cut, the ECB declared, was to "be seen as an adjustment of the level of interest rates to somewhat lower inflationary pressure over the medium term" (ECB 2001, May MB: 5). Moreover, after correcting for upward distortions, M3 growth suddenly appeared to have been *below* the reference value of 4.5% for some months. The ECB concluded that "monetary developments no longer pose a risk to price stability" (5). While the ECB never directly links its interest rate policies with nominal or real GDP growth, the bank readily proclaimed on this occasion that: "M3 growth has been on a gradual downward trend since spring 2000, reflecting the increase in the key ECB interest rates which occurred between November 1999 and October 2000." Note here also that despite the turning point in M3 growth in spring 2000 (an indicator for which the ECB reserves a "prominent" role), the bank continued hiking rates until October of that year.

The ECB suddenly became more appreciative of the role of external developments in June when it explicitly declared that the deceleration of growth was *caused by* external factors, but would be supported by both fiscal and monetary policy in the eurozone:

> Real GDP growth in the euro area in 2001 is expected to come down from the high level reached

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[9]Only days before, prominent Council members had reiterated that rates were on hold in view of a balance of inflation risks and prospects of sustained at-or-above-potential GDP growth. The Financial Times' Lex column of 11 May 2001 reads: "The [ECB] may have surprised even itself by cutting interest rates by a quarter point. It certainly surprised everyone else. ... The timing of the ECB's move .. is hard to understand. ECB officials have mounted an unusually disciplined campaign in recent weeks to talk down prospects of a cut. ... The ECB's surprise ... raises credibility concerns. The euro's drop reflects disappointment where there should have been relief."

> in 2000 to levels more in line with trend potential growth, primarily as a result of the less favourable external environment. ... At this juncture, however, the contribution to real GDP growth from domestic demand is expected to remain robust. This is consistent with the favourable economic fundamentals of the euro area, the impact of current and planned tax reforms and favourable financing conditions (ECB 2001, June MB: 5).

A month later, and a year after the onset of the slowdown, the ECB then — for the first time — related the growth slowdown in euroland to dwindling domestic demand. Albeit, this did not occur without suddenly attributing a new prominence to external developments. At this juncture, the ECB was quick to link declining investment in euroland to adverse influences from the world economy; while weakening consumption was partly attributed to adverse income effects relating to energy and food price increases. Another interesting pattern in the bank's behavior emerged at this juncture too. After acknowledging a broad slowdown in aggregate demand, and without adjusting interest rates in reaction to that diagnosis, the ECB was nonetheless ready to predict that "in the course of [2001], domestic demand should gradually recover, in view of the sound economic fundamentals of the euro area, previous and ongoing tax reforms and favourable financing conditions" (ECB 2001, July MB: 5).

When, on August 30, the next 25 basis points cut occurred, Mr. Duisenberg in his introductory statement at the accompanying press conference [PC] referred to "clear signals of lower inflationary pressures from the demand side" and then elaborated, when questioned why the ECB had waited so long, that the "slowdown in economic growth emanating from the slowdown in the U.S. is larger, deeper and more prolonged than had been anticipated earlier." Apparently not unaware of the fiscal consequences of the slowdown under way, he expressed concern about any possible waning in governments' determination to stick to their stability programmes.[10] This did not elicit any decisive monetary policy reaction in order to prevent the predictable budgetary embarrassments from arising though. Instead, Mr. Duisenberg declared:

> under the present circumstances, the automatic stabilisers should only be allowed to work fully in those countries whose budget positions are close to balance or in surplus. Let me emphasise that a medium-term perspective is essential for the conduct of fiscal policies in all euro area countries. Short-term discretionary measures aimed at strengthening domestic demand risk having an unwelcome impact on the economy, not least on account of time lags. In addition, if such

[10]By contrast, in its June 2001 Report, the IMF cautioned against "resorting to pro-cyclical policies that risk prolonging the downturn."

> measures are not consistent with the Pact, they may undermine the credibility of the consolidation process (PC 30 August 2001).

It was only in response to the terrorist attacks of September 11 that interest rates were cut more decisively, by 50 basis points each on September 17 and November 8.[11] Weakening demand was seen as reducing price pressures. With falling inflation and high uncertainty, these cuts were retrospectively described as "forward-looking" (ECB 2001, December MB: 5). Mr. Duisenberg also emphasized that monetary policy might in this way "help restore confidence among the public" (PC 8 November 2001).

By this stage, in addition to stressing fiscal consolidation, the ECB stepped up its urging on the need for structural reforms too, since these would "improve the resilience ... to adverse shocks in the future" (PC 8 November 2001) and deliver a "permanent and significant increase in potential output growth" (PC 6 December 2001). By contrast, Mr. Duisenberg seemed less knowledgeable about developments in *actual* growth. Blaming the U.S.'s slowdown was getting ever less credible as the worst had already passed on the U.S. side by that time. Questioned on divergent developments on either side of the Atlantic at the press conference on 6 December 2001 Mr. Duisenberg's responded that he had "not seen those latest figures" but that "the economic growth performance of the euro area in 2002, according to our expectation, will exceed the growth performance of the United States when looking at the annual average."

How can this optimism about the incipient resumption of growth and expected outperformance of the U.S. be explained, given that euroland was — supposedly — suffering from all-pervasive structural problems that were holding down its growth potential? One key theme in the ECB's reasoning and rhetoric was that interest rates were at "historically low levels" and *therefore* conducive to growth. Another, related to the euro's "upward potential," that euroland was not suffering from any serious imbalances. The ECB was going to become ever more explicit about supposed problems "elsewhere in the world economy" later on. At this stage,

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[11]Clearly the tragic events opened a window of opportunity to the bank, which had become seen as being hopelessly behind the curve since the spring. It is of some interest here that former Bundesbank president Karl-Otto Poehl, who served on the Delors Committee back in 1988-9 (cf, Dyson and Featherstone 1999) and was in a way the chief architect of the ECB, observed that the bank "should have lowered interest rates more resolutely months ago. It evidently incorrectly perceived the economic situation" (quoted in International Herald Tribune 1 November 2001).

the supposed absence of such obstacles was held to support the ECB's forecasted resumption of growth to its potential rate — by now — "in the course of 2002":

> The conditions exist for a recovery to take place in the course of 2002 and economic growth to return to a more satisfactory path. The economic fundamentals of the euro area are sound and there are no major imbalances which would require a prolonged adjustment. The uncertainty currently overshadowing the world economy should diminish over time. Further positive effects on economic growth should stem from the increase in real disposable income caused by the substantial decline in inflation and the impact of tax reductions in several euro area countries. In addition, interest rates across the entire yield curve *are now low, meaning that current financing conditions are clearly supportive to economic growth* (ECB 2001, November MB: 6; italics added).

In conclusion, three key features characterized the ECB's assessments and conduct during this phase: (1) after initially downplaying any risks stemming from a U.S. and deteriorating global environment, it then switched to blaming the slowdown exclusively on external influences; (2) the bank seemed either unaware of the slump in domestic demand that had started in mid 2000, or at least never took seriously the possibility that decisive interest rate cuts might be warranted to bolster demand, judging its monetary stance as conducive to growth anyway; (3) apart from misreading the economy, the bank remained "out of touch with the markets" too.

As during its tightening cycle in 1999-2000, the ECB's subsequent refusal to cut interest rates boded ill with the markets' focus on growth — the euro fell back to near its historical low in early July. In due course the slump was bound to stir up further domestic headwinds. Yet, by year-end, the ECB thought that it had cut interest rates down to emergency levels and that inflation risks would be looming high as soon as the economy might start to recover.[12]

5. 2002: AS SLUMP STIRS UP DOMESTIC HEADWINDS "CAUTIOUS" ECB SITS ON HANDS

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[12]Contrary to a widespread suspicion that Governing Council [GC] members might pay particular heed to their home country situation, Bundesbank president Ernst Welteke, who in 2001often seemed to attract more attention than Mr. Duisenberg, was especially outspoken in his warnings against cutting interest rates too fast for fear of inflation. In effect, Mr. Welteke was upholding the old Bundesbank mantra against "fine tuning" and "activist" policies and in favor of a "steady hand" policy (to be followed in downturns, though not upswings!).

Having dissipated hopes in financial markets for further interest rate cuts by the turn of the year[13], by late January 2002, after the euro cash changeover and in a climate of general outlook gloom, Mr. Issing even seemed to indicate that the next move would rather be in the upward direction, and perhaps not that far off ("EZB läutet Zinswende ein," FTD 30 January 2002). When the ECB's chief economist reiterated his fears of upward risks to price stability in mid March at a hearing at the European Parliaments Monetary Committee on March 20 this prompted the Wall Street Journal to observe that "Mr. Issing's statement's underscores the central bank's obsession with inflation, even at a time of slow economic growth and amid significant uncertainty about the strength of a recovery" ("ECB could raise rates as inflation fears set in," WSJE, 21 March 2002).

Apart from fearing inflation as such, the ECB became increasingly more bullish on the prospective recovery in subsequent months. In April the bank noted that the "persistence of excess liquidity in the economy could become a concern once the economic recovery in the euro area gathers pace" (ECB 2002, April MB: 5). And in May more indications for preparing a hike came when the ECB dropped the "appropriate" title for its interest rate stance and observed that "the prospects for price stability appear to be somewhat less favourable than they were towards the end of last year" (ECB 2002, May MB: 5). The ECB proclaimed that "euro area real GDP growth rates should again be in line with potential growth later this year and solid growth rates should be attainable in 2003" (5). The reasoning behind its optimism was revealed in the bank's repeated insistence that

> the conditions for a sustained upswing in domestic demand, including favourable financing conditions, continue to be in place. The more positive international environment should stimulate euro area exports, thereby fuelling aggregate demand in the euro area. Finally, sound fundamentals and the absence of major imbalances support the positive outlook for the euro area economy (ECB 2002, May MB: 5).

No doubt the ECB was taking a forward-looking approach to real economy

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[13]Already at the Monetary Dialogue on 18 December 2001 Mr. Duisenberg came across as upbeat on the projected recovery in the course of 2002 and as signaling an end to interest rate cuts (cf. FT.com 18 December 2001), emphasizing that with the cuts of 150 basis points in 2001 "in both nominal and real terms, short term interest rates have thus reached levels that are very low in a historical context." He also stated that "the resumption of economic growth will be predominantly domestic-led." In January Mr. Issing aired his concerns about rising money supply growth, bound to be interpreted as an argument against rate cuts (cf. FT.com 11 January 2002).

developments, at this juncture. For it was only due to a positive net trade contribution, compensating the negative domestic demand one, that GDP growth stabilized just above the zero line. The external lifeline was not going to be helped by the euro's sharp appreciation against the U.S. dollar that began in April 2002.[14] On the other side of the Atlantic, Alan Greenspan emphasised the risk of continued economic weakness, nourishing market perceptions that the Fed was in no hurry to raise interest rates ("Dollar hits three-months low on Fed caution," FT.com 17 April 2002). On this side, the Swiss National Bank even cut interest rates to compensate for currency strength. Mysteriously, the ECB seemed to seriously contemplate hiking rates soon.

Given stagnation elsewhere, the U.S.'s recovery, feeble as it was, involved the prospect of escalating current account imbalances — a theme that gained renewed prominence with the markets ("Dollar reaches two-year low vs euro on U.S. current account gap"; Bloomberg.com 20 June 2002). Corporate accounting scandals and plunging stock markets further added to the dollar's plight ("WorldCom woes push euro nearer to parity"; FT.com 26 June 2002) while credit spreads soared. The U.S. Fed signalled further cuts as recovery hopes dwindled, and speculations for interest rate cuts in euroland set in too. But, especially with inflation well in excess of 2%, the ECB was in no hurry to sympathize with outsiders' views on what the situation required. By September, the bank was merely back to describing its interest rate stance as "appropriate," i.e. dropping the tightening bias it had adopted in May, declaring that the acceleration in economic activity towards potential growth was postponed until next year rather than the end of 2002.

The ECB's reluctance to cut prompted pressures from all round, including IMF head Horst Koehler who famously reminded Mr. Duisenberg that monetary policy would be "the first line of defence." Of course Mr. Koehler was merely spelling out the textbook result that with fiscal policy being constrained, the stabilisation burden rested squarely on the central bank's

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[14]I stressed growth (or, the growth gap) as the markets' primary theme between 1999 and spring 2002. It is noteworthy that Alan Greenspan warned in mid March 2002 that the U.S.'s current account deficit (around 4% of GDP at the time) may prove unsustainable in the long run, a concern which was echoed by William McDonough, New York Fed president, who also suggested in a speech later in March that the dollar may be slightly overvalued (FT 26 March 2002). Current account imbalances, a nonissue in the markets in previous years, made their sudden comeback as a market theme weighing on the dollar — aided when U.S. Treasury Paul O'Neill was perceived as less keen on upholding the "strong dollar" policy too (cf. "Dollar remains under pressure," FT.com, 2 May 2002).

shoulders. Yet, Mr. Duisenberg's response was that he had never heard of that ("Duisenberg defends holding rates steady"; WSJE 9 October 2002).

The point is that it was no longer just a case of the SGP preventing discretionary fiscal measures to boost growth and enforcing sole reliance on automatic stabilizers. Rather, the slump's budgetary impact was by that time forcing more and more governments to enact discretionary fiscal tightening, risking a further destabilization of their economies.[15] Questioned on this problem in the monetary dialogue of 3 December 2002, Mr. Duisenberg responded:

> I refuse to think in terms of there being a trade-off between certain fiscal policies and the monetary policy stance. The monetary policy stance is determined by our monetary policy strategy, which is forward-looking and has a medium-term horizon. I am not thinking in terms of compensating by one policy events that happen in the other, in particular when they are of a structural nature (MD 3 December 2002).

When it was then explained to him that the demand impact of fiscal policy would imply a monetary policy reaction even within that strategy he revealed that: "I believe my models suggest that the impact on real output would be very limited indeed" (MD 3 December 2002).

In fact, the ECB's Monthly Bulletins' editorials implied that fiscal retrenchment itself would, in a way, be the "first line of defence," namely by boosting confidence and demand. At the start of the year, the ECB had proclaimed that "rather than hindering a return to sustainable economic growth, the adherence of fiscal policies to their medium-term objectives will strengthen consumer and investor confidence" (ECB 2002, January MB: 6). The emphasis on non-Keynesian effects was stepped up in the fall: "Credible fiscal consolidation is supportive to the outlook for economic growth. Direct effects on demand in the short term should be counteracted by higher credibility of the conduct of fiscal policy, boosting confidence and thus private spending" (ECB 2002, October MB: 6).[16]

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[15]Rejecting calls from the opposition to stimulate growth through tax cuts, Germany's chancellor Schroeder in July 2002 said he would follow a "steady hand" policy instead. While factually misleading, given that a fiscal tightening occurred, such echoing of traditional Bundesbank speak reflects the extent to which public debates are framed by central bank politicians in Germany, in particular.

[16]At a forum in November 2002, Karl Otto Poehl called on the ECB to pay more attention to economic growth: "In the present situation, price stability or inflation are not the main problems. The problems are stagnation or even a recession." But his successor Ernst Welteke outright dismissed such criticism, declaring that repeated calls for monetary or fiscal policy to be more growth-oriented were "based on fool's logic" (FT 18 November 2002). Apart from propagating Bundesbank dogma of "steady hand"

Structural reforms attained a prominent short-run role too, as the ECB asserted they:

> would help to foster consumer and investor confidence in the long-term growth and employment opportunities in the euro area, thereby having a *positive effect on consumption and investment decisions in the short and medium term* (ECB 2002, September MB: 7; italics added).

And a month later the ECB went even further and asserted that

> further delays in tackling, with greater determination, the underlying reasons for limited growth in potential output over the medium term, *and for only partially exploiting the current potential*, are costly (ECB 2002, October MB: 7; italics added).

All these reasons seemed to justify the bank's inaction — as it never seems to worry too much that further delays in cutting interest rates might be related to euroland's only partial exploitation of its current potential. At historical lows, interest rates did not seem to represent a hindrance to the resumption of growth — nor, apparently, did structural problems. It took until December 5 for the ECB to shave another 50 basis points off its policy rates last changed in November 2001:[17]

> The decision reflected the Governing Council's assessment that the evidence has increased that inflationary pressures are easing, owing in particular to the sluggish economic expansion. Furthermore, the downside risks to economic growth have not vanished (ECB 2002, December MB: 5).

In conclusion, expecting an early recovery in view of "sound domestic fundamentals and absence of major imbalances," throughout 2002 the ECB stayed put, watching as the slump persisted and stirred up more and more domestic headwinds, particularly in the form of rising unemployment, banking problems, and a worsening (SGP-imposed) fiscal squeeze. Box 2 summarizes the mechanisms at work in this phase. While U.S. households' disposable incomes where propped up by significant tax cuts, euroland's faced the opposite; on top of job losses and rising job insecurity. While the U.S. banking system's profitability got early and decisive support through a — Fed-engineered — steep yield curve, no such relief was forthcoming in euroland

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interest rate policies and M3 prominence, Mr. Welteke acted as one of the SGP's most staunchest defenders, routinely attacking the German government, in particular, for its alleged failure to carry out structural reforms and tighten the budget more aggressively.

[17]Karl Otto Poehl was quoted in the media as commenting that: "The ECB could have cut rates a bit earlier. It is sometimes a bit timid" (Bloomberg.com 5 December 2002). Only days before, however, Mr. Issing (2002) had warned of the risk of a return of stagflation (rather than deflation). Cf. also Bibow and Schlotmann 2002.

where the damages incurred in the stock market bust led to a credit squeeze, particularly in Germany. Most curiously, perhaps, as finance ministers in their plight took recourse to hiking indirect taxes and administered prices, the stagnation-caused budgetary squeeze even helped to keep up inflation — which, in turn, seemed to justify the ECB's inaction (see below).[18]

More trouble was brewing at the exchange rate front though. Throughout the period 2000-2002 (as previously between 1992-97), euroland had benefited from sizeable positive growth contributions from net exports. In 2001-02, mainly net exports kept GDP growth afloat at all. In view of the euro's rise since April 2002, which was bound to take its toll on net exports and reduce inflation in due course, the ECB's inaction seems even more inexplicable.

6. 2003-04: STILL MORE "CAUTION" AS STRONG EURO CUTS OFF LAST LIFELINE

As the ECB had preferred to "wait and see" for well over half a year since the euro's rise had started, the December 2002 cut was not going to make any timely change to euroland's key problem: stagnant domestic demand. Concern about euroland's fragility was running high and pressures for easing abound — as public finances deteriorated further while the euro continued to soar. This was not for any new intrinsic attractiveness, by this time, the euro simply appeared to "win the 'ugly contest' " (FT.com; 3 March 2003). On top of the U.S.'s current account deficit, factors like the Iraq conflict and a growing market perception that the new U.S. Treasury Secretary John Snow was not backing the "strong dollar" policy ("Dollar falls after Snow comment": FT, 5 March 2003) were weighing on the U.S. currency. Yet, at its meeting on 6 February 2003, the ECB's Governing Council [GC] judged that its stance "remains appropriate" and that "the most likely scenario is that of a gradual increase, starting in the second half of the year, in real GDP growth rates to levels close to potential" (ECB 2003, February MB: 5)

The ECB then changed course later that month when, in the context of the G7 forum,

[18]Once again exemplifying the ECB's supposedly forward-looking policy approach, Mr. Duisenberg stated at the Monetary Dialogue on 3 December 2002 that there were "factors such as the stubbornly high inflation rates, which eventually led the Governing Council to decide not to change rates. It is now the third year that we have been unable, to my disappointment also, to reach the goal of an average rate of inflation of 2% or lower."

"Mr. Duisenberg hinted heavily that the ECB was preparing to cut interest rates to stimulate growth" ("Europeans attack U.S. tax cut plan at G7 forum"; FT.com 27 February 2003). A 25 basis points cut came forth on 6 March 2003 as the "outlook for price stability over the medium term has improved in recent months, owing in particular to the subdued pace of economic growth and the appreciation of the exchange rate of the euro" (ECB 2003, March MB: 5). The cut was widely considered as insufficient, particularly as the euro was taking yet another leap upwards.

As U.S. GDP growth, although itself weak, was still outpacing euroland's, euro strengthening seemed to defy what had in previous years become market orthodoxy on exchange rate movements, a shift in convention summed up succinctly by the Economist: "Over the years, currency theories move in and out of fashion. Growth differentials are, it seems, no longer relevant; currencies are being driven instead by trade imbalances and difference in interest rates" (Economist 8 May 2003).[19] Some more subtle circumstances were involved too though. For one thing, when the U.S. Fed signaled growing concerns about deflation risks at its May Federal Open Market Committee (FOMC) meeting, this provided an extra downward spin to the U.S. dollar ("Dollar under pressure amid deflation worries"; FT.com 7 May 2003) through driving bond yields down and increasing interest rate differentials vis-a-vis the euro. For another, it soon became even clearer that all this had the Administration's blessing when Mr. Snow described the dollar's fall as a "modest realignment" ("Euro back to launch level"; FT.com 19 May 2003). In fact, it was quite remarkable that the U.S. authorities should achieve within a short time a sizeable easing of financial conditions in such an orderly way.[20]

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[19]The BIS's Annual Report (2003: 80) observed that in 2002: "Interest rate differentials seemed to re-emerge as an important factor behind exchange rate movements against the backdrop of disappointing growth prospects and the continuing decline in equity prices. The widening U.S. current account deficit and changes in composition of its financing also took centre stage, suggesting a rising risk premium on U.S. assets."

[20]Alan Greenspan started the anti-deflation campaign on 13 November 2002 by mentioning the possibility of outright purchases of longer-term Treasuries by the Fed, thoughts that were echoed a week later by Governor Bernanke (2002b). Having won the war against inflation, the Fed, at the May 2003 FOMC meeting, established what amounted to a pre-commitment strategy of holding down the Fed funds rate in view of its assessment that "the probability of an unwelcome substantial fall in inflation, though minor, exceeds that of a pickup in inflation from its already low level." Of course, assessing the success of the Fed's approach to take out insurance against an unlikely but potentially very costly event gets all too

The authorities' behavior on the European side was equally remarkable. The ECB's communications emphasized that the euro was trading around its historical average and the bank appeared to be at perfect ease with the situation ("Euro soars as ECB signals ease with strength"; FT.com 8 May 2003).[21] As to its interest rate policies, however, a conspicuous asymmetry has been revealed since 1999 with respect to exchange rate developments. Contrasting strongly with its previous aggressive hikes, the bank showed a remarkable complacency about the euro's rise since April 2002 and its foreseeable disinflationary effects. The bank hiked rates by 225 basis points within less than a year in the former case; when it misconceived that it was not economic growth but its own euro-weakening interest hikes which pushed up inflation in the first place. But it took the bank 15 months to shave off 125 basis points in the latter case when it misconceived that earlier and more aggressive steps to boost domestic demand would have curtailed the forces of persistence in inflation stemming from protracted economic weakness at a time when the euro's long promised "upward potential" was finally materializing.[22]

So it was not until June 5 that the bank's so far final cut of 50 basis points occurred. Reflecting the IMF's (2003) warning of deflation risks in Germany, the Financial Times' "Lex" column says it all: "The question of why the ECB waited until last week to cut its key interest rate to 2 percent is unfathomable. That Wim Duisenberg, ECB president, says it is too early to

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easily blurred if the event insured against does not arise — as turned out to be the case. In truth, the subsequent reversal in bond yields was remarkably subdued compared to the sharp pickup in nominal GDP growth since mid 2003. No less remarkable was the fact that — despite the anti-deflation campaign — the Fed managed to bolster confidence in stock and corporate debt markets which, together with dollar weakening, amounted to a pronounced, broad easing in financial conditions at a time of massive fiscal stimulus.

[21]The ECB's position was no doubt complicated by its "upward potential" rhetoric in previous years, which apparently had never prompted any preparation for that event. Furthermore, in contrast to the U.S. side, there is some uncertainty as to who is actually in charge of euroland's exchange rate policy.

[22]In addition, Bofinger (2003) produced evidence that the Eurosystem's foreign exchange reserves actually *declined* during the period of January to April 2003, i.e. followed the trend. Of course it always seemed puzzling why the Eurosystem failed to put its excessive dollar reserves to good use back in 1999-2000. Apart from being stabilizing rather than destabilizing in nature, interventions at that time would also have proved rather profitable to euroland's taxpayers. That, however, may not be the primary concern of an actor who takes it on himself to put pressure on governments, which under the normal functioning of democracies should only be exercised through the ballot box; including the legitimate votes (rather than actions) of independent central bank politicians.

talk about another cut is bizarre when Germany may be heading into a Japanese-style morass. The Fed's determination to stave off the threat of deflation stands in marked contrast to the ECB's complacency" (FT.com, 12 June 2003).

Commenting on the deflation debate, the June editorial noted that for the "euro area as a whole ... there are currently no forecasts indicating any deflationary risks. ... Within a monetary union, deflation is not a meaningful concept when applied to individual regions" (ECB 2003, June MB: 6). Yet, the ECB stated that apart from a significantly improved outlook for price stability that justified the cut, in its view, "the interest rate reduction takes into account downside risks to economic growth" and that "the historically low level of interest rates should contribute to an upswing" (5). As to the euro, the ECB re-confirmed that "current euro exchange rate levels are in line with economic fundamentals and with [its] interest in a strong and stable euro" (5).

Originating from the U.S., where more positive economic news started to emerge by the time of the Fed's June FOMC (which delivered 25 rather than the expected 50 basis points cut, prompting a reversal in bond yields), the global outlook changed fundamentally over the next few months. The ECB's promised gradual improvement in GDP growth in the second half of 2003 did materialize too. However, euroland's emergence from virtual standstill in the first half was not at all due to domestic developments. Quite the opposite. Final domestic demand remained stuck at a depressed level in the second half of 2003 too. The improvement between the second quarter (when GDP actually declined) and the third owed to nothing else but a spur in exports.

Of particular interest is Germany, where extensive structural reforms of labor markets and the welfare system occurred in 2003, while fiscal consolidation continued too. Whereas the ECB notoriously asserts that such policies would boost confidence, if anything, household confidence as well as income and employment expectations plunged. In fact, with real disposable incomes declining, domestic demand's negative contribution to GDP growth comes at no surprise. Despite all this, however, Germany too still managed to creep out of recession in the second half of 2003 — triumphing as the world's no. 1 exporter in that year! Effectively, then, macroeconomic stimulus measures of a kind routinely criticized by euroland's policymakers, but nonetheless successfully implemented "elsewhere in the world economy" (i.e. regions which suffer from precarious imbalances which supposedly held back growth in euroland), once again pulled the euro's zone of "stability and growth" away from the abyss. For in euroland itself,

where "stability-oriented" medicine was applied relentlessly, private spending remained flat.

Nonetheless, Mr. Duisenberg used his final months in office primarily to criticize others for not doing their part ("ECB chief throws caution to the wind"; FT.com 8 July 2003). As usual, urges from politicians to cut interest rates and stem the euro's rise provided a welcome excuse for the bank's inaction. The ECB felt that the ball was firmly in the politicians court and, in perfect denial of all evidence to the contrary, continued to push the idea that structural reforms and fiscal consolidation would bolster confidence and spending *also in the short run*:

> With medium-term inflation expectations firmly anchored at levels consistent with price stability, and with interest rates at historical lows, monetary policy has made a significant contribution to improving the conditions for a recovery in economic growth. Now, other policy-makers also have to make their contributions. Part of the weakness in economic growth in the euro area can be linked to a lack of ambition in the areas of fiscal and structural reform to further improve the conditions for investment and employment. A strong commitment to the Stability and Growth Pact and adherence to well designed medium-term fiscal consolidation strategies in those countries currently struggling with increasing fiscal imbalances would make a major contribution to improving confidence (ECB 2003, July MB: 6).

Once again, in August 2003, the IMF issued warnings on the risks to recovery in euroland, recommending a more pro-active monetary policy stance and non-pursuance of de-stabilizing fiscal policies. The FT columnist Tony Major nicely captured widely held views and hopes related to the change at the ECB's helm, observing: "Whether [Trichet's] decisive leadership will lead to more rate moves is unclear. But it could make the bank more forward-looking and ensure policy changes are more timely. For a bank that has long been criticised for doing 'too little too late,' that would be a big step towards improving credibility" (FT 9 September 2003).

But even when the G7 communique at Dubai meeting was followed by renewed euro strength[23] while an increasing number of countries were struggling with the budgetary consequences of protracted stagnation, conflicts between the ECB and the German and French

[23]Shortly before his departure, Mr. Duisenberg, apart from repeatedly observing that the dollar's decline was unavoidable ("Trichet's chance"; FT.com 5 November 2003; Central Banking 2003, November: 9) which can hardly be perceived by the markets other than inviting a one-way bet, once again even seemed to hint that foreign exchange market interventions were unlikely ("Duisenberg comments spur drop in dollar"; WSJE 7 October 2003).

governments, in particular, continued unabated — and the handover from Wim Duisenberg[24] to Jean-Claude Trichet in November 2003 left the policy deadlock unchanged. The ECB expressed "great concern" about fiscal developments (ECB 2003, September MB: 6), then "serious concerns" (ECB 2003, October MB: 6), and finally attested "a critical point" (ECB 2003, November MB: 6) for the SGP in November. At the end of the month, the budgetary crisis led to Ecofin's suspension of the sanctions mechanism of the SGP as part of the ongoing "excessive deficit procedure" against Germany and France ("Eurozone ministers freeze budget pact"; Reuters 25 November 2003), an event that was widely interpreted as the pact's demise. In truth, the Maastricht folly of unconditional (i.e. pro-cyclical) consolidation efforts continues until today.

In this context, it is of great interest that the ECB's November 2003 editorial acknowledged increases in indirect taxes and administered prices as key contributors to the stickiness in inflation. In fact, it appears that "tax-push inflation" might have added up to half a percentage point to the December projection of HICP inflation in 2004 compared to the previous projection of June 2003. In fact, this by-product of fiscal consolidation and structural reform has played a key role in keeping headline inflation stubbornly above 2% since 2002 (see Figure 3).[25] Despite representing a key factor behind the bank's repeated misses on its primary goal, the ECB does not seem to conclude that more pro-active monetary policies might lessen its mischievous working. In a way, though, tax-push inflation has improved the consistency of the ECB's policy stance. Previous inflation projections for 2004 and 2005 seemed to suggest that further monetary easing would be appropriate to counter falling inflation. By refusing to come forth, the easing was made superfluous thereby — as the budgetary consequences of stagnation and SGP-inspired consolidation efforts caused sufficient inflation persistence.

Certainly stubbornly high inflation in 2001-03 was neither due to excess demand nor

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[24]At his final Monetary Dialogue on 10 September 2003 Mr. Duisenberg humbly declared that: "Especially where monetary policy is concerned, the most important lesson that we can draw from the past five years is that we would be well advised — and my successor or successors will be well advised - to continue what we have been doing. I see no need for change in monetary policy." Interestingly, when questioned on that occasion whether he had any regrets about the ECB's six interest rate hikes in 2000, when GDP growth rates were high, though not for much longer, Mr. Duisenberg preferred not to answer that question.

[25]See ECB (2004 January MB: 27-8). The data was provided to me by the ECB, indicating that they represent rough proxies (particularly the administered price series) and should not be treated as official ECB data.

excessive wage inflation. If anything, wage inflation has been too low, staying well below any reasonable long-run nominal GDP growth trend (see Figure 4)[26]. Negotiated wages, a statistical representation of wage settlements, show a low and stable trend around 2 to 2.5% per annum. Compensation per employee as a measure of actual paid wages may indicate a mild cyclical pattern in wage drift (above trend in 2000 and 2001, below trend in 1999 and 2002). Another factor that contributes to a divergence between the two measures are changes in employers' and employee's social security contributions. In this regard it is of interest that efforts in recent years to cut employers' social security contributions in order to stimulate employment have been nullified by the slump, pushing this factor (on an hourly basis) well above the wage trend. A risk is that the stagnation-caused fiscal squeeze may force governments to reverse course and hike social security tax rates — causing the very symptom generally referred to as structural problems.

While there was no excess demand present in goods markets either in 2000, if anything deficient demand since the 2001 slump may have been detrimental to price stability too. The rise in headline HICP in 1999-2000 was largely due to rising import prices related to the euro's plunge and energy cost increases. Apart from *prolonged* euro weakness, a key factor behind the lagged rise in core inflation since 2001 was probably the sharp rise in unit-labor cost growth which occurred with the slump-related faltering of labor productivity growth (Figure 5). The ECB would blame this phenomenon of rigid labor markets. Yet, it is not clear whether faster labor shedding in recent years would have done much good to consumer confidence and spending. Perhaps policymakers may be well advised to take proper account of the structural features of the economy they control when they carelessly provoke a slump.

The key change in the third phase of the ongoing stagnation is that euroland's last lifeline — net exports — was finally cut off due to the euro's continuing appreciation which had started in April 2002. The euro's rise involved a significant tightening of monetary conditions at a time of economic weakness and fiscal retrenchment (see Figure 6). In this regard, a policy shift finally occurred in January 2004. The ECB's new president had been known for his "strong euro" stance. And in an interview with the Wall Street Journal in mid December 2003 he reaffirmed

[26] On the issue of wage moderation see Hein 2002 and Kleinknecht 1998.

what he was reputed for: “Cautious Trichet reaffirms ECB pursues a strong euro” (WSJE 18 December 2003) — a line underscored by utterances from other important ECB members at the time. In particular, Mr. Issing continuously stressed that the euro “has come back to its long-term average” and that this “correction is not something that we should be surprised about” (“Dollar falls against euro, yen as consumer confidence declines”; Bloomberg 12 December 2003). Add to this observations from U.S. Treasury Secretary John Snow that the dollar’s decline “has been orderly” and it becomes quite clear that the markets knew only one way in which to bet at the time.

Markets were thus taken by surprise when Mr. Trichet changed course only a few weeks later. At the (post-GC) press conference on 8 January 2004, he commented that “we do not particularly like excessive volatility or excessive turbulence” (“ECB chief breaks his silence, signals concern at euro’s rise;” WSJE 9-11 January 2004). While this did not make any immediate impression (“Dollar rebound halted by ECB’s indifference,” FT 8 January 2004; “Euro surges; ECB says currency gain won’t prevent export growth” Bloomberg, 8 January 2004), Mr. Trichet underscored the new line a few days later when he warned that “excess volatility and brutal moves were not welcome and not appropriate” (“ECB president’s euro worries grow,” WSJE 13 January 2004; “Euro reverses as Trichet hints at intervention,” FT.com 12 January 2004; “Euro drops as Trichet says he’s concerned about ‘brutal’ moves”, Bloomberg 12 January 2004); while his successor at the Banque de France (former ECB Vice-president Christian Noyer) added that interventions were always possible (“Notenbanker halten Euro in Schach,” FTD 15 January 2004) and other GC members echoed the new line. For the time being, the one-way bet was called off — a communication policy coup that broke with ECB traditions in this field; as successful “verbal interventions” brought the euro’s rise to a halt.

Alas, doubts about the ECB’s determination quickly re-emerged when the bank reasserted its belief that euroland will share in the recovery in global growth, despite the euro’s rise.[27] Following the G7 meeting at Boca Raton, Mr. Issing even helped to dispel fears of

[27]At its GC meeting on 5 February 2004 the ECB judged the short-term risks to the projected gradual recovery as “balanced,” professing that “robust real GDP growth in the economies of the euro area’s major trading partners can be expected to support foreign demand for euro area goods and services, although export growth may be dampened somewhat by the decline in price competitiveness” (ECB 2004, February MB: 5).

intervention ("Euro rises as ECB's Issing sees 'no point' in currency sales," Bloomberg 10 February 2004). What proved more effective in preventing the euro from soaring through $1.30 but stabilize around $1.20 in subsequent weeks instead, were disappointing news on euroland (paired with partly more positive news on the U.S. situation), igniting new speculation on further rate cuts to come ("Eurozone weakness spurs moves for interest rate cut," FT.com, 22 March 2004).

Mr. Trichet then appeared to tread new grounds in communication policy when he even seemed to hint at possible cuts in an interview with Handelsblatt ("ECB president hints at interest rate cut if domestic consumption fails to ignite," FT.com, 24 March 2004), which not just strengthened pressures for such a move ("Pressure grows on ECB to cut rates," FT.com, 26 March 2004), but thereby also helped to dampen the euro ("Euro declines to lowest this year on ECB rate-cut speculation," Bloomberg.com, 29 March 2004). But the GC once again balked at easing monetary stance at its meeting on 1 April 2004, merely replacing its "appropriate" title by the new phrase that its stance "is in line with the maintenance of price stability over the medium term" (ECB 2004, April MB: 5). Rumors emerged that "Otmar Issing and Holland's Nout Wellink orchestrated a counter-coup, insisting that the ECB could not let itself be "pushed around by governments" ("ECB in crisis as rate cut blocked by revolt," Telegraph 5 April 2004).

Yet, governments are not alone in their view that monetary policy has contributed inappropriately little for a recovery in domestic demand since 2001. This is certainly the dominant view in financial markets, and a view held by many international experts as well. Before the April GC meeting the Economist expressed its surprise "that it has taken the ECB so long to think about cutting rates" (Economist, 3 April 2004).[28]

In conclusion, after first misjudging both external as well as internal developments and then neglecting the domestic headwinds which the slump was bound to stir up, the ECB also

[28]In early April, Bundesbank president Ernst Welteke, a former provincial politician whose claim to fame rested not so much in any special expertise in matters of monetary policy than in his tireless public preaching of "belt tightening," was caught up in a hospitality affair over which he resigned (FT 16 April 2004). This marked what was probably the first incidence in Germany's history which saw public opinion swing decisively against a top official of the country's much-adored guardian of monetary stability. Of course the Bundesbank pulled its trump card that any criticism of the bank represents an attack of its all-important independence. It remains to be seen whether its hitherto untouchable status and unquestioned moral standing will fully recover from the Welteke affair.

stood by when monetary conditions tightened through euro appreciation. For a long time, if anything, the bank even seemed to invite the euro's sharp rise. The fact that the ECB failed on its price stability goal for four years in a row proves neither flexibility nor due respect for economic growth. Quite the opposite. Price pressures and inflation persistence reflected its lack of flexibility and disrespect for growth. Essentially, the ECB's plight was a consequence of its own previous blunders: first its euro-weakening interest hikes in 2000, then the budgetary squeeze that resulted from its subsequent failure to cut rates decisively as the slump progressed.

7. TAKING WORDS SERIOUS: NOT CONFUSED INFLATION TARGETING, BUT CLEAR ANTI-GROWTH BIAS

Interpreting the ECB's policy conduct since 1999 as a series of grave policy blunders that have left euroland stranded in today's inconvenient position seems both fair and bad enough. Yet, the real trouble with this bank is that it is all too likely to systematically err in one direction most of the time. The bank's performance has revealed a remarkable readiness to choke growth on the one hand, paired with an unfathomable indifference towards stagnation and obstinate reluctance to stimulate growth on the other. This anti-growth bias is structural in the sense that it has clear institutional roots, particularly the *ranking* of policy goals and the incentive structures that go with it, together with the bank's *unbounded discretion* which opens the door for this kind of zealous crusade in the first place. Current structures place dangerously few constraints on the personalities involved and the peculiar ideas and motives that may drive them.

The purpose of this section is to illustrate that the ECB's policy bias shines through rather clearly from its policy strategy and communications more generally. To simply view the bank's communications as a little confused and as reflecting some minor deficiencies in its approach to inflation targeting is missing the point completely. For the ECB is not at all engaged in what is generally understood as inflation targeting. Instead, the bank is guided by doctrines which make it a true outsider in the international arena of ideas and practices. The roots of the thinking which guides its conduct lie in German economic thought and received Bundesbank wisdom (Bibow 2003c, 2004b). Any perceived similarities between the bank's true mission and today's conventional wisdom, the theory of inflation targeting in particular, are apparent rather than real.

No doubt the ECB holds strong views on some fundamental issues. As regards fiscal policy, the ECB believes that traditional Keynesian effects are not all that important and may well be overturned by "confidence" (or, non-Keynesian/Ricardian) effects — *in the short run*. Even when euroland's (overall) fiscal stance is geared at pro-cyclical consolidation, this does not call for more accommodative monetary policy, in the bank's view. This belief is a far cry from the mainstream position that constraints on fiscal policy would raise the stabilization burden of monetary policy (Allsopp and Vines 1998, 2000). Similarly as regards structural reforms. While raising growth potential and the level of employment in the long run, according to conventional wisdom, appropriately supportive demand policies are needed in the short run. By contrast, the ECB asserts that structural reforms come along with positive confidence effects that bolster demand *in the short run*. Any enlarged potential would be *automatically* realized, it seems. If called upon to actively stimulate recovery and close a looming negative output gap, the bank would simply respond that governments should "do their part" *instead*.

A peculiar trade-off thus appears to exist between fiscal consolidation, structural reform, and monetary policy as regards short-term demand management. This is not only a rather idiosyncratic theoretical position as such. It also raises some alarming political issues. Clearly, in any democracy, there is no reason why independent central bankers should be in a position to decide which of these — apparently — alternative instruments should be applied. Proponents of central bank independence base their case on the assumption that central bankers are charged with a purely technical task, and thereby placed in a politically neutral position. Of course, even if money were neutral in the long run, this would still leave the short-run trade-off for central bankers to make a reasonable political choice on. But that is not the same thing as refusing to adequately counter a demand shock and pressurizing governments to "do their part" instead.[29]

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[29]While truly idiosyncratic in terms of theory, this is not to suggest that the ECB is alone in holding these beliefs. I stressed that a widespread perception exists, in financial markets in particular, that the ECB's has been unsupportive of growth. Yet, not few financial market players and employers' associations seem to view the mess caused thereby, now that it has arisen, as a welcome opportunity to pressurize governments to carry out certain structural reforms that would meet their particular interests. This attitude also appears to be popular among some academic researchers. For instance, in his praise of "doing such an outstanding job of pursuing a price-stability-based monetary policy," Melvyn Krauss (2004) is rather explicit about how very neutral monetary policy really is when he states that a strong currency "helps make structural reform unavoidable. In the long run, a first-class currency can help transform a second-

In assessing whether the ECB may be an inflation targeter care needs to be taken as to the substance of that approach. If the pursuit of price stability were all that is required to qualify, it would be hard to find any central bank that is not an inflation targeter. What proper inflation targeters, like for instance the Bank of England, the Sveriges Riksbank, and the Reserve Bank of New Zealand, are engaged in, in practice, is *flexible* inflation *forecast* targeting. Both aspects are essential. Starting out from an explicit numerical target for consumer price inflation, both the internal decision-making process as well as external policy communication are centered upon regularly updated and published inflation forecasts over some policy horizon. Within this framework flexibility refers to the abstention from trying to strictly stabilize forecasted inflation at its target rate at all times, as this might involve a high degree of output volatility. Instead, in practice, the quest is on for achieving some reasonable mix between inflation and output volatilities, namely through responding gradually, but symmetrically to shocks that drive forecasted inflation away from its target rate.[30]

In this regard, conventional wisdom[31] holds that only permanent supply shocks pose any proper trade-off. While temporary supply shocks should be ignored, demand shocks, by driving output and prices in the same direction, involve no conflict to an inflation targeter, the practical problems being timing and dosage. Importantly, assuming that policy transmission works through aggregate demand and that some Phillips curve type relationship between inflation and unemployment exists, the "central claim made by the theory of flexible inflation targeting is that by stabilizing inflation, output is also stabilized around potential output" (CEPR 2002: 15).

Now there is no denying that, conceptually, inflation targeting is little else but *fine tuning* the economy by means of monetary policy. It is all about optimally adjusting the policy instrument (i.e. interest rate) so as to stabilize the economy through deliberate demand management, with continuously updated and published inflation forecasts providing the key input for aiming at some desired mix between inflation and output volatilities.

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class economy into a first-class one." Interestingly, it is this kind of stuff which then gets reprinted in the Bundesbank's "excerpts from the media," a (tax-payer funded) free service to inform the public about the merits of stability-oriented policies.

[30]Architects of this approach include King (1997, 2002) and Svensson (1995, 1997a,b), in particular.

[31]See Cecchetti 2000 and Clarida et al. 1999, for instance.

Needless to say, there is no guaranty that any attempt at fine tuning the economy will necessarily be successful. In practice, both interest rate as well as communication policies might fail to stabilize and perhaps even further destabilize the economy instead. However, an important truth to be acknowledged is that, in so far as central banks are in the business of conducting interest rate policies, and they all seem to be in it, they may just as well *attempt* to do so in a way that stabilizes the economy; particularly as anything else would be outright nonsensical. According to Knut Wicksell (1898), this requires policymakers to continuously adjust the policy ("market") rate of interest so as to keep it closely aligned with an ever-moving equilibrium ("natural") rate. By contrast, a ("steady hand") policy of keeping interest rates stable in a changing environment risks setting off a cumulative process, i.e. destabilize the economy.[32] Once off track, ever larger compensating spreads might be required to reign in the economy and bring it back on course. Since the 1990s, the consensus view emerged that monetary rather than fiscal policy should be the foremost stabilization policy instrument. Fiscal policy became seen as less effective and more prone to prove destabilizing when applied with discretion.

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[32]Keynes (1923, 1930, 1936) made important contributions to this approach in his monetary trilogy. While his most fundamental insights in the General Theory concerned the permanent real effects of money, his best remembered conclusion in the *Tract* was that economists (including central bankers) would be ill-advised to ignore the practical importance of money's short run real effects (and cherish fancies about the long run only). Whereas Keynes concluded in the *Tract* that a "managed currency is inevitable," Milton Friedman (1960, 1968) later devised an automatic pilot (his "k-percent") regime that would not require continuous judgements and deliberate reactions to a changing environment (cf. Bibow 2002c), while Hayek proposed an alternative solution to getting rid of interest rate policies based on law and competition. The German economist Walter Eucken (1952) also made a contribution to this line of thinking which has perhaps been the most important source of inspiration for the ECB under the leadership of its chief economist Otmar Issing. (See Bibow (2003c, 2004b) for an analysis of these issues in the context of Bundesbank history. See Issing (2000) for a discussion of Eucken's supposed relevance which dodges the important issues.) Whether inevitable or not, the important truth is that if the choice is for interest rate policy rather than any of the above liberal plans, there is no sense in doing anything else but fine tuning (cf. Blinder 1997, 1998; Blinder and Yellen 2001). It is of some interest that in discussing Otmar Issing's assertion that a prudent central banker might get any comfort from the money neutrality postulate, Friedman (2002) not only refuted this excuse, but reminded Mr. Issing of Keynes's conclusion on long run fictions referred to above. The roots of the Wicksellian/Keynesian approach reach back to Thornton (1802). For a modern exposition see Michael Woodford's (2003) *Interest and Prices*. The fundamental Keynesian issue in all this is whether monetary policy affects, perhaps lastingly, the "natural rate"; held to be determined by real forces only according to neoclassical thought. As to the idea of preemptive tightening in 1997, Bernanke (2002a) made the illuminating observation that this "would have throttled a great deal of technological progress and sustainable growth in productivity and output."

More than mere rhetoric (or vanity) was involved, when the ECB's chief economist (and mastermind behind the bank's strategy and interest rate decisions[33]), Otmar Issing, at the press seminar on the evaluation of the ECB's monetary policy strategy in May 2003, asserted that "we have confirmed our two-pillar approach. This is totally different from what is normally seen as inflation targeting" (ECB 2003). *In essence, the message and underlying belief is that of an outright dismissal of any fine tuning*.[34] In contrast to conventional wisdom today, the ECB simply does not see any role for itself in stabilization policy. In particular, it does not accept any separate role for itself in deliberately stimulating output apart from doing so, in its view, *through* its continuous pursuance of its primary goal. Importantly, the supposed link between its primary and secondary goals is not the standard *short run* link featuring in inflation targeting. It is the *long run* case for price stability which is behind the bank's peculiar position instead. In the ECB's view, price stability is key to business and consumer confidence and leads to lower interest rates and risk premia, which allegedly induces higher investment and growth. This is held to be — always and everywhere — the best contribution monetary policy can make. Beyond that, there is nothing monetary policy could do, as Mr. Trichet declared:

> We do not fine-tune the economy. We do not reason as though we would like to speed up any part of the economy with a view to monitoring the output. We have a magnetic north, which is price stability. We believe that through price stability we can help to considerably improve the situation, the economic situation of Europe. I explained to you that through price stability we can improve sentiment among consumers because we can preserve their purchasing power. And that is a way to help — but through price stability. The balance of risks I am referring to is always a balance of risks to price stability, which is the ultimate decision-making step. All the other elements

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[33]A crucial and generally overlooked difference exists in shaping the policymaking process between the U.S. Federal Reserve and the Bank of England on the one hand and the ECB on the other. While research staff's policy-relevant analyses directly serve the Fed Chairman and Monetary Policy Committee, respectively, at the ECB, this important input is fully controlled by its chief economist. Referring to Otmar Issing's "dominating influence in the ECB's executive Board and Governing Council," Wyplosz (2003: 37) appropriately observed that: "This influence has been made possible by Issing's exclusive control of the ECB staff who prepare policy decisions. His presentations at the start of the Governing Council policy meetings are understood as giving him agenda setting power. The Duisenberg years are also the Issing years." (Cf. Handelsblatt 28/29 November 2001).

[34]Once again, all this is in line with Bundesbank wisdom against fine tuning, activism, business cycle orientation, interventionism etc. Recently, Mr. Trichet described inflation targeting as an oversimplification: "we do not rely on an equation or a system of equations. We do not rely on a forecast, as is the case in inflation targeting or, perhaps, in the previous concept of inflation targeting. When we take a decision, we look at everything, as we do every month" (MD 16 February 2004: 6).

> contribute to this balance; they include of course aggregate demand, which is a major element that we have to incorporate into this balance of risks. But again, we do not fine-tune the economy. If we were to fine-tune the economy, then it would be legitimate for global observers to think that we were more or less abandoning our magnetic north. And if we were abandoning our magnetic north, then risk premia would appear and we would have higher, not lower, interest rates. So, it is something which is extremely important to understand (PC 1 April 2004).

A focus on risk premia may well have represented a realistic way of thinking for a Banque de France governor shadowing the deutschmark. And Mr. Duisenberg too always liked to cherish his experiences as governor of De Nederlandsche Bank.[35] So perhaps the real intellectual trouble with policymaking at the ECB stems from the fact that not even the key representative from the former ERM's anchor currency has adapted to the regime change, but continues to hang on to relics of Bundesbank wisdom. Alas, these doctrines are not only useless but positively harmful when applied by the bank supposed to steer the world's second largest economic area. Bundesbank fame was built on the following asymmetric guideline: Always be ready to brake and choke growth, but never try to kick-start the economy (as eventually exports will kick in due to others' efforts). So even at a time when euroland's negative output gap was soaring and the U.S. Fed could not have been more explicit in its commitment to kick the accelerator down as hard as it can, the German chief economist of the ECB upheld age-old Bundesbank wisdom about "artificially" igniting "straw fires" when he outlined Europe's part in reducing global imbalances:

> Artificially stimulating the economy by large budget deficits and/or inflationary monetary policy is no viable option. In fact, history tells us that such policies can only provide temporary straw fires, with potentially damaging long-term consequences (Issing 2003).

Indeed, budget deficits quite naturally grow larger as stagnation drags on. And the ECB would also consider it quite natural (rather than artificial) to deliberately choke growth whenever it sniffs inflation threats behind some corner. To qualify as "fine tuning" and "artificial," the task at

[35]Most famous is probably his declaration that: "In the 16 years that I was the Governor of the central bank of the Netherlands, there were two years in which we had deflation of 0.5%. I publicly declared then that I lived in a central banker's paradise; as long as the others have more inflation, it is not a problem" (PC 8 May 2003).

hand has to be that of actively closing a negative output gap — rather than opening one up.[36]

Perhaps these views seem so alien that by default the ECB's communications are interpreted as inflation targeting in disguise; albeit suffering from some deficiencies which cause confusion. Unsurprisingly, the ECB's world view has also led to irritations at many a Monetary Dialogue. Since it is strange that the obligation of supporting the EU's general economic policies should have made any appearance in the Maastricht Treaty in the first place, if the ECB inevitably, it would seem, provides such support "through" maintaining price stability anyway. Yet, that is exactly what the ECB notoriously asserts:

> We pursue our secondary objective every day, Madam Chairman. Again, we do believe that maintaining price stability, and our efforts to achieve that, is the best contribution that monetary policy can make to a period of sustained economic growth. No monetary policy action to specifically influence growth could come without paying the price that we would not reach our primary objective and, therefore, you cannot and you should not expect us to do more than what we are doing, namely, maintain price stability, thereby creating the best possible conditions for economic growth (Duisenberg, MD 5 March 2001).

Struck by this baffling inconsistency not just with the Treaty's logic but also with the mainstream theory of inflation targeting, one prominent ECB Watcher commented:

> In this remarkable interpretation of the Treaty, the ECB fulfills its double mandate by reducing it to a single responsibility, a focus solely on price stability. All other objectives are then realized automatically. In this view the ECB cannot be held responsible for what happens in the real economy. We consider that this view is not just narrow, but mistaken (CEPR 2002: 12).

Indeed, or so it must seem when looked at through inflation targeting lenses. The point is: these are not the ECB's lenses. And the wish not to be held accountable for whatever happens in the real economy is only one part of the story.

The other no less important part is the belief that monetary policy is best run by completely abstracting from "the short run" (considered the fine tuning sphere), and be treated as

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[36]It is here where Walter Eucken's (1952) credo comes fully to the fore that sound government policy should consist of "Ordnungspolitik" (establishing the right forms of a competitive market economy) but not include interventions in the market process itself. According to Eucken, with a proper "Ordnung" (order) established, which includes his famous principle of "primacy of currency policy," there is *no role left for stabilization policy*. Far more than semantics is involved when — originating from this ordoliberal vision — policymakers and commentators under the Bundesbank's spell have learned to refer to "stability policy" rather than "stabilization policy." Of course the ECB's interest rate policies are straight forward interventions in the market process and no more "Ordnungspolitik" than in the case of any other central bank; even if it might act under such an illusion (or pretense be involved?).

if it were purely a long-run affair.[37] The continued emphasis on monetary growth is related to this position, the belief being that as long as M3 grows at least at the rate of its — long run — reference value, monetary policy cannot possibly be a hindrance to growth.[38] Similarly as regards the bank's notorious reference to "historically low interest rates," even when this is completely nonsensical from a Wicksellian/Keynesian theoretical viewpoint.[39] In the ECB's view, there simply is no more active part to be played by monetary policy other than being no hindrance to growth; judged by certain criteria as interpreted by the ECB. When the task at hand is boosting growth, anything "active" would be "artificial" and could only cause "straw fires." If the bank has done "its part" of being no obstacle, in the bank's view, all that is left is for the economy to revive itself. If it does not, this must be due to "structural problems" or perhaps a lack of confidence; but somebody else's fault in any case. Hence others must "do their part" and reform structures and/or consolidate public finances — which would boost confidence, in the ECB's view.

One might wonder then why the ECB cut interest rates at all in recent years, particularly

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[37]For instance, at the Monetary Dialogue in January 2002, Mr. Duisenberg argued: "we know for sure, monetary policy in the short run can have an impact on the development of growth and with that the development of employment, but in the long run, the only impact that monetary policy has in on nominal values, on inflation. ... and it is the longer term that we have in mind when taking monetary policy measures" (MD 23 January 2002). While this argument is a variation on Mr. Issing's "straw fire" theme, at the Monetary Dialogue in February 2003 Mr. Duisenberg then seemed to favor the opposite — liquidity trap/policy ineffectiveness — kind of excuse for monetary policy inaction in a slump: "Monetary policy could choke economic growth in an overheated economy. It cannot, on the contrary, induce economic growth when that growth is perceived to be too low."

[38]Notice also that despite starting out in 1999 in an environment of a significant negative output gap, the ECB's handling of its "reference value" for M3 did not take this factor into account. When it comes to output, Bundesbank wisdom holds that it is safe to let bygones be bygones. For with time, persistent unemployment will be defined "structural" and the GDP growth trend conveniently re-estimated, so as to close any negative output gap without ever risking "straw fires." Given that money is always neutral by assumption, the blame may always be put at the unions' door; and the outcome perhaps dubbed hysterisis (Blanchard and Summers 1986, Ball 1997, 1999a).

[39]It is almost as if the ECB has never heard of Wicksell at all. Protracted stagnation together with historically low interest rates are not seen as confirmation of the fact that euroland has never been in such a mess before or, as Milton Friedman (1968: 7) put it: "low interest rates are a sign that monetary policy *has been tight*." Instead, they count as yet another success of the ECB, so that Mr. Trichet recently went out to declare that "If we have a low level of interest rates, it is not due to a random behavior of markets, it is because we were skillful enough to pass on the best yield curve available in the euro area before the euro, to the euro" (PC 1 April 2004).

when inflation was still above 2%. Of course it is hard to offer a compelling rationale for deliberate interest rate cuts from within a frame of thought that despises fine tuning, activism, interventionism and all that; but appears to find it *inevitable* to conduct interest rate policies nonetheless. But a clear pattern has emerged in recent years: the ECB prefers to delay cuts until pressures from the outside reach boiling point. And at times when central banks around the globe are slashing interest rates and pressure is mounting from all round[40] that the ECB should follow suit, there is indeed a point at which the bank can no longer postpone the inevitable without losing completely whatever credibility it might still have. Yet, the fact that even the ECB eventually delivers interest cuts in a slump is *not* the point. At issue is its marked asymmetry. For the ECB never waits for long when it feels like fine tuning interest rates upwards.

A lot has been said about the ECB's ambiguous, asymmetric, and perhaps too ambitious "inflation target." And it is true that the bank's chosen definition of price stability itself reveals the asymmetry in its approach. Of course many observers found it striking that even after its internal strategy evaluation process the bank has stubbornly refused to define its primary (or "sole") goal in a properly symmetric way.[41] But the inherent asymmetry in its approach and in the thinking that guides the bank's conduct is revealed in its communications more generally too.

For instance, questioned on the bank's price stability definition and its upcoming strategy evaluation process, Mr. Duisenberg explained at the Monetary Dialogue on 17 February 2003:

> as my colleague, Mr. Issing, has sometimes said in public, this [definition] basically implies that, in practice, we are more inclined to act when inflation *falls below* 1% and we are also inclined to act when inflation *threatens to exceed* 2% in the medium term. Short-term movements in the actual inflation rates have no impact on our policy considerations and decisions (MD 17 Feb 2003: 11; emphasis added).

In view of the last sentence, one might perhaps view the asymmetry between falls (actual) and threats (expectations) as a slip of tongue — or one may not. As Mr. Duisenberg's explanations on another occasion back in 1999 was even more revealing. On the one hand, the "pre-emptive"

[40]Importantly, as government pressure triggers stability-oriented central bankers' preoccupation with their own independence and hence tend to provoke delays, pressure from markets and other authorities is required.

[41]For proponents of inflation targeting this has been a key issue right from the beginning. See Svensson (2000b, 2002a,b), for instance.

interest rate hike in November 1999 were justified as:

> we have a forward-looking approach and both the monetary indicators and the assessment of all other indicators pointed to risks on the upward side of price stability. The longer you wait in reacting to that, the more you have to do, and therefore it was a pre-emptive strike and by definition pre-emptive can never be early enough to strike at the risk of inflation accelerating (MD 29 November 1999).

While striking at the risk of inflation can never be too pre-emptive, when questioned on pre-emptive cuts for avoidance of slipping into a Japanese kind of situation, Mr. Duisenberg argued:

> On the contrary, the experience in Japan was almost more of an incentive that we should not fall into that trap, namely of lowering interest rates to a level close to zero, as has been undertaken in Japan, with no noticeable effect on the real economy, so far at least. It seems that monetary policy in the Japanese situation does no longer work, does not function, does not do the trick, of helping the economy to revive again. That would be more of an argument against further lowering interest rates rather than in favour of it (MD 19 April 1999).

The argument that a liquidity trap might be best avoided by avoiding pre-emptive interest rate cuts in the first place not only seems nonsensical from a theoretical viewpoint. It also contrasts starkly with the practice and attitude shown by the U.S. Fed in response to the 2001 slowdown.[42]

Little wonder that a widespread perception prevails that the ECB overemphasizes upward risks to price stability at the expense of growth risks and generally responds to actual rather than expected declines in inflation — a perception that has been frequently underscored by GC members justifying the bank's (belated) cuts with reference to recent declines in *actual* inflation. At times of worldwide falling interest rates the bank was thus generally described in the media as "backward-looking," as following a "rear-mirror approach," and as doing "too little too late."

Academic economists tend to excuse the bank for such "caution" as inflation was stuck above 2% and the newcomer still had to establish his anti-inflation credentials (while financial market participants were actually preoccupied with pro-growth credentials). The least one would expect, then, is a clear admission that this reputation-building exercise has come at a hefty real price (with costs still piling up and no real benefit in sight as yet). Simply congratulating the bank for keeping inflation expectations anchored below 2% is a bit like praising a student for keeping the car from rolling through having his foot firmly pressed on the brake for the whole of the

[42]Cf. Ahearne et al. 2002, Bernanke 2002b.

driving lesson. Like “driving” a car, keeping inflation expectations low can be all too easy.[43]

Another consideration is that a lot of stagnation and fragility may have to be endured before any threats of inflation falling below 1% might ever arise on the ECB’s radar screen. As inflation persistence apparently played a role in the bank’s “wait and see” attitude and revealed aversion to cutting interest rates in recent years, this whole issue is highly pertinent to the widespread criticism that the ECB might be excessively ambitious in trying to keep measured inflation below 2%. It is worthwhile to explicitly discuss this issue within an inflation targeting framework. This will not only illustrate some important virtues of inflation targeting in contrast to the ECB’s counterproductive approach to maintaining price stability and supporting economic growth, but may shed some light on potential pitfalls with inflation targeting too.

Figure 7 illustrates the impact of, and policy reaction to, demand shocks in a flexible inflation targeting regime. The presence of nominal rigidities is depicted by a non-linear supply curve. From this it might at first appear as if an inflation targeter would be well advised to follow an asymmetric rule and react more aggressively to booms than to sluggish growth. However, should the inflation targeter be aware of those structural problems giving rise to inflation inertia and the near-horizontal shape of the aggregate supply curve at low levels of inflation, these features would be picked up in the inflation forecast. In case of a negative demand shock, the aim to stabilize inflation, while stabilizing output at its potential too, would thus trigger an appropriately aggressive (rather than cautious) reaction. Similarly, in the presence of a negative output gap, an inflation targeter would be relaxed about accommodating output growth in excess of potential growth as inflation would be forecasted to remain stable over a range of output levels. In other words, with a high degree of inflation inertia and certainly as long as inflation expectations remain anchored (around the explicit numerical inflation target), an inflation targeter would — in effect — be primarily engaged in stabilizing output around its potential.

Given the ECB’s notorious complaints about labor market rigidities it is hard to imagine

[43]Quite remarkably, the bank has moved the goal posts and habitually declares “its own success” in keeping inflation expectations “below 2%” when it had demanded that: “There is only one criterion on which the ECB, as the European monetary authority, will be and should be judged, and that is whether it delivers what it was instituted for, namely price stability. That means internal price stability in Europe. That is the only judgement, the only criterion on which the ECB should be judged. I cannot make that message clear enough (Duisenberg, 29 Nov 1999, MD).

that it might expect stagnation and labor market slack to quickly cause any disinflationary pressures or even deflation threats. Indeed, the bank has shown itself quite relaxed about *any* risk of deflation in euroland exactly because rigid labor markets would provide a firebreak against such risks. Without any appropriately aggressive policy reaction, a negative demand shock will thus have real rather than nominal consequences; and without even causing discomfort to a central bank primarily or solely aiming at keeping inflation below 2%.

Notice that if structural reforms were to be carried out in a situation of protracted stagnation, low inflation, and "historically low interest rates," an uncomfortable situation might arise — with the firebreak gone and the central bank low on ammunition. But it is not even clear that getting rid of the near horizontal portion of AS would make policy more efficient anyway. After all, inflation targeting is not about "waiting and seeing" until wage inflation actually falls. Instead, it is about forecasting the disinflationary effects of a negative demand shock. Whether disinflation would primarily hit prices or output does not matter *if output stabilization is considered part of the job anyway*. What is important is that wage inflation is properly anchored, for which the explicit numerical target and inflation inertia are both helpful.[44]

Nonetheless, the ECB's position appears to be that governments should carry out structural reforms that turn the horizontal portion of AS into a linear curve, whereas an alternative would be for the ECB's definition of price stability to be raised above the level at which AS is near horizontal. Concerns that the ECB's definition of price stability may be "too ambitious" are partly related to the zero lower bound on nominal interest rates, which calls for a sufficient safety margin in making sure that monetary policy is effective in dealing with

[44]This issue goes back to Keynes's analysis in chapter 19 of the General Theory, which suggests that stable wage inflation might actually make monetary control easier and more effective. The U.S. case of recent years is instructive, as a sharp fall in wage inflation together with soaring labor productivity growth pushed unit-labor cost growth well into negative territory. In coping with this deflation threat the Fed was both vigilant and appropriately aggressive in its reaction, but also lucky in receiving fiscal policy support on an unprecedented scale. Importantly, this does not imply that a less aggressive monetary policy reaction may be optimal under eurozone circumstances: "If there are more rigidities, or if we think that fiscal policy is more constrained in Europe than in the United States, a more activist stand may be required by the ECB in the future to support general economic conditions in the euro zone" (CEPR 2002: 46). As to the past and present, the ECB has in effect relied on structural rigidities to forestall deflation, while blaming the predictable employment and budgetary consequences of its own inaction on others. More generally, if wage moderation is pursued as a medium-term employment strategy, symmetry of the inflation target is essential to assure that the required monetary policy stimulus is actually forthcoming.

deflationary shocks; particularly in case structural reforms were carried out.[45] But recommendations for relaxing it are also well-grounded for the reason that a somewhat higher rate of inflation might be conducive to lower equilibrium unemployment.[46] As Figure 8 illustrates, the question is whether there is really a unique vertical long-run supply curve out there, which is unaffected by this policy choice.

We are thus once again confronted with a situation where an independent central bank, supposedly an agent charged with a purely technical task, might be in a position to play political games and demand structural change from its democratically elected principal. In a democracy, one should think, the central bank agent should be required to put up with, and conduct optimal monetary policy appropriate for, whatever economic structures might exist, or otherwise resign if he does not like his job too much. Yet, in all too many ways the ECB has shown itself quite willing to, at least until governments meet certain demands, simply turn a blind eye towards the real effects of negative demand shocks (believing itself not to be in charge of output stabilization anyway). With respect to nominal rigidities Mr. Issing accordingly judged that:

> the "greasing the wheels" argument does not constitute a convincing argument against price stability. A cursory look at the U.S. data for the 1990s shows that low unemployment and low inflation are not necessarily incompatible. Moreover, concerns about nominal rigidities are best overcome through structural reforms in the labour and product markets. Nevertheless, whether nominal rigidities provide an argument against aspiring to a constant price level/zero inflation as opposed to a small positive rate of inflation is an open issue. ... It appears possible that the experience of an extended period of price-stability will influence the behaviour and attitudes of economic agents and institutions (Issing 2001: 192, 200).

Why this kind of judgement should be based on U.S. and U.K. facts, supposedly flexible economies, is not clear. And speculating about changes in agents' behavior may be a bet worth taking, from the bank's viewpoint, if failure of the experiment can be easily blamed on structural problems. But do not miss the clearly expressed attitude that it is not for the ECB to accommodate itself to its environment, but for the environment to be reformed to its own liking instead. Clearly, money is *not* neutral and independent central bankers are *not* acting politically neutral either when their decisions are *designed to* bring about certain structural changes — by

[45]Cf. Summers 1991, and Fuhrer and Madigan 1997, for instance.

[46]Cf. Tobin 1972, Akerlof et al. 1996, Mankiw 2001a, and Wyplosz 2001, for instance.

monetary force!

Closely related to this fundamental issue is Mr. Issing's following observation, which also sheds some very interesting light on developments in recent years:

> One argument that is sometimes used in the European context is that a temporary downturn can have persistent (or in the extreme case permanent) effects on unemployment due to the existence of a degree of hysterisis (Blanchard and Summers (1986)). ... it is sometimes suggested that central banks should be extremely cautious in tightening policy since any adverse output effects could prove protracted and costly; as a corollary, it is suggested that central banks should "give growth a chance" even if this means "taking risks with inflation." ... I believe that the policy conclusions that are sometimes drawn from this are deeply misguided and indeed dangerous. The existence of persistence in unemployment makes it even more important to ensure than the central bank avoids a situation in which disinflation becomes necessary. Given the favourable starting position of the ECB, this militates towards a forward-looking and pre-emptive approach which prevents inflation from emerging in the first place and in particular avoids inflation becoming ingrained into people's expectations" (Issing 2000: 196).

For what Mr. Issing fails to mention is that avoidance of potential disinflation costs by preemptively engineering a recession because of *perceived* inflation risks does not at all avoid those real costs from arising. Quite the opposite. *A central bank obsessed with the idea of taking no risks with inflation and, as a corollary, disinclined to giving growth a chance will be the very mechanism that enforces an anti-growth bias upon the system*. Particularly, if this central bank never feels obliged to stimulating a recovery even in view of a soaring negative output gap, this may very well *cause* hysterisis in the first place. Conveniently, the central bank's preference for operating in an environment of negative output gaps may not even show up in the data lastingly, if re-estimations of trend growth in line with actual growth allowed (or not) in this way routinely occur. Unemployment may be declared "structural" and finance ministers attacked for the apparent slippage in "structural" balances. Bundesbank traditions are highly relevant for coming to grips with the ECB, particularly as there is some continuity in personalities involved.

A critical assumption underlying conventional wisdom on the role of monetary policy as that of aiming at some appropriate mix of inflation and output volatilities is that successful short-run stabilization policies prevent the economy from straying away from its long-run equilibrium path, which itself is held to be unique and independent of monetary policy. An alternative way to express the same idea, which may be more appealing to a sceptic, is to require that policy errors

are not systematically biased and cancel out over time.[47] Clearly, the possibility that monetary policy may be non-neutral with regard to the long-run level of unemployment poses a serious challenge to this conventional wisdom.[48] Closely related are the issues whether monetary policy should not experiment with allowing unemployment to fall below historical measures of the NAIRU (Solow 1998) and only disinflate "opportunistically" by waiting for the next recession rather than deliberately engineering one (Orphanides and Wilcox 1996). It is an interesting thought to view actual U.S. developments in the 1990s in this very light.[49]

Similarly regarding euroland, one issue is that the ECB may have accepted an unnecessarily high NAIRU by picking a too ambitious price stability definition. Another issue is that the ECB's predisposition to err on one side of the (high) NAIRU for most of the time may also have further negative real repercussions in the long run. Actual developments since the bank's forward-looking and preemptive inflation prevention effort in 2000 have proved rather intricate indeed. It is not just that nominal rigidities may have prevented a sharper disinflation, so that reluctance to respond to demand weakness implies that — in continuation of past habits —

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[47]As Milton Friedman (2002: 366) put it in his refutation of Mr. Issing's comfort-seeking fancies: "Taken seriously, monetary neutrality means that central bankers are irrelevant: real magnitudes — which are what ultimately matter to people — go their own way, independently of what the central banker does. Central bankers are important insofar as money is not neutral and does have real effects. Neutrality propositions give little if any guide to effective central bank behaviour under such circumstances. Perhaps they offer comfort to central bankers by implying that all mistakes will average out in that mythical long run in which Keynes assured us 'we are all dead.' " Keynes [Tract on Monetary Reform, 1923] went on, "Economists [central bankers] set themselves too easy, too useless a task if in tempestuous seasons they can only tell us that when the storm is long past the ocean is flat again."

[48]The whole wisdom of a NAIRU guided monetary policy may be questioned (Galbraith 1997, 1998).

[49]Of course it is not fully clear whether this came about by accident or design and most observers seem to agree that the good-luck factor played a significant role in all this (Blinder and Yellen 2001, Mankiw 2001b, for instance). As to the first half of the 1990s debates concerned the question whether the Fed's response to the recession may have been too cautious (Friedman 1992), and its hiking in 1994-5 too aggressive (Papadimitriou and Wray 1994). As to the second half of the decade, the verdict on the Fed's role in the stock market bubble (or, more generally, the criticism of the so-called Greenspan put) and in triggering the slowdown (Wray 2000) may still be out. Furthermore, there is the much broader issue of suitability and sustainability of the 1990s policy mix and the private-sector imbalances it involved, as highlighted in the path-breaking work of Wynne Godley (cf. Godley 1999, Godley and Izurieta 2001, 2003; see also Papadimitriou and Wray 2003). Perhaps it may be fair to conclude that the Federal Reserve pursued policies that were generally supportive of respective Administration's economic policies and also responded to challenges which arose along the way in a flexible spirit — which is far more than one could say about certain central banks in other regions of the world.

unemployment is bound to become persistent. In addition, the fiscal repercussions of the slump have provoked the phenomenon of tax-push inflation, indicated in Figure 8 as an upward shift in the relevant portion of AS. In effect, then, we ended up closer to a safer rate of inflation, erroneously interpreted by some observers as evidence of the bank's flexibility, but harvested a double-whammy in terms of output lost on the way.[50]

In an inflation targeting regime, one possible way of addressing this issue is to target an appropriate price index that excludes tax-push inflation.[51] An even better way suggests itself though for any properly forward-looking approach to monetary policy, namely: taking those vital interdependencies between monetary and fiscal policies fully into account in the first place. Proponents of inflation forecast targeting argue that no explicit policy coordination would be required since fiscal stance enters into the inflation forecast and hence monetary stance too. In the context of the Maastricht regime, that would mean that any serious inflation targeter would have an extra interest in preventing stagnation and *thereby* the budgetary squeeze that would otherwise impact on the "primary" price stability objective too. I do not need to repeat here in any detail that the general perception of the ECB's attitude towards output stabilization and fiscal policy has been a fundamentally different one.

This leaves me to briefly discuss the euro's plunge from an inflation targeting angle, which I argued above set the scene for subsequent developments. Obviously a central bank that targets internal price stability does not at the same time have a "target" for the exchange rate too. But the exchange rate is a key channel in policy transmission, affecting both output and prices, and especially the latter relatively quickly too; with fast-track direct "pass-through" to headline inflation and more lagged effects on core inflation as import-price increases work their way through the whole structure of costs and prices. In theory, including the theory of inflation targeting, it is generally assumed that monetary conditions tighten or ease through all channels in

[50]So far in this ongoing slump the rise in unemployment has been surprisingly small, implying a risk that in case the current export-led "recovery" falters, labor shedding might accelerate and bolster domestic headwinds.

[51]And it is noteworthy that the industry leaders in inflation targeting (Bank of England, Sveriges Riksbank, Reserve Bank of New Zealand) do indeed pay proper attention to this factor.

parallel, that is, interest rate hikes (cuts) go together with currency appreciation (depreciation).[52]

In practice, however, matters are more complex, hinging primarily on market perceptions and expectations as guided (or not) by policy communication.[53] After all, the "euro puzzle" was that the relationship suggested by theory was contradicted by the facts in 1999-2001 (see section 3 above). Monetary conditions for long failed to tighten in 2000, but the composition of demand stimuli shifted drastically as the ECB's hikes choked domestic demand while euro depreciation prolonged the export boom. Since depreciation quickly pushes up inflation, it would at first appear as if monetary tightening represents the appropriate reaction within an inflation-targeting regime. The trouble is that this might prove to be rather counterproductive if currency weakness — and hence rising inflation — is being driven by interest hikes in the first place. Monetary policy might then easily end up in a vicious circle. Ex post policy might still *appear* appropriate though, as the original policy blunder is covered up nicely by its inflationary consequences.

One upshot is that an inflation targeter would be well advised to take the prevailing financial market climate carefully into account ex ante and steer market expectations and perceptions in line with policy intentions. In fact, this holds for any central bank that wishes to avoid communication failures and consequences like the ones that arose with the euro's plunge. Another is that simply lifting the ECB's "inflation target," while making euroland a safer place, would not solve the key problem: the bank's anti-growth bias. Arguably, if we had started out from 1.8 rather than 0.8 percent inflation in 1999 and if the ECB had adopted a "below 3 percent" price stability definition, things would have played out not much differently. It may require more comprehensive reform to assure symmetric and growth-oriented monetary policies in future.

In conclusion, the fact that the ECB stopped hiking rates before inflation peaked does not prove that it is forward-looking.[54] Nor do the bank's interest rate cuts at times when inflation was

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[52]See Ball 1999b, Svensson 1997b, 2000a, Clarida et al. 2001, for instance.

[53]In the 1990s, the RBNZ and the Bank of Canada experimented with monetary conditions indices, which attach certain weights to the policy interest rate and the exchange rate in assessing policy stance, in the implementation of their respective inflation targeting strategies, but met difficulties which were not least related to policy communication and anticipation.

[54]As the CEPS 2001 report wrongly concluded.

above 2 percent prove that it is flexible in targeting inflation.[55] When it is becoming plain to the naked eye that the economy is tanking, not even the world's most independent central bank will get away with keeping interest rates steady at levels which proved sufficient to provoke the slump in the first place. At issue is the asymmetry in the bank's approach: its readiness to choke growth even unnecessarily, joined with a marked reluctance to stimulate growth even when urgently needed. Quite sufficient to inflict great real damage, this anti-growth bias can have unpleasant inflationary side-effects too. Approving the ECB's conduct as having been in line with inflation targeting is not only wrong, but good for one thing only: giving that approach a bad name.

8. A CHASM BETWEEN WORDS AND DEEDS? THE TROUBLE WITH TAYLOR RULES AND ALL THAT

Economics is about explaining economic behavior and developments as based on agents' supposedly rational calculations and perceptions of their environment. When it comes to assessing the ECB's performance, however, academic economists tend to be amazingly quick at dismissing consensual perceptions of the ECB's conduct as both incorrect and apparently inconsequential. For instance, Wyplosz (2003: 36) observes that "the conventional wisdom among many observers is that the Eurosystem has been slow, acting too late and too little." But then he promptly asserts that: "A careful analysis of the record does not support this view. Except in mid-2001, a variety of tests show that the Eurosystem reacted appropriately." Wondering why the "widespread impression of indecisiveness" arose nevertheless, he blames it on the bank's peculiar strategy: "By openly defending its flawed strategy whilst acting otherwise, the Eurosystem allowed misinterpretations and misguided perceptions."

I am baffled by conclusions like these. The profession has spent the last few decades with arguing out the all-importance of expectations and credibility. Transparency in policy conduct, a clear and credible policy strategy in particular, are held to be vital to effective policy communication and successful monetary policy. No doubt the ECB is legendary for its communication problems with financial markets. While the outcome of the bank's internal

[55]As the CEPR 2002 report wrongly suggested.

strategy evaluation process, presented as a "clarification" in May 2003, was generally welcomed as a step in the right direction, it was also judged wholly inadequate for overcoming the ECB's "communication gap." In fact, Wyplosz (2003) repeatedly refers to the ECB's "faulty strategy," that major source of confusion which lies behind the bank's perceived lack of transparency and gives the "impression that the Eurosystem remains a prisoner of old and simplistic doctrines" (Wyplosz 2003: 35). Yet, miraculously, the bottom line is: a "nearly impeccable record."

This presupposes not only that the bank, while proving quite able to notoriously fool the outside world, did not allow itself to get muddled by the strategy which presumably guides its internal policy-making process. But also that market perceptions — and agents' behavior based thereupon — have been largely irrelevant. Nor did the fact that the ECB misjudged developments throughout (as the analysis in sections 4, 5, and 6 has shown), and does indeed seem to believe in doctrines which are "old and simplistic," prevent the world's most independent central bank from doing a "good job" overall and achieving a "nearly impeccable record."[56]

Taking a closer look at the kind of supposedly "careful analysis" and "variety of tests" that yield the conclusion of a "nearly impeccable record" may thus be in order here. Probably the most fashionable tool in standard policy assessment exercises today is "Taylor's rule." When John Taylor (1993) first proposed the "rule" named after him, his understanding of it was that the tool would be of both descriptive and normative value. His starting point was that the U.S. Fed's conduct between the mid 1980s and early 1990s had been good, in his view. His finding was that the following simple reaction function described the Fed's good performance rather well:

$$i^T = r^e + \pi^* + \gamma_1(\pi_t - \pi^*) + \gamma_2(y_t) \qquad (1)$$

In this i^T refers to the central bank's (nominal) target rate of interest (or: Taylor rate), which is supposed to be set by considering three factors: first, the equilibrium real rate of interest, r^e, second, an equilibrium or target rate of inflation, π^*, and, third, deviations from the target inflation rate and capacity output; where y_t is an output gap measure and γ_1 and γ_2 are feedback parameters measuring the strength of policy response to inflation and output, respectively.

[56]Svensson's (2003a: 56-7) verdict runs along similar lines, as do many others: "in the end one cannot say that interest rate decisions have been systematically wrong. What one can criticize the ECB and the Eurosystem for is an ill-conceived monetary policy strategy, with excessive emphasis on the monetary pillar, and an asymmetric and ambiguous definition of price stability, as well as a lack of transparency."

A few observations are in order here. Importantly, Taylor's "rule" is *not* a rule of the non-reactive type as proposed by Milton Friedman (1960, 1968). Instead, it follows the Wicksellian/Keynesian reaction function approach to monetary policy, requiring continuous adjustments in the policy instrument aimed at keeping the system in equilibrium through deliberate management rather than by autopilot — incorporating the wisdom of three other giants. To begin with, there is Fisher's (1896) hypothesis concerning nominal and real interest rates. Next, there is Wicksell's (1898) fundamental insight that it is not the absolute level of interest which matters in assessing/determining stance, but the relative level (or, "spread") compared to some equilibrium rate of interest. Finally, the explicit and separate consideration of the output gap may perhaps be seen as a tribute to Keynes (1936). In general terms, the behavior prescribed by the rule is in the nature of "leaning against the wind," appealing from a stabilization policy viewpoint, but also reflects the age-old bond market wisdom that nominal interest rates tend to be aligned and move along with nominal GDP growth, suitable from a distributional viewpoint too.

Alas, there is also many a pitfall with Taylor's rule. For instance, neither the equilibrium real interest rate nor the output gap are directly observable. And their estimates are crucial to policy assessments by means of this "benchmark" tool. Furthermore, it may be criticized that the rule focuses on monetary policy alone but ignores fiscal policy. Apart from price effects, fiscal policy enters the picture only indirectly, namely through its impact on the output gap. Issues of policy mix and trade-offs are thus not explicitly considered. The same may be said for the financial system and asset prices, which — via the short-term interest rate directly controlled by policy — appear to be under perfect policy control. For instance, as regards the exchange rate as a key transmission channel, one issue concerns the effects of exchange rate changes on output and prices, another the supposed control link between interest rates and the exchange rate.

That said, it would not be true that the Taylor rule prescribes backward-looking behavior, if today's inflation and output gap were good predictors of tomorrow's inflation. In fact, inflation forecasts which enter as key input into the policymaking process in inflation targeting regimes typically describe the inflation process as being both highly inertial and mainly driven by capacity utilization (apart from shocks, u), i.e., of the form:

$$\pi_t = \pi_{t-1} + a(y_t) + u_t \qquad (2)$$

Whether any resemblance between Taylor's rule and inflation targeting may be real or apparent is not the issue here.[57] Rather, the crucial point about Taylor's rule is that there is not just one such rule, but infinitely many — sharing the above general family character. Most fundamentally, although generally overlooked: Adopting any particular one may fundamentally change the world and, hence, tomorrow's policy environment too. Therefore, interpretation of results derived by this rather flexible assessment tool requires particular care, which is worth illustrating.

Figure 9 provides an example of a standard Taylor rule exercise. The real interest rate was set at 2.8%, so that the Taylor rate matches the ECB's stance at the start of EMU (thereby attesting appropriateness *by assumption*). The output gap was estimated statistically by an H-P filter, another popular tool. The chosen price measure is a three-months moving average of HICP headline inflation. The feedback parameters for inflation and the output gap are 1.5 and 0.5%, respectively. The actual pattern of the ECB's policy path since 1999 shows the expected "leaning against the wind" property. If anything, it seems, the ECB was far too accommodative throughout. Moreover, the initial interest rate cut in April 1999 was a clear mistake, whereas the series of hikes that started in November 1999 seemed appropriate and not aggressive at all. Subsequently, as the economy deteriorated, the ECB became even softer. On this reading, then, any charge of an anti-growth bias would seem untenable. Criticism would rather seem justified as to the ECB's repeated misses on its primary objective. One might worry about the bank's credibility and anti-inflation credentials, and recommend either more toughness or raising the inflation target, so as to bring words into line with (apparent) deeds (CEPR 2004).

Beware that it may always be possible to show — by "careful analysis" — a much closer alliance between the ECB's policy rate path and *some* Taylor rate path, and conclude that the ECB made no systematic policy mistakes but conducted fairly sound interest rate policies all along. The routine assessment exercise of one prominent ECB Watcher (CEPR in London) is particularly revealing as regards the "variety of tests," illustrating rather nicely that many reasonable hypotheses of systematic policy making would yield a disapproving verdict on the

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[57]Cf. Woodford 2001 and Svensson (1999), for instance. The latter introduced the distinction between "target rules" (e.g. inflation targeting) and "instrument rules" (e.g. Taylor rule) and stresses the role of "judgment" in (rule-based) policymaking (Svensson 2003b). In this context, manifold confusions stem from the "time-inconsistency" theme (Bibow 2001d).

ECB. In fact, on studying the CEPR 2001 report one might even get the impression that this group of researchers had to calibrate rather intensively to finally come up with a reasonably good fit for its “hybrid rule,” which has the ECB respond aggressively to both core inflation and (externally) forecasted inflation.[58] Unfortunately, the very rule which in year t seemed to prove that the ECB did a great job turned out to show the bank out in the wilderness in year t+1. Hence a new rabbit had to be pulled out of the magician’s hat. Reluctant to question the infallibility of an independent central bank or conceive of any break in (hitherto sound, it seemed) policy in 2001, a “new rule” was introduced that featured a somewhat higher inflation target, lower equilibrium real interest rate as well as an output growth target of 1.2%. After another round of careful analysis with a variety of tests, victory (i.e. approval of soundness) was solemnly declared again. It was even shown that a Fed-in-Frankfurt could not have done a better job (CEPR 2002).

How much faith should one have in this kind of careful analysis? It seems to me that this whole assessment exercise approach is fundamentally flawed. Researchers start out from their conviction that independent central banks cannot make serious mistakes, so that the ECB’s policy must have been broadly appropriate, if not optimal. They then search for some particular Taylor rule (and seemingly sensible hypothesis) that provides a reasonably good fit for the ECB’s actual path, and finally declare that the bank’s course has been sound (as no systematic mistakes could be detected). Alas, what we are dealing with may be little else but wishful thinking.

Start with the equilibrium real interest rate. Most studies take a neat shortcut to the matter and simply use some historical average. For euroland numbers between 3 and 4 percent of even higher (depending on the reference period) were commonly used in the late 1990s and until recently. Reflecting the same kind of wisdom, Mr. Duisenberg in one of the bank’s notorious references to “historically low” interest rates (suggested as proof of the ECB’s “no-hindrance-to-growth” stance) dropped the number 4.6% as the euro area’s short-term real interest rate for the period 1981 to 1998 (MD 18 December 2001). Apart from being nonsensical from a theoretical viewpoint, this neatly reflects that the ECB itself did not quite believe its own propaganda on

[58]Commenting on the motivation for their hypothesis no. 8, the report reads: “None of the simple rules considered so far seem to provide a satisfactory account of the pattern of interest rate changes observed during the first two years of EMU. But some informal exploration of the data suggests the hybrid rule” (CEPR 2001: 34).

EMU as a fundamental regime change. Clearly, the 1980s and (pre-EMU) 90s were a period of exceptionally high real interest rates, a period of disinflation through tight money. As one side-effect public finances deteriorated drastically both due to a soaring interest burden and rising and persistent unemployment.[59] EMU was meant to change all this. In fact, fiscal policy is no longer allowed to (partly) compensate for tight money but unconditionally geared at fiscal consolidation instead. For this to be realizable at all, a sea-change in monetary policy is required, too.

Interestingly, Taylor's (1993) *a priori view* was that of an equilibrium real interest rate in line with long-run productivity growth, which he put at 2% for the U.S. Starting from there one issue is that a discount might apply to the short-term (i.e. riskless) rate if yield curve and banking profitability considerations are allowed for. In any case, if euroland cannot perform as well as the U.S., due to structural problems and all that, its equilibrium real interest rate should be correspondingly lower. Furthermore, if fiscal policy is set on a tight stance for years to come, a neutral monetary policy stance should allow for this factor too. Therefore, I put the *ceiling* for euroland's equilibrium real interest rate at 1.5%. Given the ECB's tolerated rate of inflation of 1-2%, the equilibrium nominal short-term interest rate lies between 2.5% and 3.5%.

As to the output gap, it is noteworthy that up-to-date estimates (like the H-P filtered series used above, for instance) show a significant positive output gap in euroland in 1999-2001, implying that a nice boom with excess demand took place at that time. Back in 1999, by contrast, the general perception was one of significant slack all round. In fact, the consensus view in 2000 was that euroland, for the first time in a decade, was on its way to closing the protracted negative output gap that characterized the area's performance during the Maastricht convergence process; which was probably a conservative assessment at the time.[60] In my view, there is absolutely no sense in rewriting history and creating a boom ex post that never took place. In fact, it does not even take cynicism to observe here how convenient a tool H-P filters and such likes provide for

[59]Cf. Pasinetti 1997, 1998, and Bibow 2004a on this issue.

[60]For instance, the OECD's Economic Outlook no. 69 of June 2001 estimated an output gap for the euro area of -0.3 percent of GDP for 2000. The European Commission observed in its Annual Review (2000: 52): "the output gap is still negative in 2000 and there are currently no signs of overheating."

covering up the blunders of independent central banks.[61] Postulating money neutrality seems to prove it too: A tight money policy mistake which, regrettably, brings about a particular sub-optimal real world history may, by use of convenient statistical techniques and Taylor rule philosophy, still be camouflaged as systematic and appropriate monetary policy.

Or one might treat the matter seriously. To illustrate what is at issue, let us start from contemporary estimates and assume a zero output gap for the final quarter of 2000. Extrapolating the potential output path at 2.25% per annum (i.e. the midpoint of the 2-2.5% range asserted by the ECB) implies a 4% negative output gap in 2004Q4. With a 1.5% equilibrium real interest rate, feedback parameters of 1.5% and 0.5% for inflation and output deviations, and a 1.5% target inflation rate for HICP *exclusive of tax push*, Taylor rule wisdom is shown in Figure 10.

On this benchmark, the ECB's stance was not only far too tight at the start of 1999, but remained so throughout its tightening binge from November 1999 until October 2000 when the bank stayed well ahead of the curve. Admittedly, the former blunder was a Bundesbank legacy, which was also behind the euro's initial decline until the summer of 1999. But another key pitfall with Taylor rules may be appreciated when considering the ECB's euro-weakening interest rate

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[61]For instance, the European Commission's 2001 Annual Review still observed that: *"In 2000, short-term interest rates were clearly above the level suggested by the Taylor rule*. Since October 2000, the time of the ECB's last interest hike, three-month interest rates have come down, and re-entered the Taylor corridor by April 2001. By August 2001 they have reached neutral territory, and after the recent cuts actual rates became accommodative" (EC 2001: 57; italics added). The Commission's 2003 review tells an altogether different story. In retrospect, it appears as if interest rates barely approached neutral (Taylor rule) levels *from below* in the second half of 2000. Thereafter they apparently stayed well below neutral levels, so that the Commission declared that monetary policy was "accommodative to economic activity during the slowdown" (EC 2003: 31). With history being conveniently rewritten in central bankers' favor, it is clear that finance ministers are the goats. This view is of course difficult to maintain since nominal budget deficits slipped by merely two percentage points since 2000 despite euroland being now in its forth year of sluggish growth. One may thus wish to bear in mind that the Commission declared in its 2002 review that: "Despite some budgetary slippage, the fiscal stance has been broadly neutral since 1999, enabling monetary policy to respond flexibly and coherently to changing economic conditions and price pressures" (EC 2002: 61) — even if the bank actually failed to live up to its responsibilities. Curious developments occurred in Germany last year. As actual GDP growth disappointed yet again, potential growth was statistically re-estimated downward. As structural fiscal balances deteriorated accordingly, it then appeared as if Germany had enjoyed a fiscal expansion in 2003 — despite numerous tax increases and expenditure cuts which led other research institutes (IMF, for instance) to estimate a fiscal tightening of between 0.6 and 1% of GDP (cf. FTD 18 and 21 November 2003).

hikes that started in the autumn of 1999. For by pushing the euro down and inflation up, the bank created the apparent justification for its rate hikes in the first place. Without repeating here the analysis of previous sections at any length, it thereby also shaped the path of real economic history, which then forced the reluctant bank to come forth with "cautious" interest rate cuts even as inflation was above 2%. Given these blunders, the events of September 11, for once, may have brought the ECB closer into line with requirements. But in 2002 the ECB quickly fell back on its preference for being behind the curve when it comes to easing, and exactly because of doing "too little too late" tax push then provided yet another apparent excuse for its very obstinacy.

Clearly, the path of economic history, both prices and output, would have been a different one without these blunders. The upshot is that Taylor rule exercises, fashionable as they are, may even fail to pick up systematically ill-guided policies. By ignoring that embarking on some particular policy path, whether sound or not, means shaping a particular economic history and, hence, future policy environment too, calibration of some seemingly reasonable Taylor rule so as to track some actual policy path may be no better than wishful thinking.

In contrast to other "careful analyses," I thus conclude that the ECB — expressed in Wicksellian terms — has reluctantly allowed the market rate of interest to trail a declining natural rate of interest downwards. And from a Keynesian viewpoint one would add that the decline in the natural rate was itself caused by ill-guided monetary policy. In the event, as fiscal consolidation and other headwinds burdened the economy, the bank merely accommodated domestic demand to stabilize at a depressed level. Conspicuously persistent inflation, although a consequence of its own blunders, may have been one obstacle to proper monetary stimulus. Perhaps purely political motives provided another, as a widespread suspicion holds.[62] The

[62]If true, the state of democracy in euroland would seem to be in severe trouble. Interestingly, this widespread suspicion even made its way to the Monetary Dialogue in September 2003 when the Chairperson Christa Randzio-Plath pressed Mr. Duisenberg hard on the issue of policy mix and sanctions. Curiously, Mr. Duisenberg appeared to confirm a highly hypothetical question on an ECB response in terms of interest rate sanctions in case of a "more horizontal" (or, Fed-like) mandate (cf. MD 10 September 2003: 13). When the same matter came up again at the next Monetary Dialogue in December 2003, Mr. Trichet seemed keen to stress that "I repeat that I never said 'if you do this, we will do that.' My predecessor never said this and I trust that no central bank would say this" (MD 1 December 2003: 14).

analysis here suggests however that the ECB simply has no concept of a symmetric, growth-oriented monetary policy based on Wicksellian monetary theory. Imagine a timid driver who has a clear idea of using the brake to slow down the vehicle anytime he fancies a mouse behind some corner, but outright denies that proper driving requires use of the accelerator too. Unsurprisingly, unless placed on a sufficiently steep downward course, courtesy of the rest of the world, his vehicle may fail to move forward.

So let me stress that nothing stands in the way of euroland's recovery but its outstandingly inept macroeconomic policy management. In the spring of 2004, the disinflationary effects of euro strength are working their way through the system, meeting ever new rounds of tax-push inflation. With ongoing fragility at the domestic front, it will greatly depend on external events whether inflation might stay "close to 2%" in future. And the same holds for growth and employment. As ever more fiscal tightening is in the pipeline, the ECB — effectively — continues with its hazardous gamble of reliance on sufficient external push to overcome the domestic consequences of its own inaction.[63] Since not much of a "shock" may be required to finally tip the boat though, this may well be a case of gross negligence.[64]

From the viewpoint of the rest of the world, no doubt a change in macroeconomic policy management in euroland would be preferable to a situation where the world's second largest economic area enjoyed yet another externally-sponsored recovery. To be sure, euroland's policymakers would continue to blame the inevitably growing international imbalances on those unsound policies conducted elsewhere in the world economy which provide the very basis for

[63]Mr. Trichet is amazingly explicit on this when he refers to the following "normal sequence of events" in an interview: "Growth starts with exports, then passes on to investment and then to consumption. That is the normal sequence for Europe in this phase of the cycle" (FT 22 April 2004). In other words, euroland's guardians of stability believe in a natural right for free riding on those whom they routinely attack for their allegedly irresponsible policies. This is just another clear piece of evidence that the ECB does not believe its own propaganda about EMU as a regime change. Recall for instance Mr. Duisenberg's explanation that "Europe is overwhelmingly dependent on domestic demand, both investment and consumption. Therefore, to a large extent, Europe is isolated, but not entirely, I admit, from developments elsewhere" (MD 5 March 2001). Suffice to mention that this makes complete nonsense of the original rationale for EMU as a way to make Europe more of an equal partner to the U.S.

[64]Rising oil prices, aggravated by the euro's weakening from its peak earlier this year, no doubt complicate matters, providing another "external shock" to euroland's policymakers to blame ongoing woes upon. Yet, the true question is why euroland got stuck in its current mess in the first place, and the answer advanced here is that its own macroeconomic policies were the key destabilizing shocks at work throughout.

their own notorious "stability-oriented" free-riding.

9. CONCLUSIONS AND ESSENTIALS FOR ECB REFORM

Neither the world economy, external shocks, or the euro are to blame for euroland's ongoing woes. Nor are structural rigidities to blame for protracted domestic demand stagnation that has characterized the domestic scene since 2001. Instead, systematically ill-guided macroeconomic policies are the root cause of euroland's woes.[65]

Given ex ante knowledge of an SGP-imposed medium-term restrictive fiscal stance, and the risk of potential shut-offs of automatic stabilizers, in light of economic theory, it was clear from the start that the stabilization burden would rest squarely on the shoulders of the ECB. Yet, the ECB does not accept this role, and its deeds have lived up to its words. Guided by idiosyncratic beliefs about the economy that are fudged with autocratic views about a central bank's role in a democracy, the bank has persistently reneged on its obligation to support the EU's general economic policies. Puzzling as it may seem at first, the bank's obsession with its primary or sole goal of price stability has caused it to persistently fail at that front as well.

The trouble started with the euro's plunge in 1999-2000 when, in a climate of general growth enthusiasm, the new currency was punished by the markets because of its guardian's (barely hidden) growth apathy. This event pushed inflation well above 2 percent and provided the key reason behind the bank's reluctance to cut interest rates as aggressively as it had hiked them earlier on. But the bank is predisposed to systematically err in one direction anyway. The trouble is that the ECB's "caution" regarding inflation risks, which it might imagine at any juncture, may amount to gross negligence regarding growth risks. A central bank that is always ready to choke growth preemptively but never ready to kick-start the economy, is not a guarantor of stability and prosperity, but a persistent drag on growth and a paramount threat to stability. A widespread fear by outside observers is that the economic doctrines, which seem to guide the bank's conduct, may be primitive and outdated. The economic analyses and projections under the ECB's

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[65]As a thought-experiment, imagine what U.S. structural unemployment would be today if Maastricht-style "stability-oriented" macroeconomic policies had been inflicted upon the U.S. in recent years. Cf. Schettkat 2004.

powerful chief economist have been consistently and far off the mark.

Due to its asymmetrical approach, the bank failed to act preemptively and prevent euroland's fiscal regime from shifting into reverse gear, so manifold domestic headwinds were stirred up along the way. A conspicuous effect of its "wait and see" reaction to the slump was tax-push inflation, which has emerged as a key cause of inflation persistence in recent years. Although the euro's rise since April 2002 helped to squeeze inflation to below 2 percent, it has also cut off the area's last lifeline. The euro's rise, in effect, has prevented euroland from continuing to free ride on expansionary efforts carried out "elsewhere in the world economy." Instead, euroland is left with a mix of overly restrictive fiscal and monetary policies that are imposed by an independent central bank with an anti-growth bias. The consequence is persistent domestic demand stagnation.

A conspicuous chasm exists between perceptions of the ECB in the financial markets and media ("too little too late" growth apathy) and of academic economists, who are eager to prove that the ECB is close to achieving results with a Goldilocks quality despite its heavily criticized communication problems. While criticisms of the ECB's communications are mainly based on attempts to rationalize the bank's conduct within the theory of inflation targeting, approvals of its interest rate polices most popularly come through Taylor rule assessment exercises. This paper finds fault with both approaches and rejects the idea of a chasm between the ECB's words and deeds. The analysis shows that Taylor rule exercises may amount to be little else than wishful thinking and that distortions arise when the bank is viewed through inflation-targeting lenses, since the bank has made it clear *by word and action* that it is altogether opposed to the concept and to any kind of fine tuning. The ECB largely continues Bundesbank traditions (its supposed model) in light of its words and the asymmetry of its actions, which strongly err in one direction. This approach, no doubt, has served the Bundesbank well, but its effect on domestic demand is now much harder to overcome, since the anti-growth bias strictly applies to and — with the support of the SGP — drags down much of Europe today (rather than positioning Germany as chief free-rider on non-"stability-oriented" policies carried out elsewhere in the world economy).

It would be interesting to scrutinize the relevance of Europe's regime change toward the Maastricht EMU in the context of growing international imbalances since the 1990s. A particularly intriguing aspect is the criticism leveled against the U.S. Federal Reserve that its

policies may have been too growth friendly in the second half of the 1990s. The criticism implies that the Fed's approach featured an asymmetry opposite to the ECB. This is a topic for future research however.

In view of the focus of this assessment, it is appropriate to focus my reform proposals on the ECB, but exclude euroland's fiscal regime (which itself is beyond repair). My key recommendations for reforming the world's most independent central bank concern three essential aspects:

(1) Discontinue the antiquated "high priest" form of central bank independence.[66] Replace it with a form that is compatible with democracy and conducive to good performance. The U.K.'s monetary structure may serve as a model here, making it clear who is master and who is servant, and focusing the Bank of England's efforts on its tasks (rather than self-serving comments on everything else).

(2) Governments should be the master in formulating the bank's policy remit (i.e., specifying it within the limits of the law) and the European Parliament (through a committee) should play a role in supervising the bank's conduct and holding it accountable. The supervisory role should include quality control over issues of monetary policy strategy and operating procedures. Accountability should include the power to sack central bankers for malperformance, which presupposes publication of minutes and voting records. Rules should apply as to the committee's resort to scientific expertise. Publicly-funded research on monetary policy issues should be independent and controlled by the European Parliament rather than the ECB (through the bank's financial independence). As to the bank's policy remit, euroland authorities are well advised to move toward a "dual mandate," as exemplified by the U.S. Federal Reserve.[67]

(3) While proposals (1) and (2) are intended to repair the institutional part of the problem, the issue of "accidents of personality" (to borrow Milton Friedman's polite term) remains. At issue is

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[66]Elsewhere, I have dubbed the conspicuous contradiction of granting central bankers unbounded discretion the "Maastricht paradox": "starting out from an overriding principle of disciplining policymakers as the foundation for stability, the ECB ended up as "benevolent dictator" in the scheme" (Bibow 2001a).

[67]And U.S. authorities might wish to consider Europe's disappointing experiences as strong advice against swapping the Fed's dual mandate for a (German-style) "price stability above all else" one. See Friedman and Kuttner 1996 and Thorbecke 2000, 2004.

a lack of intellectual capital and diversification. One measure to achieve better quality might be to negate the current Treaty requirement that Executive Board members have to be EU nationals at least for a lengthy transition period. The ability to choose among non-nationals should induce governments to focus on merit rather than passport. Furthermore, the ECB's leadership should be enriched from outside central banking circles. Again, the Bank of England's Monetary Policy Committee might serve as a model.

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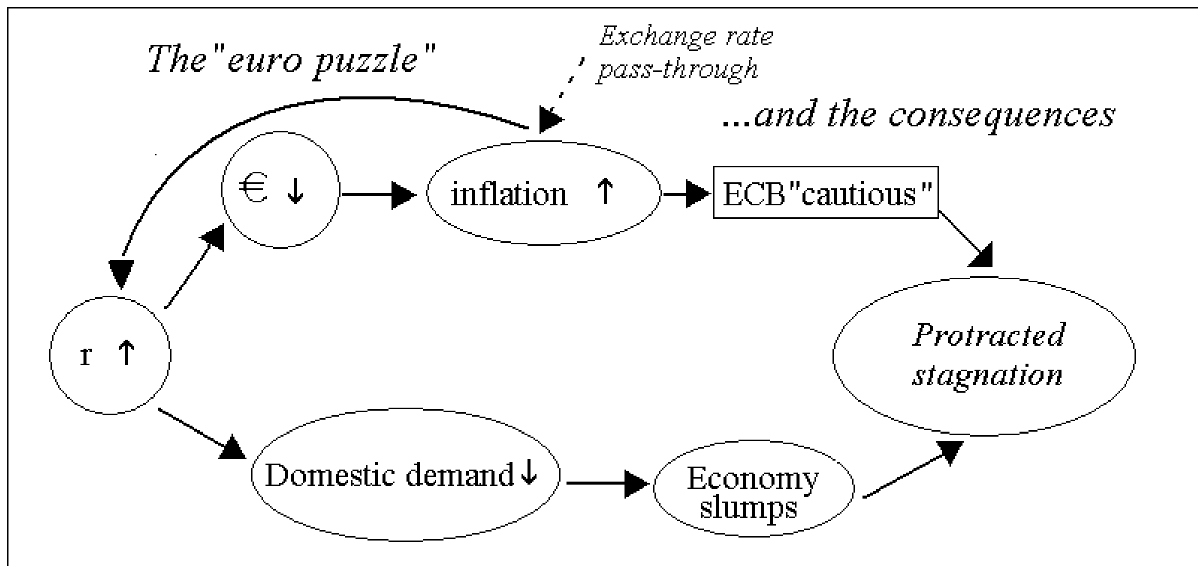
Box 1. Setting the scene for caution and stagnation



Box 2. Stuck in a "stability oriented" vicious circle

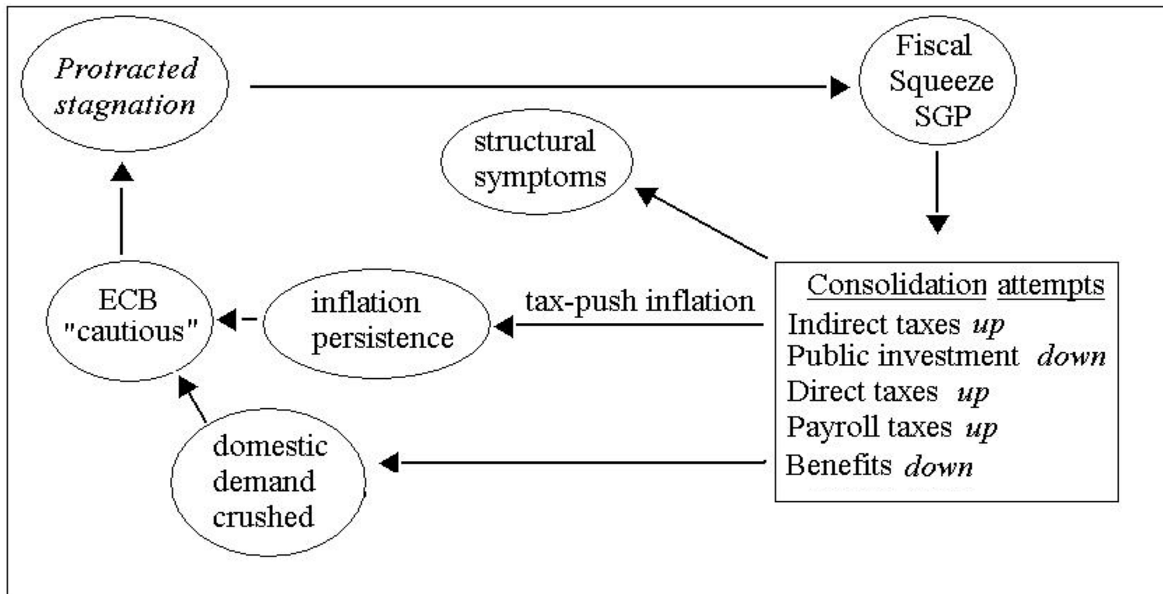
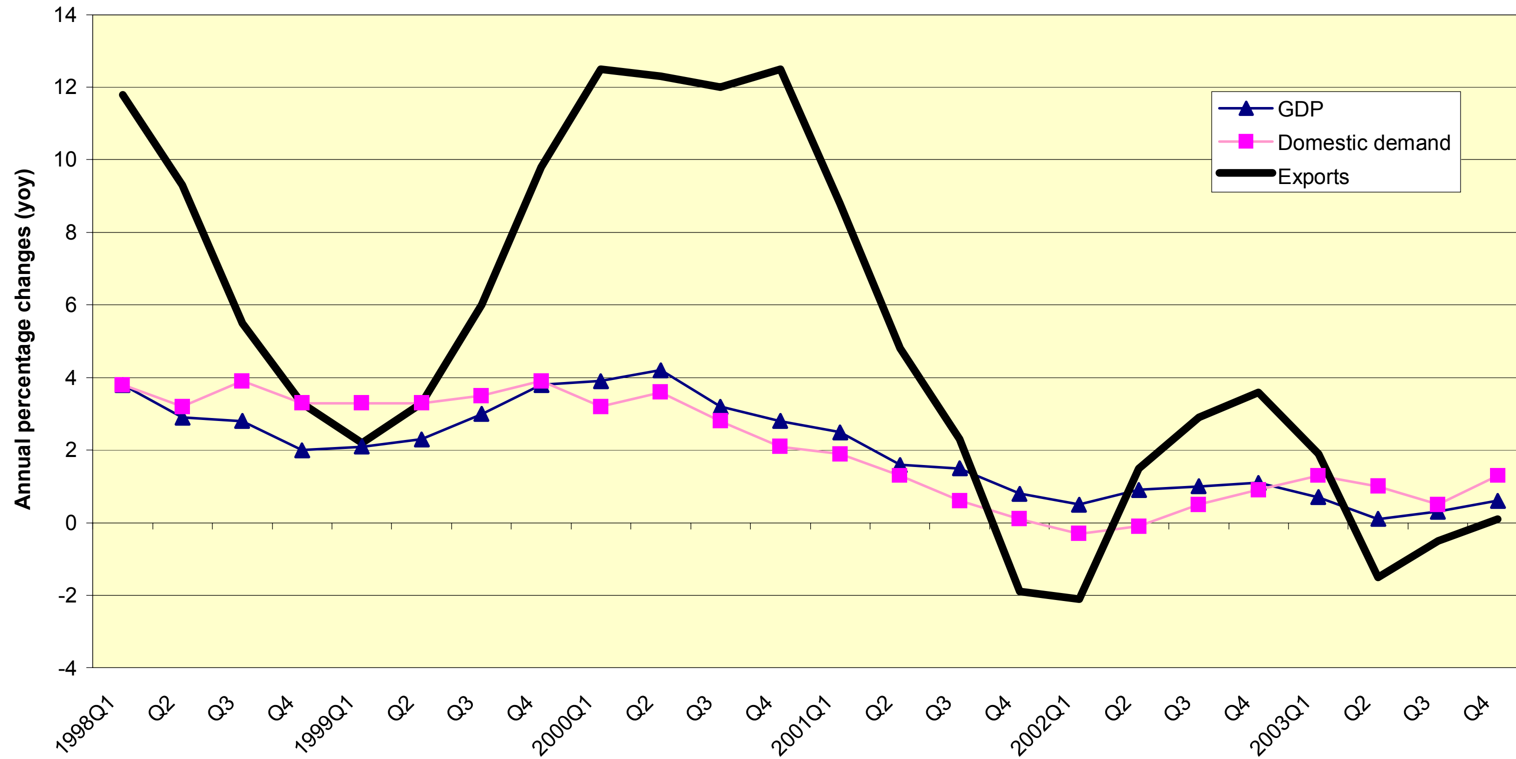


Figure 1. It's a homemade slump, stupid

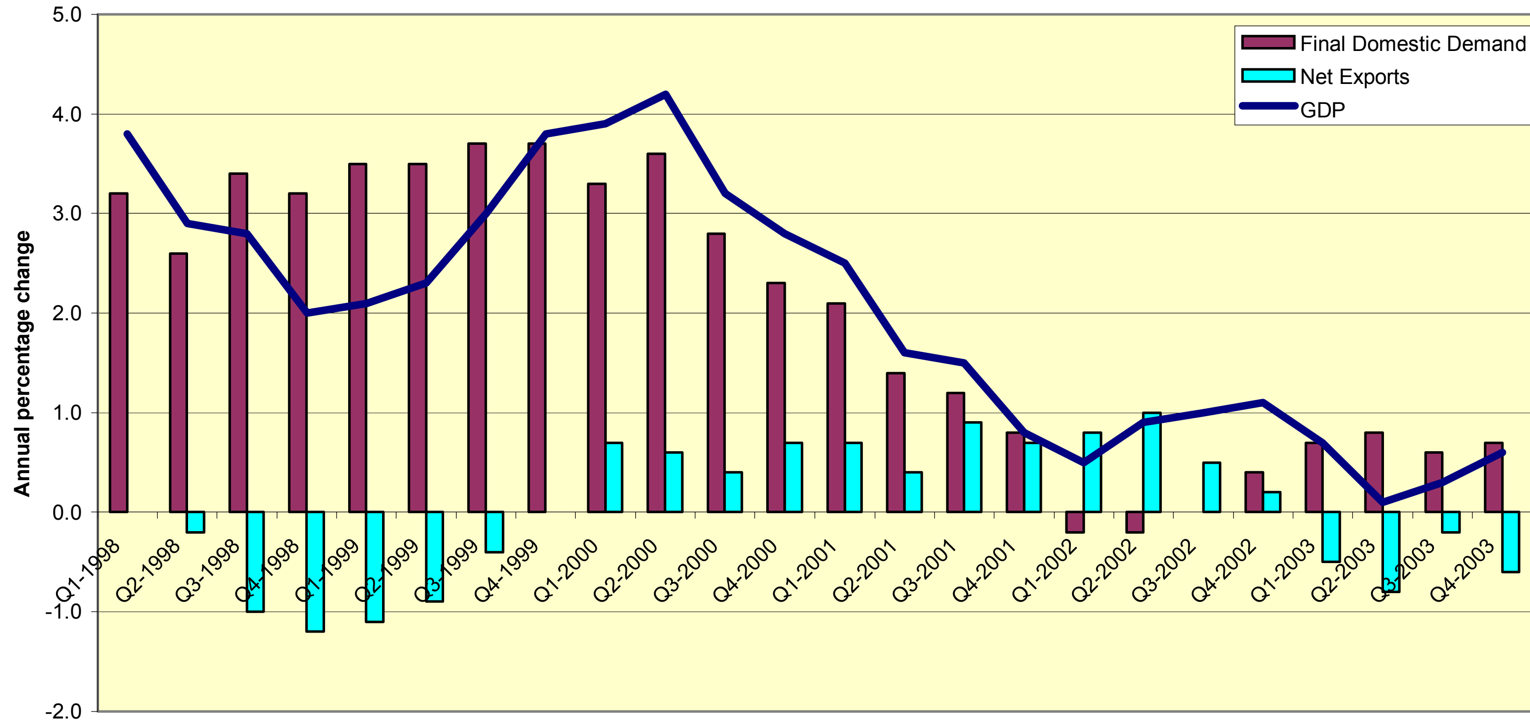


Source: Eurostat, ECB

Note: GDP at constant (1995) prices, quarterly growth rates, seasonally adjusted (1998-2003)

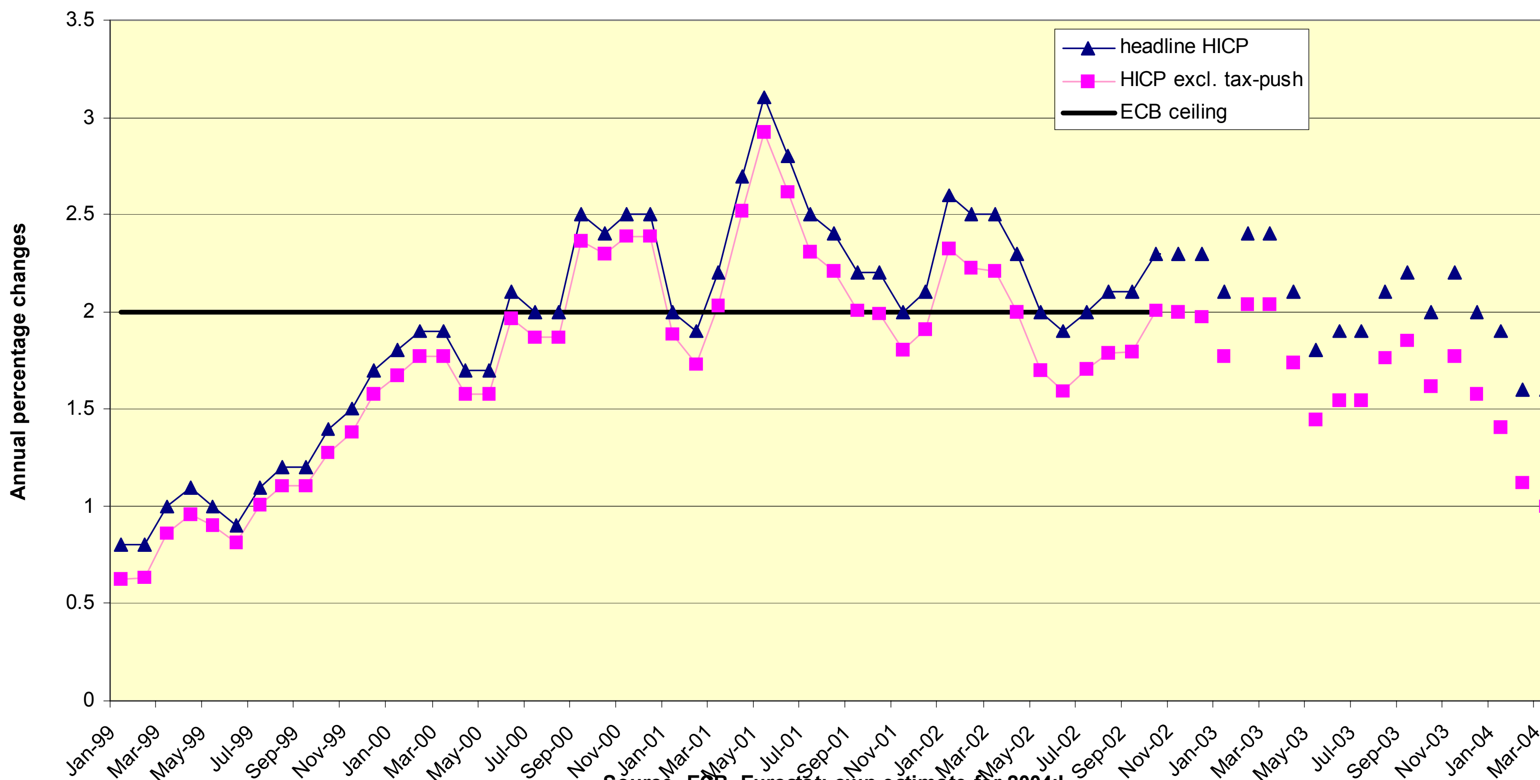
Figure 2. Net exports prevent recession as domestic demand fails to revive

Euro's revival has not made things any easier; nor should it



Sources. Eurostat, ECB (Monthly Bulletin April 2004)
Note: Contributions to GDP growth. Seasonally adjusted data in constant 1995 prices

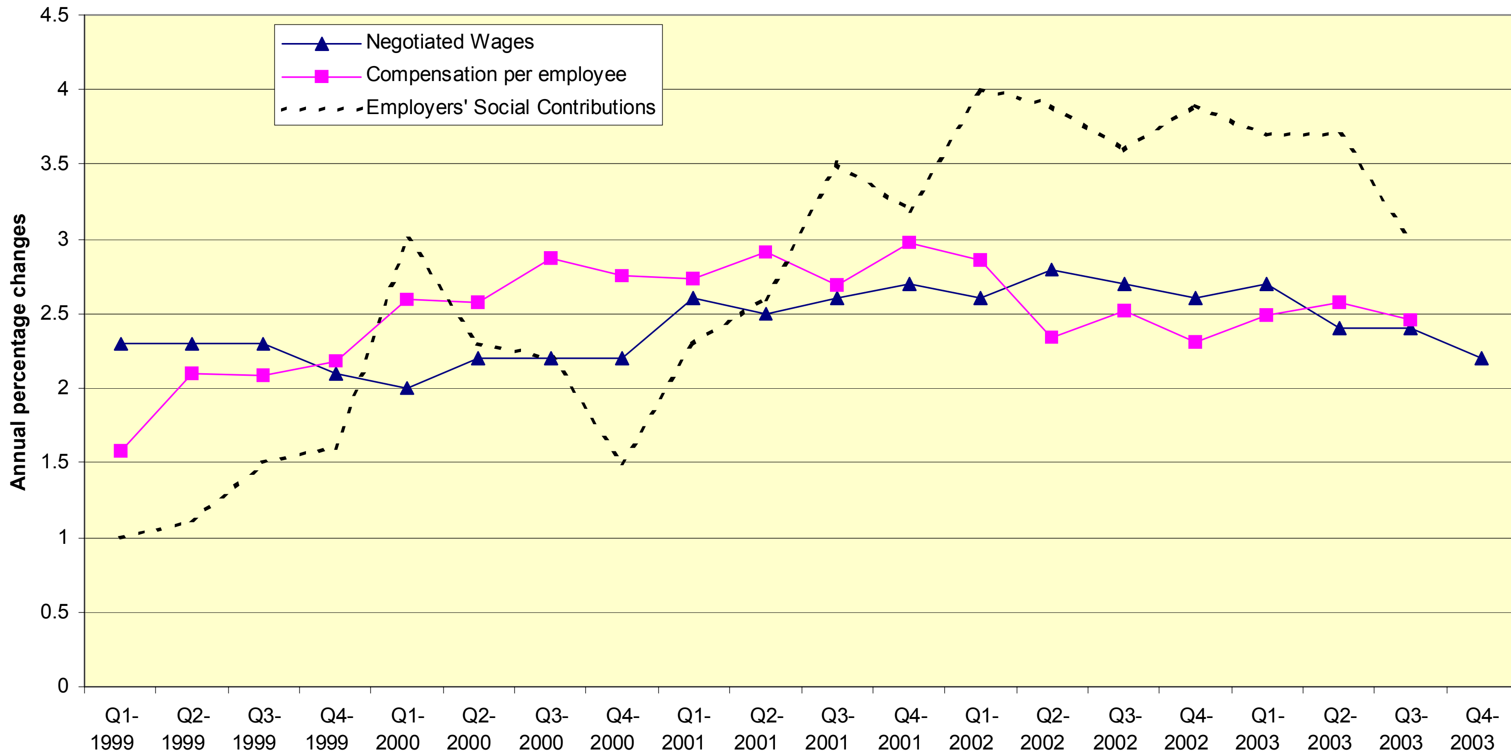
Figure 3. Misses on primary objective in 2002-03 owe to tax-push inflation



Source. ECB, Eurostat; own estimate for 2004:I

Note. Taxes on tobacco products and measure of administered prices within the services sector (aggregate HICP weight of 5.6%) included here most likely underestimate true tax-push inflation.

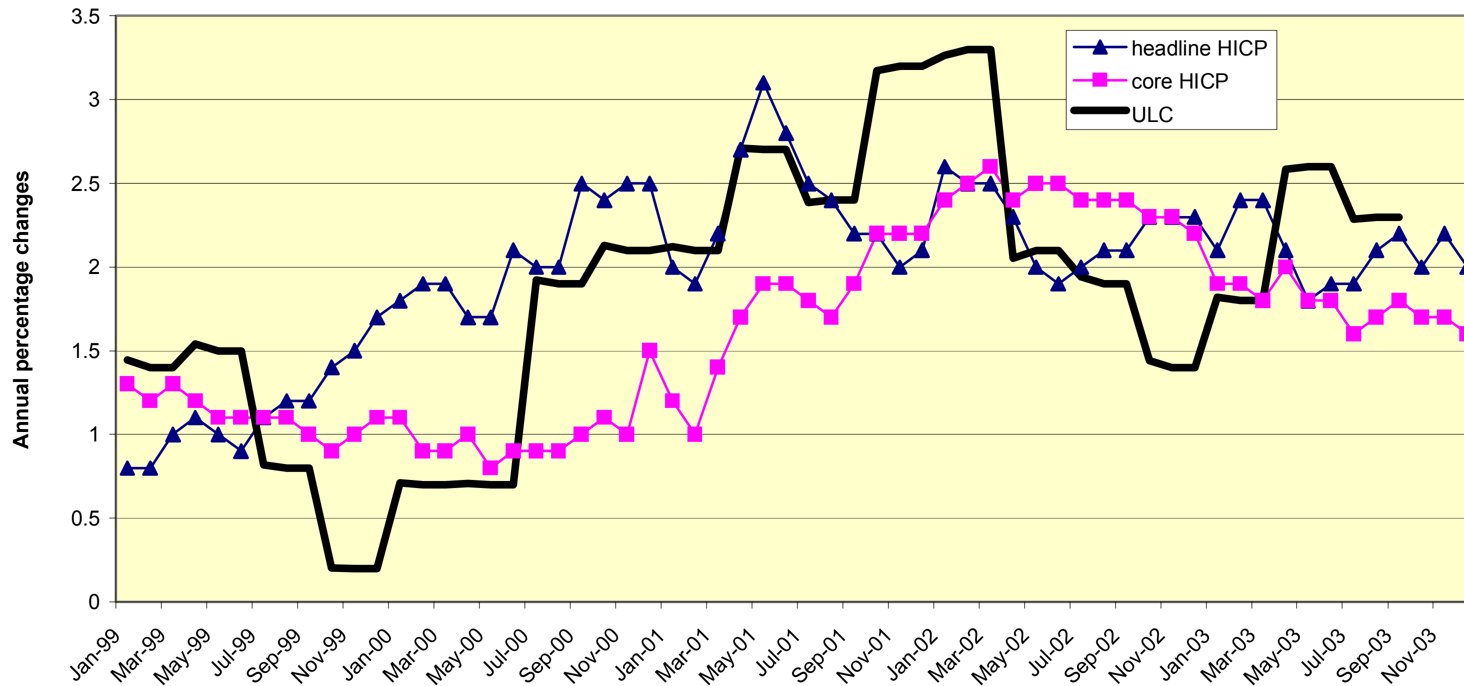
Figure 4. Extensive, perhaps excessive wage moderation that ultimately did not pay off



Sources. ECB, Eurostat

Notes. Index of negotiated wages refers to collectively agreed wage increases. Compensation per employee includes direct earnings and all indirect compensation. Employers' social contributions based on hourly labor cost index.

Figure 5. Nor was the slump helpful to keep core inflation in check

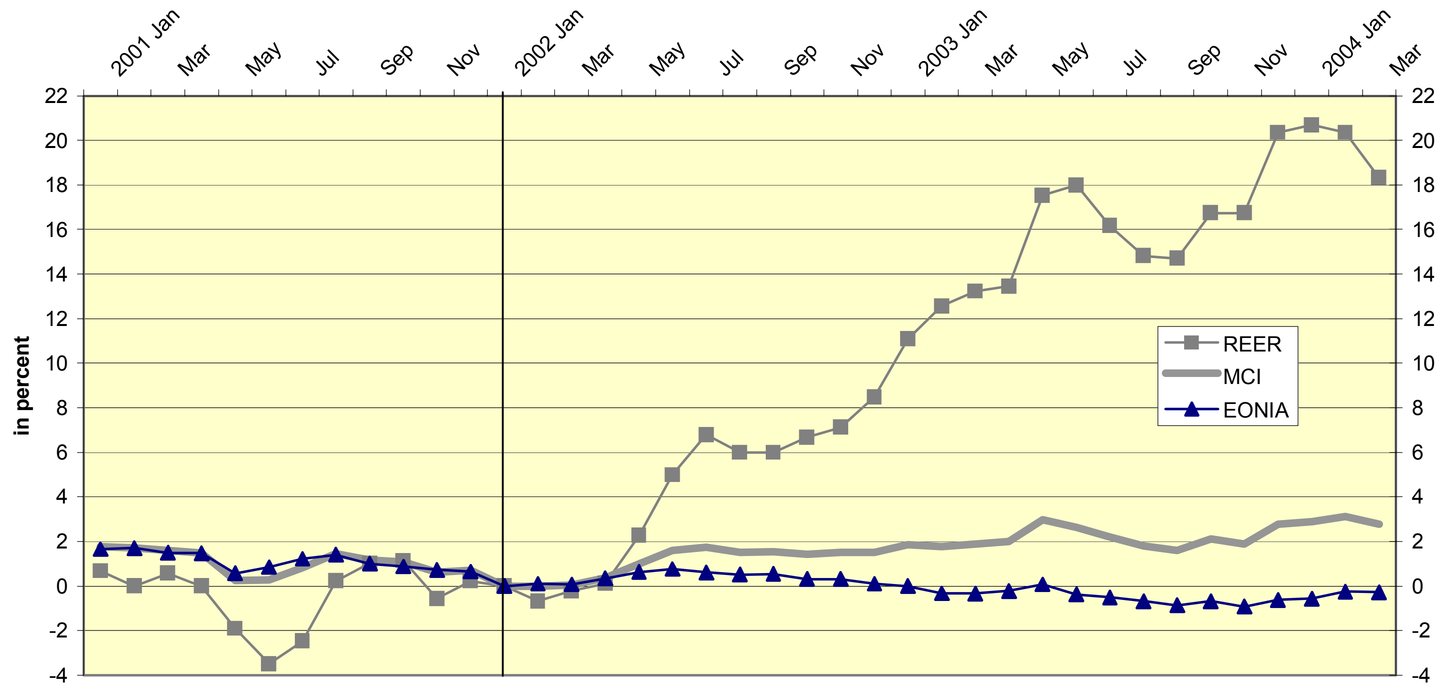


Sources. ECB, Eurostat

Note. As slump crushes labor productivity growth, unit-labor costs pushed up despite low and stable wage inflation.

Figure 6. Monetary conditions in euroland

(Base: January 2002)



Source: ECB Monthly Bulletin (Apr 2004)

Notes: EONIA deflated by HICP, REER (CPI deflated, broad group of countries), MCI based on 6:1 weighting.

Figure 7. Negative demand shock calls for aggressive policy reaction

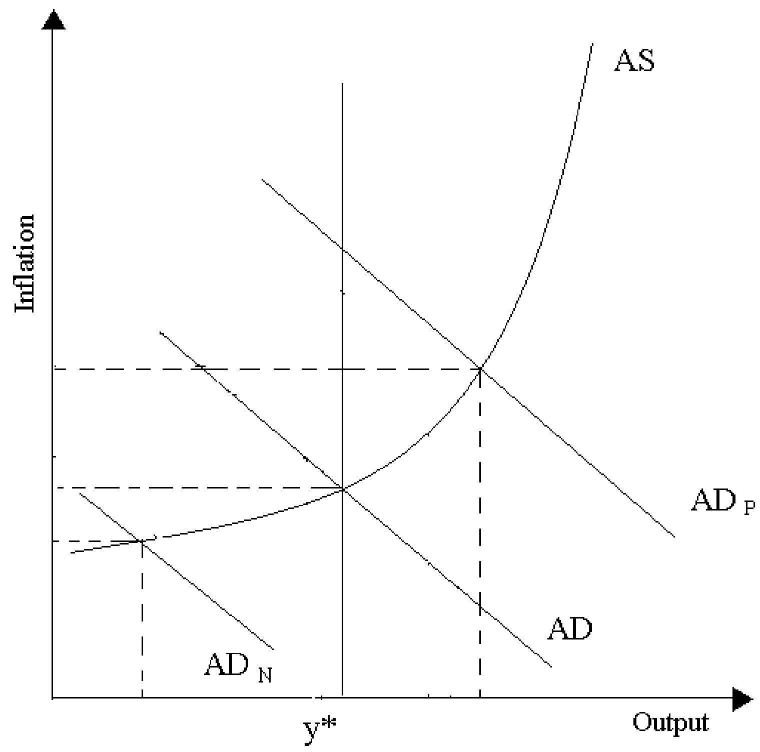


Figure 8. Cautious reaction may have nasty consequences

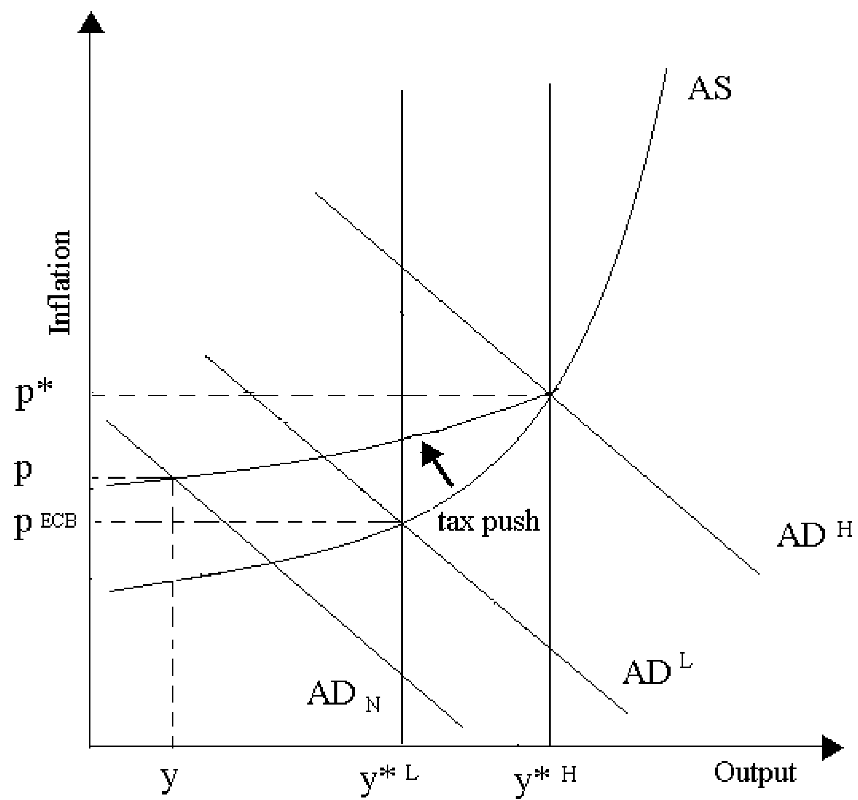
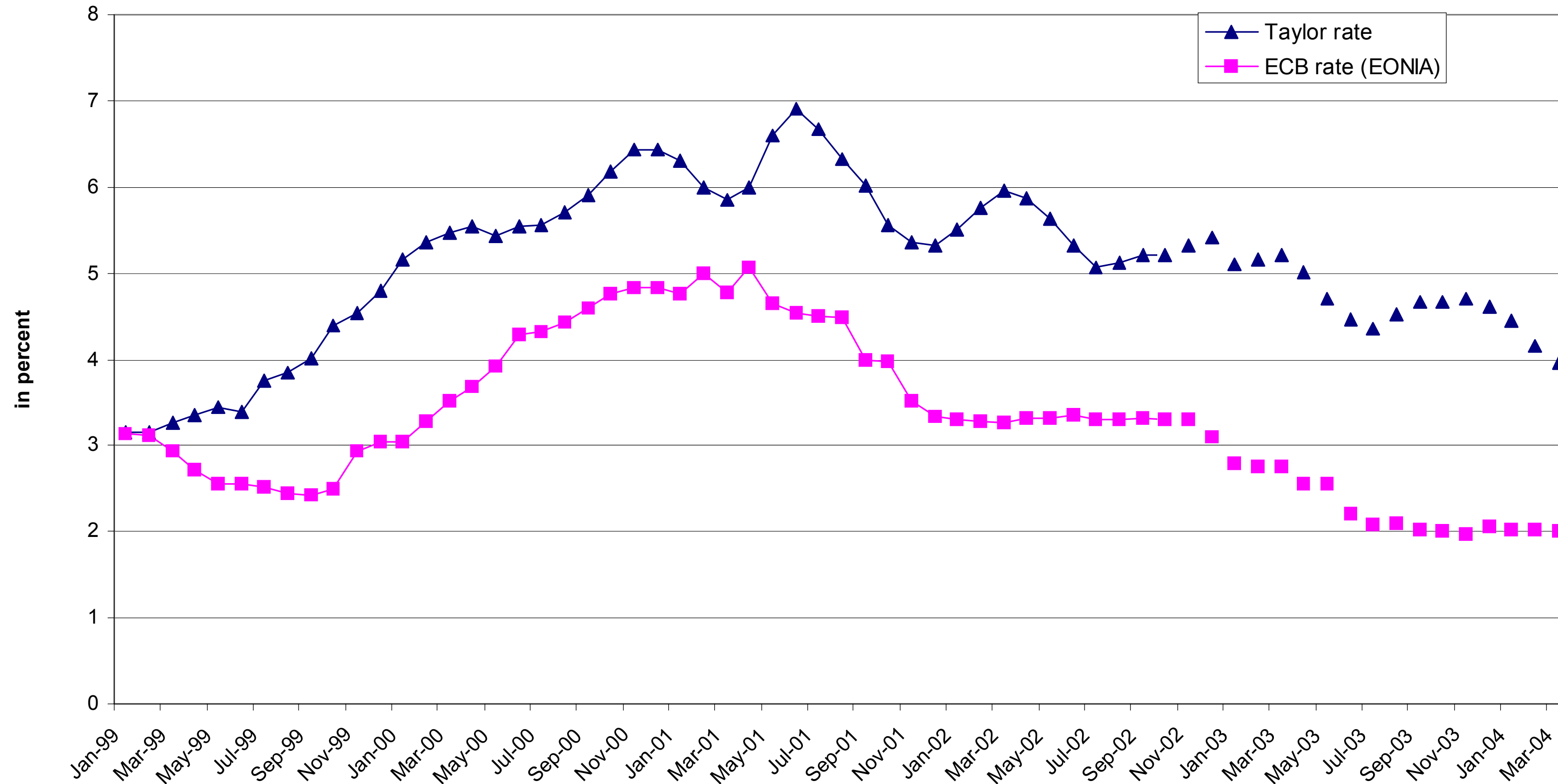


Figure 9. A Taylor rule revealing too accommodative ECB

Failure on overriding objective apparently due to softness throughout

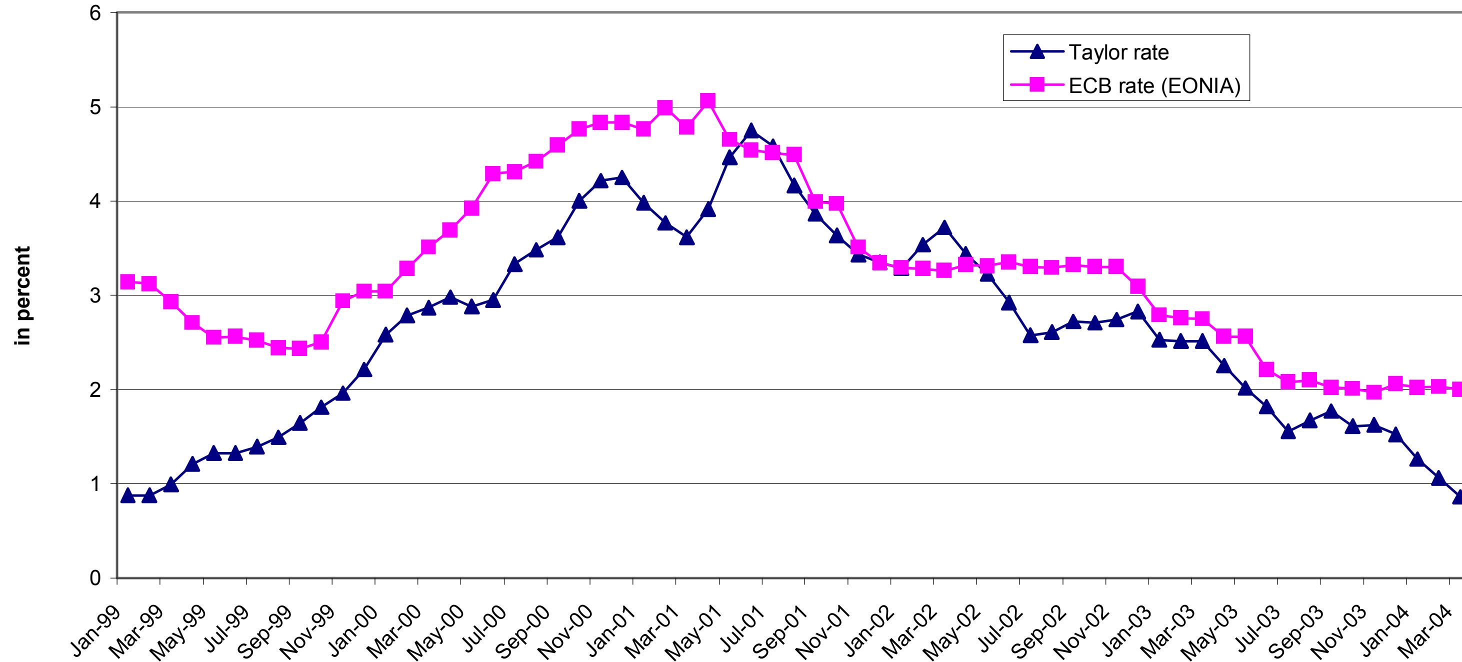


Sources. ECB, Eurostat

Notes: HP-filtered output gap, real equilibrium interest rate (2.8%), target inflation (1.5% HICP headline), inflation and output gap feedback parameters (1.5, 0.5), inflation (3m moving avr)

Figure 10. Another revealing Taylor rule

"Ahead of the curve" as euro plunges, "behind the curve" as euro soars



Source. ECB, Eurostat

Notes: output gap (2000:4=0), real equilibrium interest rate (1.5%), target inflation (1.5% HICP ex tax push), inflation and output gap feedback parameters (1.5, 0.5), inflation (3m moving average)