Is a loose monetary policy still appropriate for the Eurozone?

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The November 2016 expert survey of the Centre for Macroeconomics (CFM) and the Centre for Economic Policy Research (CEPR) invited views on a recent report by the German Council of Economic Experts (Sachverständigenrat), which argues that the current monetary policy of the European Central Bank (ECB) is no longer appropriate and that it is masking structural problems in Eurozone countries.

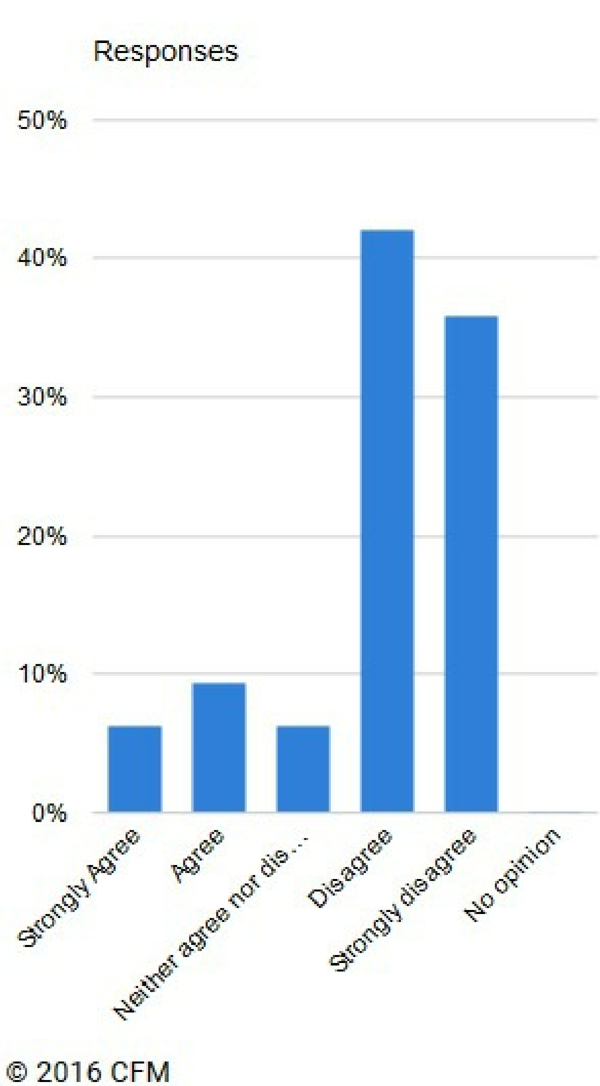
More than three quarters of the 64 respondents disagree with the view that ECB monetary policy should become less accommodating. Panel members also disagree with the view that ECB policy is masking structural reforms. The panel is divided, however, on whether ECB policy is making implementation of structural reforms less likely.

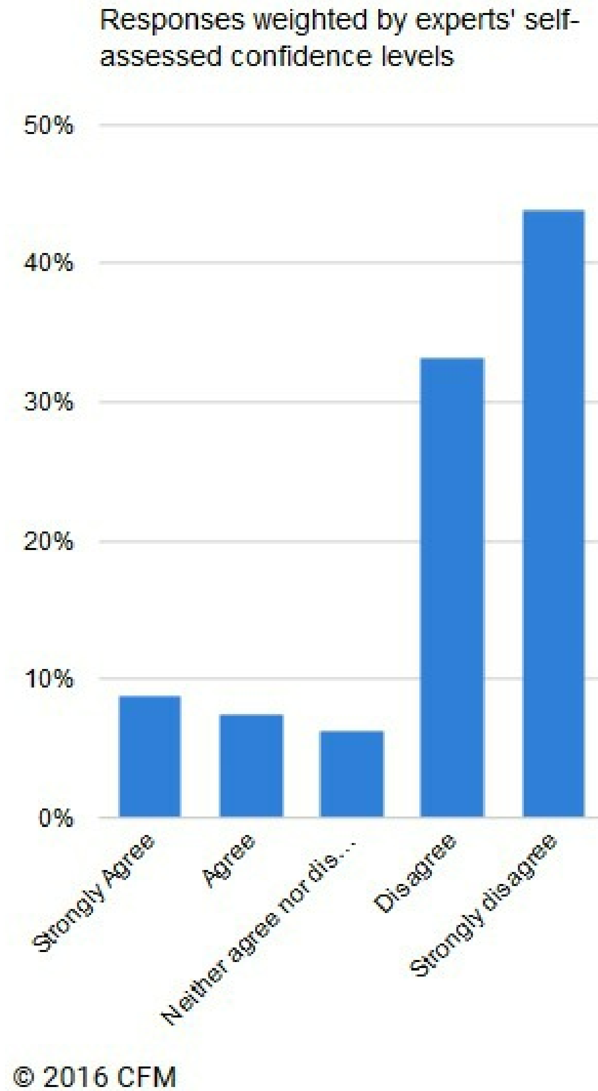
Background

In its annual report, the German Council of Economic Experts argues that: *'Exceptionally loose monetary policy by the European Central Bank (ECB) contributed significantly to the upturn in the euro area, although its extent is no longer appropriate in light of the state of the recovery.'* Moreover, the report says: *'Given considerable structural problems persist, growth is not self-supporting. Willingness to reform has faded, and some member states lack necessary budget discipline. Monetary policy masks these problems and increasingly threatens financial stability.'*

The first question in our survey asked panel members whether they think that it is indeed the case that the current monetary policy by the ECB is no longer appropriate.

Question 1: Do you agree that that exceptionally loose monetary policy by the European Central Bank (ECB) is no longer appropriate?





Sixty-four panel members answered this question and a very large majority (78%) disagrees or strongly disagrees with the proposition. A small minority (15%) agrees or strongly agrees. These numbers barely change if weighted with self-assessed confidence.

Among the panel members that disagree with the statement, many point to the current levels of inflation and slack in the economy. For example, Costas Milas (University of Liverpool) writes: *'With inflation consistently under-shooting the target for more than three years now, it is really difficult to agree with the German experts. In fact, the inflation survey forecasts (from the ECB website) indicate that inflation will still be below the target (at 1.8%) in five years.'*

Michael McMahon (University of Warwick) points out that: *'The appropriateness of ECB monetary policy must be judged by whether or not it is likely to contribute to the achievement of the central bank's objectives. These objectives are clearly laid out in Article 127(1) of the Treaty on the Functioning of the European Union. Price stability is the over-riding objective and only subject to achieving that should the ECB look to support the other objectives of the EU.'* Sushil Wadhwani (Wadhwani Asset Management) adds that: *'To have a central bank not trying to achieve the target it set for itself would further undermine its credibility.'*

Several experts think that the weak level of aggregate economic activity in the Eurozone is an additional reason for the ECB to continue its current policies. Pietro Reichlin (LUISS, Università Guido Carli) writes: *'The recovery in most of the Euro Area economies is still lagging and this appears to be related to the ongoing debt overhang of private and public institutions… More generally, low interest rates appear to be the right policy choice to help peripheral countries with limited fiscal space in their struggle to stabilize public debt.'*

It is worth pointing out that several commentators stress that monetary policy by itself is not enough. For example, Jordi Gali (Universitat Pompeu Fabra) writes: *'I don't think loose monetary policy by itself will be sufficient to restore growth. Instead it should be accompanied with an expansionary fiscal policy that targeted countries where underutilization of resources and deflationary pressures are more evident. Given the current high debt ratios, it would be best if the fiscal stimulus were to be financed with money creation.'*

Some of the experts who disagree make clear that they are quite astonished by the views of the German Council of Economic Experts. Simon Wren-Lewis (University of Oxford) says: *'The German policy consensus continues to show a degree of macroeconomic illiteracy which is astounding. The OECD suggests there is a sizable negative output gap in all the major Eurozone economies except Germany (where it is roughly zero). The Eurozone core inflation rate is still below 1%, and the core inflation rate in Germany is well below 2%. Even if ECB policy was made in the interests of Germany rather than the Eurozone as a whole, it is not at all clear that this report makes sense.'*

Similarly, Richard Portes (London Business School) is very critical of the report: *'unless the German Council of Economic Experts could argue that exiting from QE* [quantitative easing] *would raise inflation and inflation expectations, or propose alternative policies to fulfil the mandate, they should desist from ECB-bashing and let the ECB get on with trying to do its job.'*

Whereas there is a lot of similarity in the reasons put forward by the majority that disagrees with the question, a variety of different reasons are given in support of the view that the exceptionally loose stance of the ECB's current monetary policy is no longer appropriate. Sylvester Eijffinger (Tilburg University) writes that: *'the exceptionally loose monetary policy by the ECB does not stimulate economic growth in the Eurozone and undermines financial stability by distortion of the market prices of government and corporate bonds, in particular in the peripheral countries of the Eurozone.'*

Akos Valentinyi (University of Manchester) points out that: *'another problem is that the ECB asset purchases cause a shortage of liquid assets in the Eurozone. This is a problem as new regulations increased the banks' demand for these assets.'*

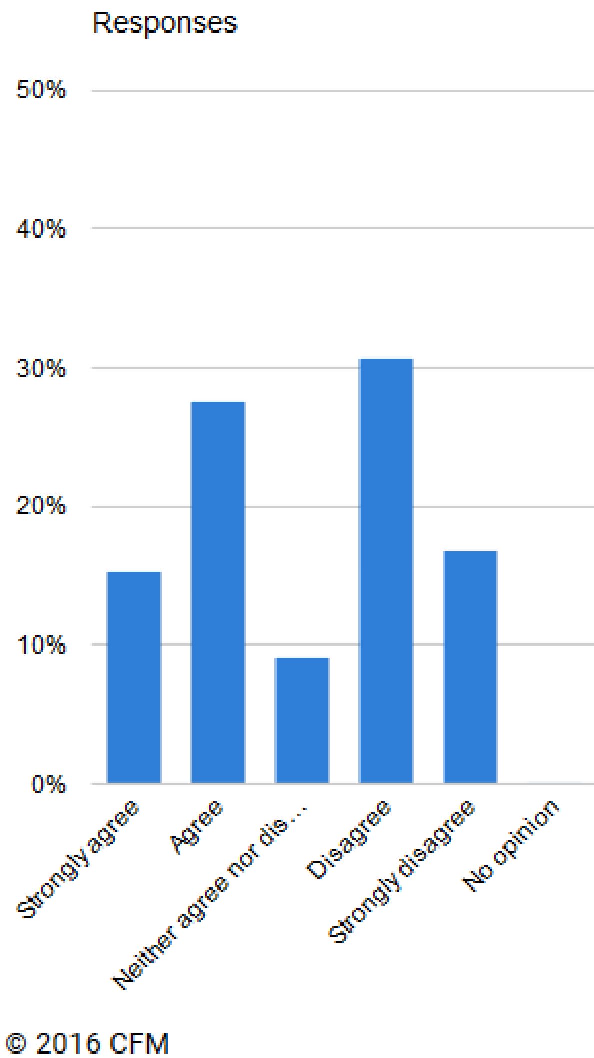
John Muellbauer (University of Oxford) thinks that another disadvantage of current policies is that they may *'be counter-productive in core Eurozone countries like Germany, France and Italy. In Germany and France, higher house prices contract consumer spending (given income etc.): home equity withdrawal is expensive or impossible so the US-type channel, which also operated in Ireland and (to a lesser extent) in Spain, is missing. Prospective first-time buyers need to save more for the large cash deposit needed to get a mortgage.'*

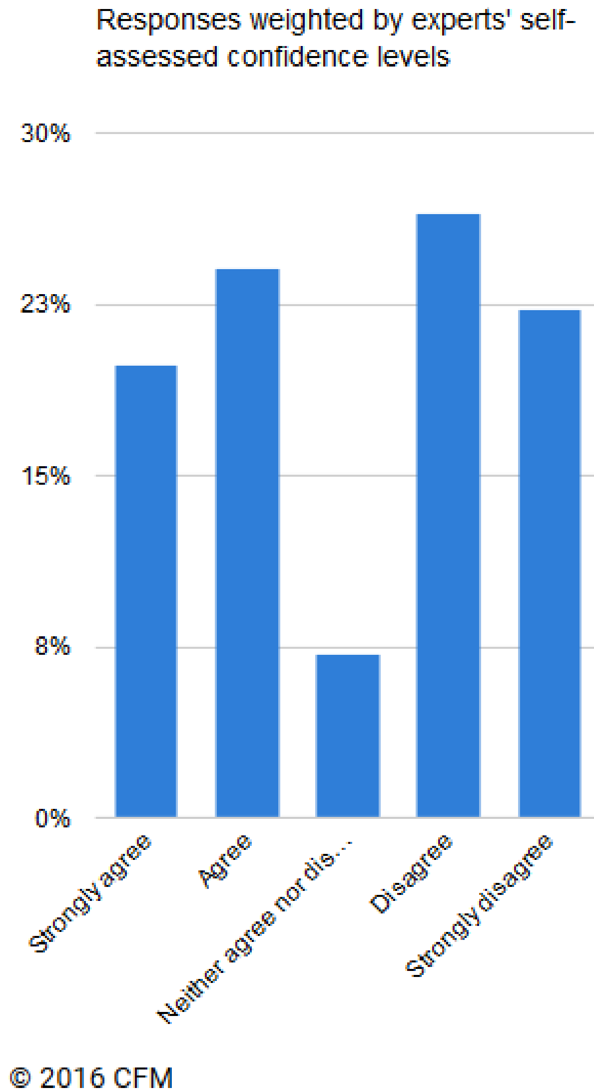
Finally, Ray Barrell (Brunel University London) takes issue with the view of the majority that current low levels of inflation rates ask for a continuation of the current expansionary monetary policies: '*there is clearly a good case for the ECB to modify its monetary stance. Inflation is expected to rise toward target in 2017 as oil prices have strengthened and some European economies are close to full capacity.'*

ECB's monetary policy and masking of structural problems

The second question focuses on the other claim of the German Council of Economic Experts that ECB's expansionary policy is masking structural problems in Eurozone countries.

Question 2: Do you agree that the ECB's monetary policy masks structural problems of member states?





Sixty-five panel members answered this question. Panel members seem divided on this issue with a minority of 44% that either agrees or strongly agrees and a slightly larger minority of 47% that either disagrees or strongly disagrees. The residual is made up of panel members who neither agree nor disagree.

First of all, many of the experts do agree with the notion that there are non-trivial structural problems that need to be addressed. Morten Ravn (University College London) writes: *'There are clear needs for structural policies to address the disappointing state of many economies where high levels of youth unemployment have effectively sacrificed a generation since the financial crisis, where inequality is high, and where wage and price adjustments are very sluggish. Loose monetary policy cannot substitute for reforms.'*

Reading the comments makes clear that the panel members are actually not divided on whether ECB's monetary policy is 'masking' structural problems, but that they are divided on whether it potentially prevents national governments from dealing with them. For example, Charles Bean (London School of Economics) writes: *'I don't believe that it* [ECB monetary policy] *"masks" the structural problems – they are still perfectly evident – though it certainly reduces the pressure on national governments to address them.'*

Since our panel members do not seem to think that 'masking' is the problem, we focus the remainder of this summary on our panel's views on whether ECB's monetary policy makes it less likely or more likely that structural reforms will be implemented. On this issue, the panel members are clearly divided.

The key argument supporting the view that continuation of the ECB's expansionary policy will make implementation of structural reforms more likely is that this is easier to do in an environment in which monetary policy stimulates economic activity. John Driffill (Birkbeck, University of London) says that one can implement *'such reforms more easily in an situation of low unemployment and robust growth rather than in a high unemployment/low growth situation, since the initial effects of such reforms might well be to cause more, not less, unemployment, even though their long-term effects will enable lower unemployment.'*

The key argument supporting the view that ECB's monetary policy is preventing or at least delaying structural reform is the moral hazard issue that the ECB's exceptionally loose monetary policy is lowering interest payments on sovereign debt and, by doing so, making it less critical for governments to implement policies that safeguard government financing. Several commentators support this view.

Roberto Perotti (Università Bocconi) argues that: *'There is no doubt that high-debt countries, and Southern European countries in general, have benefited enormously from the "whatever it takes" of Draghi. There is little doubt that the decline in interest rates on their public debt has encouraged them to take it easy in terms of their fiscal policy, after some effort around 2011 and 2012. This is a very standard moral hazard problem of loose monetary policy.'*

Roberto Perotti does qualify this statement by adding: *'however, there is a huge uncertainty regarding the appropriateness of a very tight fiscal policy in these countries anyway; in addition, none of them gives signs of sheer fiscal irresponsibility, just some relaxation. In light of this, again prudence would suggest accepting these side costs and continuing with the current monetary policy for some time.'*

Similarly, Pietro Reichlin is of the opinion that: *'to some extent, I agree that we cannot ignore the moral hazard induced by ECB actions in a Monetary Union, where member countries retain their sovereignty over spending and public debt.'* But he also points out that there are caveats, one of which is that: *'the ECB promise to raise inflation up to the 2% target has not being delivered, and this imposes further limits to the solutions of the structural problems faced by peripheral economies.'*

Richard Portes takes a very strong position against the moral hazard argument: *'"Masks structural problems" by promoting economic expansion and price stability? Give me a break. … The only story is the "moral hazard" argument – that governments feel less pressure to reform if they feel less pressure from the bond markets. Where is the evidence? The slowdown in reforms supposedly documented by the OECD is not based on any quantitative evidence. Even if one accepted it, one could argue that previous reforms had exploited "low-hanging fruit", so it would be normal that the observed effort would slow down. Moreover, it is a common political economy argument (with some empirical support) that reforms are easier in the context of a reasonable pace of growth – otherwise there are too many losers. Did Mr Schaeuble write this report?'*

But some panel members do see evidence for the negative effects of current ECB monetary policy. Sylvester Eijffinger argues that: *'a very clear example is the structural reform agenda of the Italian prime minister Renzi which has not been implemented since almost two years with reference by Renzi to the Italian low capital market interest rates which make structural reforms in Italy less necessary.'*

In striking contrast, John Muellbauer thinks that the experience in Italy provides support for the opposing view: *'it is true that ECB QE has pushed the spread of Italian sovereign bonds a little below what economic fundamentals would suggest. But there is not much evidence that high values of these spreads in the past led to systematic reforms in Italy.'*

Finally, there are panel members who think that monetary policy is not relevant. Luigi Guiso (Einaudi Institute for Economics and Finance) writes: '*there are member states that undoubtedly have serious structural problems; monetary policy is neither masking nor delaying those problems. The truth is that the solutions to those structural problems are totally independent of the monetary policy regime. They depend on deeper features of those countries, not least their institutional design and ability to cope with political economy problems.'*

Whether ECB monetary policy accommodates or prevents implementation of structural reform is a fascinating question. In terms of judging the ECB, however, it is important to keep in mind that: '*the ECB would be straying beyond its legal mandate were it to deliberately underachieve on its inflation objective in order to place more pressure on member states to undertake the necessary reforms. Such behaviour by the ECB would lack democratic legitimacy',* in the words of Charles Bean.

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Notes:

- *This post is based on German Council of Economic Experts' view of ECB policy , a survey of the Centre for Macroeconomics.*
- *The post gives the views of the author, not the position of LSE Business Review or the London School of Economics.*
- *Before commenting, please read our* Comment Policy.

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