COMMENTARY
Thinking ahead for Europe

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Why are central bankers shifting the goalposts?

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The theme of this year's meeting of the world's central bankers in Jackson Hole, Wyoming, had little to do with monetary policy. "Fostering a Dynamic Global Economy" is, of course, an important topic. But it is telling that the European Central Bank also chose, for its own annual gathering, a similar non-monetary topic: "Investment and Growth in Advanced Countries".

There is nothing wrong with central bankers discussing challenges in areas like growth, trade and investment. But central banks are made independent precisely because it is understood that they are accountable for achieving their own objective of maintaining price stability, regardless of the economy's underlying growth rate. So why is it that central bankers would rather look at external issues than focus on their own area of responsibility?

So far, we have not yet received a satisfactory answer.

The current conditions are favourable for monetary policy-making, particularly for the ECB – as a brief look at history makes clear. Since the creation of the Economic and Monetary Union (EMU) in January 1999, the ECB has been solely responsible for determining its monetary policy. (Although national currencies remained in circulation until 2002, exchange rates were "irrevocably" fixed in 1999.)

The ECB's job was hard from the beginning. After all, when the euro was born, global financial markets were in turmoil, owing to the Asian crisis of 1997 and the Russian default of 1998. The VIX index, which measures stock-market volatility, had hit 44% in August 1998, and during the euro's first few years, it hovered around 25-30%, compared to around 12% today. While unemployment in the euro area was declining, the rate was close to 10%, and it remained higher than today's level, 9.3%, for all of 1999. See Table 1 below.

From a monetary-policy perspective, there was also a need to cope with the deflationary legacy of financial crisis. Indeed, when the euro area was established, prices were increasing by less than 2%, and headline inflation was stuck at around 1%. Those two key indicators of monetary policy are at almost exactly the same levels today, but financial markets are significantly more settled now than they were then.

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Table 1. Changes in policy-relevant indicators in the euro area, the US and Japan (1999-2017)

	Activity rate	Unemployment rate	Global VIX	Headline inflation	Core inflation*	Policy rate	CB access reserves (% of GDP)**
EA	6.4	-0.3	-10.2	0.1	0.2	-3.0	22%
US	-0.9	0.3	-10.2	-0.5	-0.4	-4.1	14%
Japan	10.1	-1.6	-10.2	0.7	0.0	0.0	70%

Note: Green = improvement or higher inflation.

* Core inflation is defined as the overall index excluding unprocessed food/all food. Both inflation and core inflation for 2017 are based on latest annual rate of change of July 2017.

** Access reserves are estimated as total Central Bank liabilities less cash in circulation. Access reserves provide a good proxy for the scale of the unconventional monetary policies as these reflect the bond purchases within the QE programmes (see Gros, 2017).

Data sources: AMECO and Eurostat.

In 1999, despite slightly below-target inflation, high unemployment and financial-market volatility, the ECB Governing Council did not even consider zero or negative interest rates, much less unconventional policy measures. Instead, its first action, in 1999, was to fix the main policy rate at 2%.

Over the course of that year, the ECB did cut the benchmark rate by 50 basis points, to the then-unprecedented level of 1.5%. But it did so just to give the economy a chance to recover. After a few months, it reversed course, putting the year-end policy rate back at 2%. Over the next year, the rate was raised to 3.75%, even though inflation had not accelerated by more than a few dozen basis points.

Today, the ECB is facing a much more comfortable situation. While inflation is undershooting the 2% target by a similar amount, the labour market appears to be in much better shape.

But is it? It is widely assumed that a deep recession induces many of the unemployed to leave the labour market, because looking for a job seems pointless. If many such discouraged workers have left the labour market, a recovery of the unemployment rate to pre-recession levels can be misleading. That is why the unemployment rate needs to be considered in conjunction with the labour-force participation rate.

By that measure, the euro area is actually doing much better today than it was in 1999. With the labour-force participation rate five percentage points higher than it was back then, it seems clear that fewer workers have been discouraged from job-seeking today than at the start of EMU, and thus that there is less under-utilised potential in the economy.

Against this background, it is difficult to explain why the ECB continues to insist that unconventional monetary policy measures – such as negative interest rates and continued bond purchases – are needed. The long-term inflation outlook might be somewhat more uncertain today. But can a few dozen basis points in (poorly measured) long-term inflation expectations justify the need for massive quantitative easing and a policy rate 250 points lower than it was at a time of weaker market fundamentals?

This incongruity is not limited to Europe. In the United States, too, one finds a similar combination of inflation and unemployment both today and two decades ago. In 1999, a core inflation rate of around 2%, combined with unemployment below 5%, justified a federal funds rate of 5% (and a 'normal' balance sheet). Today, the Federal Reserve has kept its benchmark rate below 1.5% – 350 basis points lower than in 1999 – and has postponed any reduction in its bloated balance sheet.[1]

In Japan, inflation in now higher than it was in the wake of the Asian financial crisis; unemployment is at its lowest level in 50 years; and the labour-force participation rate continues to reach record highs. Yet Japan, like the US and Europe, continues to display a quixotic tendency to tilt at deflation windmills, with rock-bottom interest rates and purchases of massive amounts of government debt.

Central bankers surely wish for a dynamic global economy. But that is something over which they have little influence. Rather than discussing issues that are extrinsic to their core concerns, they should focus on explaining why they have shifted their goalposts so much – and whether it is time to start moving them back.

Reference

Gros, Daniel (2017), "Implications of the Expanding Use of Cash for Monetary Policy", CEPS Policy Insight No. 2017/21, CEPS, Brussels, June (https://www.ceps.eu/publications/implications-expanding-use-cash-monetary-policy).

[1] We might also note that the only area for which all indicators would justify a more expansionary policy today is the US, whose central bank is also the only one that is actually tightening its policy.