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MECB UPDATE:

Alberto Alesina
Harvard University and CEPR

Olivier Blanchard
Massachusetts Institute of Technology

Jordi Galí
CREI, Universitat Pompeu Fabra, Barcelona, and CEPR

Francesco Giavazzi
Università Bocconi, Milano, and CEPR

Harald Uhlig
Humboldt Universität zu Berlin and CEPR

Europe has a new central bank. The ECB must develop its own version of accountability and public debate over monetary policies. It is natural for CEPR, as a network of policy-oriented academic economists, to contribute to the establishment of a new tradition. Monitoring the European Central Bank (MECB) brings together economists internationally known for their work on macroeconomics and monetary policy. A full MECB report is published each Spring, complemented by an Update published in the Summer.

EXECUTIVE SUMMARY

This is a mid-year update of the third MECB Report published by the same authors last Spring. It is divided into three parts. The first two discuss recent developments in monetary policy in the United States and in Europe, comparing the behaviour of the Fed and that of the ECB in the first months of 2001. The third part discusses an issue which has recently become a source of concern in Europe, namely whether one should worry about current account imbalances within the euro area. The three main points of this Update can be summarized as follows:

- The Fed was right to be aggressive. The US would probably be doing much worse, were it not for the interest rate cuts.
- The ECB is right not to be, at least so far. But it should have the right rhetoric as well.
- The current account deficits of Portugal and Greece are symptoms of positive developments within the euro area. Stopping them would amount to slowing down investment by preventing an important source of finance.

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THEMES OF THIS UPDATE

This report updates a paper on the European Central Bank (ECB) that we published earlier this year ('Defining a Macroeconomic Framework for the Euro Area' Monitoring the European Central Bank No.3, Centre for Economic Policy Research, March 2001). It is divided into three parts. In the first two we discuss recent developments in monetary policy in the United States and in Europe, comparing the behaviour of the Federal Reserve Bank (Fed) and of the ECB in the first months of 2001, when the prolonged US expansion came to an end.

In the third part we discuss an issue which has recently become a source of concern in Europe, namely whether one should worry about current account imbalances within the euro area. In our earlier report we emphasized how different inflation rates across countries of the euro area are not necessarily a source of concern. Here we make a similar argument regarding current account deficits.

The three main points of this Update can be summarized as follows:

- The Fed was right to be aggressive. The US would probably be doing much worse, were it not for the interest rate cuts.
- The ECB is right not to be, at least so far. But it should have the right rhetoric as well.
- The current account deficits of Portugal and Greece are symptoms of positive developments within the euro area. In countries that start from a level of income below average, and are integrating into the euro area, a current account deficit is typically the manifestation of the build-up of domestic capital. Stopping it would amount to slowing down investment by preventing an important source of finance.

THE FED AND THE ECB DURING THE FIRST PART OF 2001

During the first half of 2001 the Fed and the ECB have behaved rather differently. While the Fed has cut its target for the Federal Funds Rate from 6.5% to 3.75% in a series of dramatic 50 basis point cuts, the ECB almost stood still, merely adjusting its 4.75% main refinancing rate down to 4.5% in May 2001.

The extent to which the two central banks have behaved differently in the first half of 2001 is remarkable. Up to a year ago it looked as if the ECB was following the moves of the Fed with a lag of four to five months, with the exception of the ECB cut in April 1999 (see Figures 1 and 2, where vertical lines denote the beginning of quarters). If that pattern had continued, the ECB cut of last May should have been the first in a long sequence of interest rate reductions. At this juncture, this seems unlikely to happen.

Figure 1: Interest Rates in Europe and in the United States: 2001

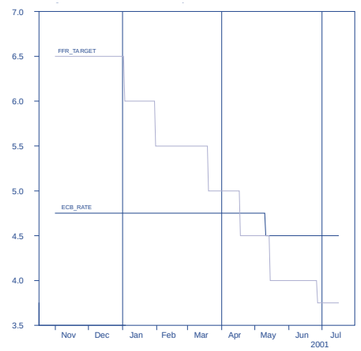
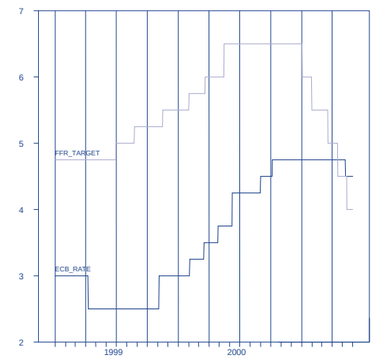


Figure 2: Interest Rates in Europe and in the United States: 1999 and 2000



So why the change? There are at least three views about this:

- The Fed is playing its world leadership role responsibly, acting in the face of a global downturn, whereas the ECB ignores these developments, interpreting its mandate as leaving no room for considerations other than price stability in the euro area;
- The Fed has begun to target the level of the stock market, reacting to the erosion of paper wealth which started last year, while the ECB has kept its focus much more tightly on inflationary developments, which offer no room for cuts;
- The situation in the euro area and in the US is simply different: while the economy started to head down very suddenly in the US, not much has changed with respect to growth prospects in Europe.

We think that the third view is correct. To make the case we start by looking at the Fed: we show that the sequence of US interest rate cuts is no surprise: the Fed has behaved as should have been expected based on the experience of the Greenspan years. Then, we look at the ECB.

WERE THE US INTEREST RATE CUTS DURING THE FIRST MONTHS OF 2001 'SURPRISING'?

One may ask what would have happened if Greenspan had not cut interest rates in a sequence of steps since January 2001, but instead had left the Federal Funds Rate at its 6.5% December 2000 level?

Using data for the Greenspan years (that is, from 1986 until March 2001) for estimation, we did two simulations:

- A first one based on what the Fed did and our best prediction of what it will do in the future.
- A second one – counterfactual – based on the assumption that, from January 2001, the Fed kept and would continue to keep the interest rate constant and equal to 6.5%.[1]

The simulations extend to the year 2003, to give us a sense of things to come. The results for the Federal Funds Rate, CPI inflation and for the percentage change in real GDP compared to December 2000 are in Figures 3, 4 and 5. The solid bands are the 16% and 84% confidence bands for the first simulation; the dashed lines are the corresponding confidence bands for the constant interest rate scenario. Obviously, there is no uncertainty regarding the Federal Funds Rate in the second scenario. The vertical line denotes the start of the simulations. (Note that in the first simulation we use actual data up to and including March 2001.)

Three results stand out:

- CPI inflation is predicted to fall under both scenarios: in fact, at constant interest rates, US inflation could have entered deflationary territory rather quickly;
- The confidence band for interest rates under the first scenario includes very low nominal interest rates, around 1% starting somewhere towards the beginning of 2002. We do not want to imply that Japanese conditions will take hold in the US, we merely note that by extrapolating past Fed behaviour and simulating forward using historical measures of uncertainty, and based on the currently low and falling rates, extremely low interest rates may be a serious possibility in the near future;

[1] We estimated a vector auto-regression with monthly data on CPI inflation, oil prices, non-borrowed reserves, M1, real GDP interpolated to obtain monthly data) and the Federal Funds Rate. The variables were transformed using logarithms, in particular of the Federal Funds Rate, in order to avoid going into negative territory. In the first exercise we used the actual data until March 2001 and simulations beyond that. These simulations are constructed taking draws for future interest rate changes, and changes in other variables, based on historical uncertainty. The second exercise differs from the first in that we keep the Federal Funds Rate constant at 6.5%. More precisely, we have picked a sequence of monetary policy surprises (relative to the policy rule estimated for the past) in such a way as to imply a constant interest rate: such a constant rate would have been quite surprising indeed! To identify these surprises we have used a technique developed by Harald Uhlig ('What are the Effects of Monetary Policy Shocks on Output? Results from an Agnostic Identification Procedure', CEPR DP No. 2137, 1999), additionally imposing that a surprise tightening of monetary policy eventually leads to a worsening of GDP growth.

What if the Fed had not cut?

Figure 3: Fed. Funds Rate

Figure 4: US Inflation (CPI)

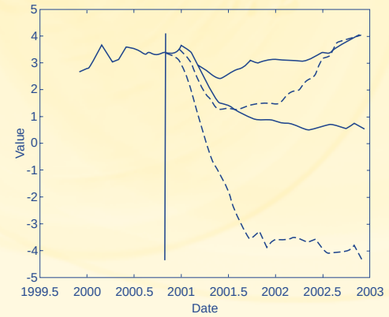
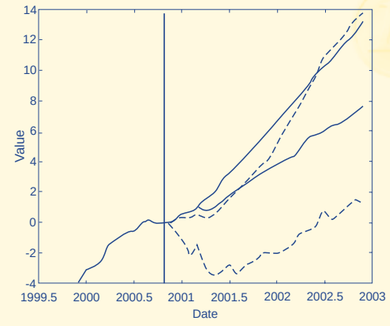


Figure 5: US GDP growth



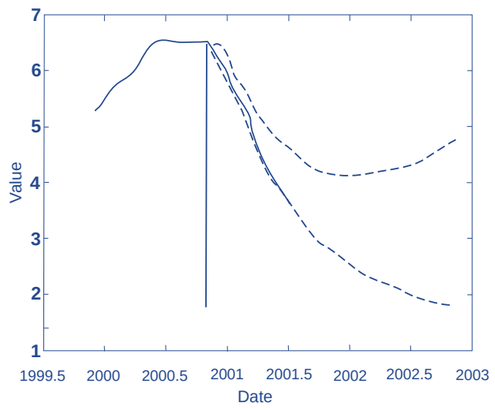
- The confidence bands for GDP growth at the end of 2003 are much tighter in the first than in the alternative scenario, even though the simulation under the first scenario contains more uncertainty as to what interest rates will do. This is because, as future uncertainty unfolds, the Fed, in the first scenario, is allowed to react to changing circumstances and can thus keep GDP growth steadier.

As with all simulations, those presented here should be taken with a grain of salt. In particular, the confidence bands for both exercizes do not exclude a rise in US inflation starting sometime in late 2002 – obviously sooner in the scenario of rapidly falling interest rates. But overall we interpret these results as indicating that the Federal Reserve has probably done the right thing in cutting interest rates so swiftly.

In fact, these cuts were not surprising at all. This is shown in Figure 6, where we replace the second, constant-interest-rate scenario, by the assumption that there had been no monetary policy surprises at all in December 2000, January, February and March 2001. In other words we ask what interest rates would have been had the Fed behaved exactly as predicted in light of the data available for those months.[2]

Extrapolating past behaviour leads to the prediction of a sequence of interest rate cuts almost identical to those that have actually taken place, at most at a slightly slower speed. Not surprisingly, the results for GDP growth and inflation (which we do not report) are essentially identical to those obtained using actual interest rate data for January to March. Based on past data, we should not be surprised that the Fed did what it did.

Figure 6: Were the Fed cuts surprising?



UNDERSTANDING THE ECB INTEREST RATE DECISIONS DURING THE FIRST MONTHS OF 2001

Now we turn to the ECB. Deciding the proper stance of monetary policy in the euro area is, at this particular moment, not an easy task. Two forces are running in opposite directions. Headline (HICP) inflation has been above the 2% limit for the past 14 months. Since the beginning of the year, as the inflation numbers came out, the ECB has revised its projection for average inflation in 2001 from 2.3% in December 2000, to 2.5% in June 2001. At the same time everybody expects inflation to come down next year: the ECB's own projection of average inflation during 2002 has been revised downward, from 1.8% last December to 1.7% in June 2001.

The uncertainty concerns the macroeconomic scenario that will accompany the projected reduction in inflation. Is this telling us that the euro area is about to enter a sharp slowdown, or will inflation come down simply because the temporary effect on consumer prices of higher oil and food prices is dying out? The ECB, consistent with its downward revision in the inflation projection for 2002, has revised downward its growth projection: the mid-point of the projection range for growth during 2002 now stands at 2.6%, down from 3% last December – a slowdown, but not a dramatic one: the lower limit of the projection range is 2.1%.

Since the beginning of 2001, as the growth prospects for the world economy worsened, the ECB has been facing mounting pressure from different fronts to lower interest rates. The aggressive interest rate cuts enacted by the Fed reinforced such pressures. Up to the time this Update has been written (the middle of August), the ECB has done little to appease such demands: policy rates have remained unchanged at 4.75% since October 2000 until early May, when they were adjusted down to 4.50%.

The ECB decision to cut interest rates by 25 basis points in early May could be interpreted as a way to let off some of that pressure. If this were the case, this episode would once again highlight the importance of effective independence of the ECB. Thus far the ECB has acted in a way that did show independence and this episode is not the signal of a change of course.

A different explanation is that the May decision represents a break with the policy pattern followed by the ECB until recently, and signals the decision to respond to medium-term inflationary pressures in a forward-looking manner. If so, this is potentially a very good development.

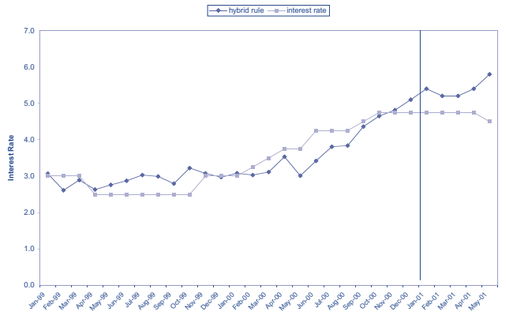
[2] It should be emphasized that in order to 'predict' what the Fed would have done we are using not just past, but also contemporaneous data and the computed, systematic reaction of the Federal Reserve to such data, assuming it acted as it did in the past.

Has the 'rule' changed?

In our original report, we argued that the ECB's interest rate decisions over its first two years of existence could be explained pretty well by means of a hybrid rule. That rule has the central bank respond quite aggressively (with a coefficient as high as 2) to both core inflation (HICP minus food and energy) and the one-year ahead inflation forecast, both expressed in terms of deviations from target, and receiving equal weight. That rule, described in detail in the original report, is consistent with a steady-state real interest rate of 2.5% and a medium-term inflation target of 1.5%.[3]

We showed that the interest rate implied by that simple rule tracked pretty well the actual interest rate set by the ECB from the launch of EMU until roughly the end of year 2000. Such a good fit could not be attained by other simple rules that focus on headline (HICP) inflation, the output gap, or even core or expected inflation alone. The good fit until the later months of year 2000 can be clearly seen in Figure 7, which extends the evidence provided in our previous report through May 2001; the new data appear to the right of the grid line.

Figure 7: Understanding ECB's Interest Rate Decisions



Interestingly, far from justifying the necessity of an immediate relaxation of monetary policy, the pattern of interest rates implied by the rule since December 2000 would have called for a gradual upward adjustment of rates to a level slightly above 5% and not far from 6%. The explanation for the discrepancy in the most recent months is simple: while inflation forecasts have remained largely unchanged (they have come down from 1.8% in December 2000 to 1.7% in June 2001), core inflation has edged up significantly: from 1.5% in December 2000 to 2.1% in May 2001, according to the preliminary estimates by Eurostat.

[3] The 1.5% target is the mid-point in the target inflation range underlying the derivation of the reference value for M3 growth. The target range implicit in that derivation is 1%–2%, which differs from the 0%–2% generally taken to represent the ECB's inflation target by most commentators and analysts.

Consistency with the ECB's earlier pattern of decisions, as summarized by the simple 'hybrid' rule described above, would have called for an increase of more than 50 basis points. Thus, the cut in interest rates by the ECB, while modest, appears to imply a significant break with its past behaviour.

Can we make sense of what has happened?

One explanation is that the ECB is putting more weight on medium-term inflation forecasts than we assumed in our rule. If so, the shift to a rule that gives more weight to medium-term inflation forecasts in making interest rate decisions is not only desirable: it is also consistent with the Bank's announced strategy: 'Price stability shall be defined as a year-on-year increase in the HICP for the euro area of below 2%. Price stability according to this definition is to be maintained over the medium term.' (ECB, Monthly Bulletin, January 1999).

Is inflation in the euro area really declining?

The main argument brought up by those who would want to see the ECB further reduce interest rates – namely the worsening of GDP growth prospects in the euro area – should not be a good enough reason for the ECB to reduce interest rates, unless those gloomy prospects are accompanied by an unambiguous, persistent decline in medium-term inflation forecasts, a possibility that has yet to materialize. To illustrate that point, we have collected inflation forecasts for 2001 and 2002 from different sources and looked at their evolution over time. Figures 8 and 9 display that information.

Not surprisingly, forecasts of average inflation for 2001 have been increased over time as a result of unanticipated, already realized, higher rates. For 2002, some sources have revised their forecast downward but by little (typically 10 basis points), sometime before the May cut. Since then several sources have readjusted upwards again.

Figure 8: 2001 Euro Area Inflation: Changing Forecasts

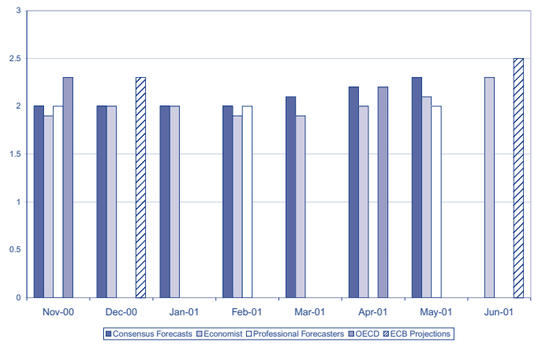
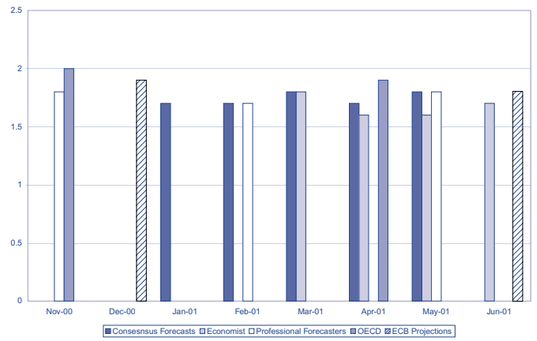


Figure 9: 2002 Euro Area Inflation: Changing Forecasts



In the absence of forthcoming news of a very different sign on the inflation front, it would be extremely hard for the ECB to explain an immediate interest rate cut, let alone reconcile it with its objective or its own past behaviour. So, indeed, its current stance seems reasonable.

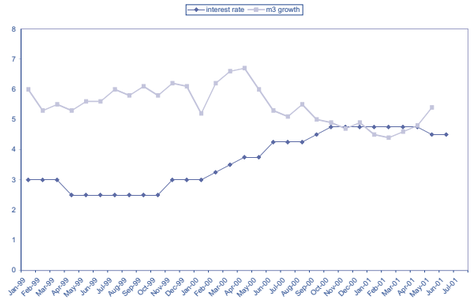
The ever-embarrassing 'first pillar'

Relying on the recent downward trend in M3 growth as the basis for interest rate cuts – as was done to explain the May decision – seems to be fully misguided. While the behaviour of monetary aggregates may in principle provide useful information about inflation prospects in the euro area, it is hard to justify why it should be assigned any special role beyond that of a potentially useful leading indicator of inflation—and, hence, an additional element in the ECB's current second pillar.

Fortunately, and in spite of the ECB's rhetoric, the Bank's interest rate decisions, until recently, seem in a way to have been made independent of developments in M3 growth, as Figure 10 illustrates.

Moreover, in the past few months, statistical problems have influenced euro area money figures: this does not help the transparency of interest rate decisions explained on the basis of such figures. *'There have been non-negligible upward distortions to the annual growth of M3 as a result of non-euro area residents' holdings of other marketable paper included in M3, for which precise statistical information is currently being developed. [...] Taking into account these upward distortions [...] it can now be concluded that there is no longer a risk to price stability over the medium term emanating from the first pillar.'* (W F Duisenberg, in the Introductory Statement to the 10 May 2001 Press Conference, which announced the interest rate cut).

Figure 10: Interest Rate and M3 Growth



Unfortunately, the figures turned out differently. In the July Monthly Bulletin the ECB reported that the annual growth rate of M3 (in the new definition, adjusted for holdings of money market fund/shares units by non-euro area residents) increased to 5.4% in May 2001, from 4.8% in April; the three-month average to 4.9% from 4.6%.

Against that background, the use of first-pillar developments to justify interest rate decisions is worrying, in particular because it suggests that the transition to an explicit, transparent, inflation targeting regime may take somewhat longer than most economists had hoped for.

Summing up

The ECB is doing the right thing – but it should do it for the right reasons. Why hide behind the first pillar? The Bank should stop leaving markets and policy analysts to guess what it is really attempting to accomplish – as by doing this it runs the risk of a breakdown in communications.

SHOULD LARGE CURRENT ACCOUNT IMBALANCES WITHIN THE EURO AREA BE A SOURCE OF CONCERN?

In the process leading to EMU, convergence was the name of the game. But while convergence remains important in the area of public finance – at least to the extent that countries' fiscal policies are constrained by the Stability and Growth Pact – many of the interesting macroeconomic issues within EMU today originate from the build-up of macroeconomic divergencies among member countries. In our main report we discussed the case of Ireland, where the combination of high productivity growth and some overheating of the economy pushed inflation significantly above the euro area average. Here we discuss the Portuguese external imbalance – a fact not limited to Portugal: Greece, the new member of the monetary union, is about to experience a very similar problem.

Since it was admitted into EMU in early 1998, Portugal has run a current account deficit that is large by any standard, and is particularly large for a country whose current account was essentially balanced in the mid-1990s. In 2000, Portugal's current account deficit exceeded 10% of GDP.

The IMF explains Portugal's current account imbalance as follows: *'More than half of the deterioration from broad balance in the mid-1990s was due to a decline in national saving. While investment increased strongly, this was partly for housing, with limited effects on future export capacity. The widening current account deficit was not related to a deterioration in traditional measures of competitiveness. [...] The current account deficit is financed predominantly by rising net foreign liabilities of the banking system; net flows of FDI turned negative [...] as the ongoing internationalization of Portuguese firms led to sizeable investment outflows.'* (IMF, Staff Report for the 2000 Article IV Consultations with Portugal, September 2000).

It is useful to consider these imbalances from a longer-term perspective. Table 1 shows how savings, investment and the current account have evolved since the Portuguese revolution, also distinguishing between the years preceding and following Portugal's entry into the EU in 1985. The comparison between the second part of the 1980s and the years since Portugal joined EMU helps us to understand what lies behind the current account deficit of the late 1990s.

Both entry into the EU and, later, into the monetary union have been accompanied by a jump in the growth rate of investment.

Table 1:

Portugal: Savings, Investment and the Current Account (per cent of GDP)

	1974-85	1986-90	1991-95	1998-2000
Current account	-6.60	-0.60	-3.10	-8.90
Gross private savings	22.90	28.00	23.10	16.10
Gross national savings	20.30	27.10	21.60	18.60
Investment (rate of change)	-1.30	11.00	2.00	7.00
Pro-memoria GDP (rate of change)	2.20	5.50	1.80	3.40

Source: European Commission, *Spring 2001 Economic Forecasts.*

The first time, however, this was entirely financed by an increase in domestic savings; since 1998, the contrary has been the case – private savings have fallen and investment has mostly been financed through foreign borrowing.

Entry into the EU in the mid-1980s was accompanied by rapid liberalization of the product market. This increased the productivity of capital: both savings and investment increased. But EU membership, at least at the beginning, had limited effects on financial markets: up to the mid 1990s Portugal remained, on the financial side, a relatively closed economy, with relatively high real interest rates and, notwithstanding the investment boom of the late 1980s, with still relatively low capital.

The late 1990s differ from the previous period in two respects. First, the single currency and the single market – which was officially completed in 1992, but took many years to work its effects through the European economy – eliminated many barriers to capital flows. As the premium on domestic real interest rate vanished, investment boomed. Second, financial liberalization weakened the credit constraints faced by Portuguese firms and households: this lowered the private saving rate. The fall in domestic saving, however, did not prevent the new round of capital accumulation, since this could now be financed through foreign borrowing.

The effects of EMU and the single market on investment rates and current account balances are not specific to Portugal. Figure 11 documents the change in the ratio of investment to GDP across the EU in the second part of the 1990s and shows how this change is related to a country's level of income (measured at Purchasing Power Prices). Investment grows faster in lower-income countries: the four countries where the increase in the investment-to-GDP ratio is larger are Ireland, Portugal, Greece and Spain.

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Figure 11: PPP GDP and the change in the Investment-GDP ratio: EU, 1995-2000

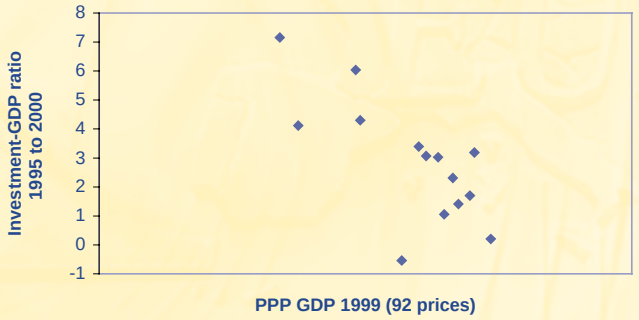


Figure 12: PPP GDP and Current account deficits, EU 1995.

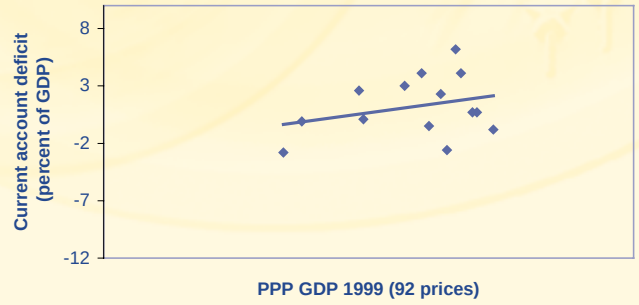
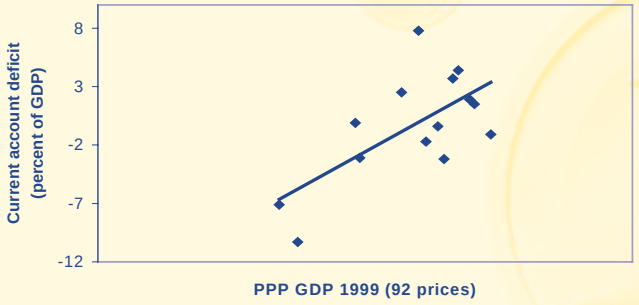


Figure 13: PPP GDP and Current account deficits, EU 2000.



Figures 12 and 13 document the effects of financial liberalization and capital market integration on the current account. Both figures show a country's current account balance as a function of its level of income. Figure 12 uses data for 1995; Figure 13 for 2000. The difference is remarkable. In 1995, before EMU, there was almost no correlation between a country's current account and its level of income. Five years later, the relationship has become relatively strong: lower income countries – those countries where investment rates have increased the most – have the largest current account deficit. As in Figure 11, the current account deficit in 2000 is larger in Portugal, Greece and Spain. Ireland is different, since it has been able to finance its higher rate of investment (Ireland was the country, in Figure 11, showing the second largest increase in the investment-GDP ratio) almost entirely with domestic savings, also thanks to a government budget surplus in excess of 4% of GDP.

Should these current account deficits be a source of concern?

Our analysis suggests that they should not. These deficits mostly finance the increase in investment rates induced by a country's integration into the EU: outside financing is possible because the single currency and the single market have increased the degree of financial integration in Europe. Since external borrowing is mostly directed at financing investment, higher output in the future will pay for the interest on the foreign debt. Again no reason to worry. Moreover, the channel that could turn an investment boom financed abroad into a balance of payments crisis – that is, the currency mismatch between foreign borrowing and domestic lending – is much weaker within EMU, at least to the extent that foreign borrowing takes place in the euro area.

Summing up

For a country that is integrating into the euro area, and starts with a below average level of income, a current account deficit is typically the manifestation of the build-up of domestic capital. Stopping it would amount to closing down an important source of finance.

Centre for Economic Policy Research
90-98 GOSWELL ROAD • LONDON EC1V 7RR • TEL: (44 20) 7878 2900 • FAX: (44 20) 7878 2999 • EMAIL: CEPR@CEPR.ORG
WWW.CEPR.ORG