

One size fits none

As the German economy stalls, should the ECB shift its policy focus from the eurozone as a whole? By Henrik Enderlein.

When Angela Merkel, the frontrunner to become Germany's next chancellor in September, is asked these days whether she considers the ECB's current policy to be appropriate, she carefully avoids any clear answer. This is not surprising. You can't win a German election by criticising the central bank, but you can well lose one. Indeed, there is still some kind of Pavlovian conditioning in German society that immediately triggers scepticism about those who express doubts vis-a-vis the monetary authority.



Henrik Enderlein

Doubts over the ECB In this context, it has been an easy task for the ECB to dismiss occasional criticisms from German politicians, media and the public. Positioning itself as the legitimate heir to the Bundesbank, the ECB gained from the nimbus of what was Germany's most respected institution. While the euro is not really popular in Germany (according to a recent poll 56% of Germans would welcome the D-Mark back), its monetary authority has benefited from the impressive reputational capital of its predecessor.

That might change. Off the record, ministry officials and policy advisers increasingly focus on the ECB's share of responsibility for Germany's decline from the world's model economy to the sick man of Europe. In early June, a leaked background note from the German Ministry of Finance, explicitly referred to the price that Germany has been paying for the high level of real interest rates in economic and monetary union (EMU). A few months earlier, Wolfgang Clement, Germany's economic minister, openly asked the ECB to lower rates.

The ECB rightly ignored such calls. Giving in to shortsighted political criticism is certainly the worst way to enhance EMU's credibility. On the other hand, it might be about time to look more closely at the German case

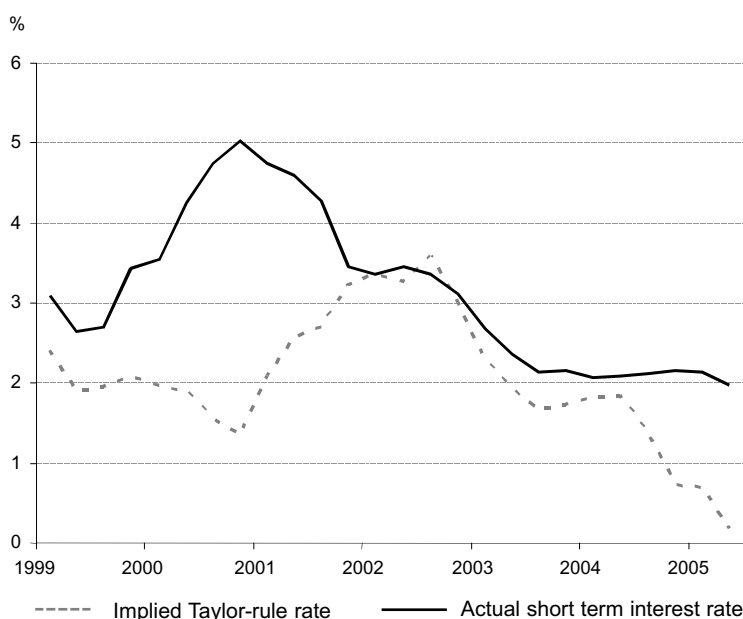
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and to ask whether policy conclusions should be drawn. The difficult question to be answered is whether one of the ECB's main mantras – the doctrine of “one size fits all” – is still the right one. Although of a delicate nature for the ECB, the issue might deserve more than being answered by the same policy positions and their rationales again and again.

Germany is the biggest economy in EMU (it accounts for roughly 30% of euro-area GDP) and, as is now becoming obvious, has suffered most from the current EMU set-up. There are clear indications that monetary conditions have been much more restrictive than appropriate for the German economy since the EMU began. Standard Taylor rules indicate that since 1999 interest rates should have been on average roughly one and a half percentage points lower (see figure 1)¹. A peak was reached in winter 2000-2001, when the ECB rate was more than 350 basis points higher than the rate the Taylor rule considered healthy for Germany. One year later Germany's growth rates had turned negative.

The wrong rates for Germany

Figure 1: Monetary conditions in Germany

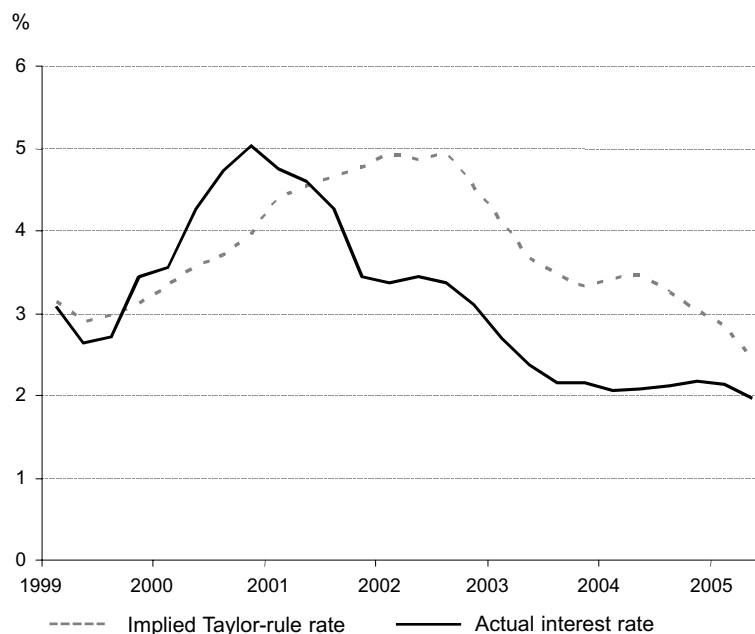


The message of this graph becomes more persuasive when compared to the euro area as a whole. Indeed, as figure 2 shows, the ECB's monetary policy has been on average 60 basis points less restrictive than the Taylor rule would have suggested. Even if one should certainly not put too much emphasis on Taylor rules, which react quite sensitively to the underlying

1 The calculations are based on the standard formula: $i_t = r^* + \pi_t + 0.5[y_t + (\pi_t - \pi^*)]$ with i_t as the nominal interest rate, r^* as the targeted equilibrium real interest rate (a constant, here assumed to be 2%), π_t as the average rate of inflation (here operationalised in accordance with Taylor as the GDP deflator), y_t as the current output gap, and π^* as the central bank's inflation objective (a constant, here assumed to be 2%). Data is from the OECD's *Economic Outlook*.

assumptions, the overall message of this simple analysis is clear and confirmed in several studies: Germany has been suffering from a euro-area monetary policy that was clearly not appropriate for its domestic economy.

Figure 2: Monetary conditions in the euro area



While it would be foolish to attribute the lack of German growth just to high real interest rates, the opposite would also be false. Germany is suffering from both supply- and demand-side problems. Thus far, most discussions in Germany and the rest of Europe have focused exclusively on the former. Chancellor Schröder’s reform package is a first attempt to get the supply side back on track. However, as the political difficulties in adopting and implementing these reforms clearly illustrate, implementing structural reforms with lacklustre growth (or even a recession) is a politically impossible task.

Moreover, it is doubtful that structural improvements in the German economy can generate growth if demand stays as depressed as it is. Both consumer spending and investment rates are at their lowest for decades. Textbook models would certainly suggest accompanying measures by monetary policy to get out of that vicious circle.

Europe’s inflexibility

Put into a wider perspective, the inappropriateness of the ECB’s monetary policy for Germany gives rise to an important conclusion from the first six years of EMU, which probably comes as a surprise to most economists: there seems to be a primacy of the pro-cyclical real interest rate effect over the counter-cyclical real exchange rate effect. The single nominal interest rate as set by the ECB translates into country-specific real interest rates. Germany has faced higher real rates than the rest of EMU for much of the past six years. Member states with higher inflation (eg, Spain) have benefited from lower or even negative real interest rates. It is often claimed

that domestic prices across EMU (and thus also real interest rates) are bound to converge, given the mobility of goods and services. It is argued that self-reinforcing cyclical phenomena will be stopped by a decline (or boom) in exports, caused by the real appreciation (depreciation) of the exchange rate.

Proponents of that approach, however, put too much emphasis on price flexibility and factor mobility. A significant share of domestic output derives from spatially fixed factors, such as real estate and heavy machinery, which are not affected by direct price competition. Regional and cyclical divergences in EMU do not seem to be self-correcting, or self-correction appears to take too long. The Netherlands has probably just become the first victim of the real exchange rate effect. The Dutch experienced the highest inflation rates of the euro area in the first years of EMU and are now paying the price. Germany, however, which entered EMU with an overvalued exchange rate, may still have to wait some years before low inflation has passed through sufficiently to start generating growth on the basis of increased competitiveness.

The relationship between the real interest rate effect and the real exchange rate effect has crucial implications for the future of EMU. If, as was the case in the first six years of EMU, the primacy of the former over the latter is a structural feature, we will see a trend towards divergence instead of convergence in the euro area. Ultimately, there could be a risk that EMU splits into two equally sized groups of countries, one with high growth and high inflation rates, the other with low growth and low inflation rates, with the ECB targetting a zero growth and zero inflation average in the middle. This scenario may become more likely as new EU members join EMU.

Diverging, not converging

In such a context, the ECB's monetary policy would be inappropriate for all EMU members. As such, this would not generate insurmountable problems. As Wim Duisenberg, the ECB's first president, noted as early as September 1999: "A single currency does not call for uniform wage developments or uniform economic or social policies in general. On the contrary – where national or regional economic developments are different, this should be reflected in different policy responses and wage developments." In other words: fiscal policy and wage-setting should be in charge of stabilising the domestic business cycle.

When Duisenberg made that remark, he was probably thinking about high-growth and high-inflation countries that would face low or negative real interest rates. Such countries can quite easily stabilise their domestic economies by way of fiscal retrenchment and wage restraint. As Germany shows, however, it is much more difficult to correct a bust cycle.

Trapped in a downturn

In a bust context, fiscal policy's room for manoeuvre is limited in a twofold manner. First, at the domestic level, as soon as there is too much deficit spending, economic agents will start anticipating future tax rises and reduce consumption and investment. Second, at the European level, there is the well-known collective action problem related to fiscal free-riding and its famous response: the stability and growth pact. Were the European economy politically integrated, the problems of the pact would be solved with fiscal federalism. The solution would be a radical shift to a full-fledged system of fiscal federalism. The EU budget or some redistributive mechanism would ensure that surplus-money from the

fastest growing member states was used to compensate low-inflation and low-growth countries. This might have some appeal, but it looks unrealistic at present: could you imagine Ireland wiring money to Germany?

Wage-setting cannot provide an effective response either. Although wage-restraint can ultimately restore growth through gains in competitiveness, in the short run it depresses domestic demand (mainly consumption) even further. Real wage increases, as sometimes asked for by German trade unions, are not a good response either: they would even further reduce firm's profits and depress domestic investment.

Putting all this together, three main conclusions can be drawn that relate directly to the role of the ECB. First, inflation and output-gap differentials in EMU tend to increase rather than decrease. This effect is a direct consequence of the primacy of the real interest rate effect over the real exchange rate effect. Second, the ECB could face a "n=0" problem: its monetary policy might be appropriate for the euro area as a whole, but not for any individual member country. Third, all countries face adverse effects from the ECB's monetary policy, but countries exposed to high real interest rates and a bust cycle are virtually unable to use domestic instruments in business cycle stabilisation.

From these conclusions, an open debate on the "one-size-fits-all" approach appears warranted. Or, to put it more bluntly: it is time to ask whether it wouldn't make more sense for the ECB to target the largest homogeneous sub-area of EMU (most probably, but not necessarily Germany).

Target Germany In fact, the system would come very close to the European Monetary System – but precluding realignments in exchange rates. The central bank of the biggest economy would set interest for the currency area as a whole. Domestic instruments in other countries would have to be used to contain inflationary pressures. This, however, relates to an important collective action problem. If the ECB were to target a single region or country, it would lose its power to contain threats to price stability in the euro area as a whole. There could be incentives for high-growth countries to run high inflation rates. That risk, however, should be balanced against the risk of a wrong ECB policy for all countries – even the biggest ones.

It is crucial for the euro area that its largest economies generate sufficiently high rates of growth. Germany in particular has to grow much faster to bring the whole of Europe back on track. An exclusive ECB focus on the biggest and most important economic areas would ensure a much better cyclical stabilisation in these areas that would then spread out across Europe. What we have observed over the past six years is the contrary: lacklustre growth in Germany spilling over to the rest of the euro area.

From a legal perspective, nothing prevents the ECB's governing council from dropping the "one-size-fits-all" approach. The relevant legal texts (the Treaty on European Community and the Statute of the European System of Central Banks) carefully avoid any reference in that direction. The ECB communicated its decision to follow its current stance in a press statement in October 1998: "The ECB governing council makes it clear that it will base its decisions on monetary, economic and financial developments in the euro area as a whole. The single monetary policy will adopt a euro area-wide perspective; it will not react to specific regional or national developments." It might not be such a bad idea to reconsider that statement. □