Briefing

July 2015

The ECB and the financial crisis

Rigid theory vs a pragmatic approach

SUMMARY

The European Central Bank's (ECB) main objective is stable inflation in the Economic and Monetary Union (EMU). During the financial crisis, the ECB decided to face the economic slump by, amongst other actions, increasing and then decreasing interest rates and the money supply. In addition, it launched a quantitative easing (QE) programme which aims to stabilise some Member State economies. The ECB's monetary decisions evoked mixed reactions in the euro area and triggered a debate on the relevance of price stability, austerity and deficit spending.

The ECB's monetary policy is broadly in line with Monetarist economic theory, according to which, changes in money supply are the main determining factor for business fluctuation – in both a positive and a negative sense. During the crisis, however, the very different Keynesian economic model – notably increasing public spending and fiscal policy measures to stimulate the economy – experienced a revival.

Beyond the debate on the right theories and their practical application in combating economic downturn, the ECB demonstrated more pragmatism than before the crisis by, for example, adjusting and expanding its toolkit. The ECB, along with some experts, argue that only the combination of monetary and fiscal measures can end deflation and recession in the EMU.

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Glossary

Bonds: Debt securities issued by private companies or governments to raise money.

Deflation: A sustained fall in the prices of goods and services.

Inflation: A general increase of prices for goods and services. The inflation rate is generally indexed in a year-to-year comparison, e.g. the Harmonised Index of Consumer Prices (HICP) used by the ECB. A low inflation rate is synonymous with price stability.

M3: Describes the broad monetary aggregate of the ECB (and other central banks). It is a key indicator in estimating the monetary base in an economy and an important instrument to control inflation.

Main refinance operations (MRO): An important monetary instrument used by the ECB for regular open market operations and to steer short-term interest rates. MROs provide liquidity to banks and usually have a maturity of one week.

Nominal/real scale types: A nominal value refers to an unadjusted rate, value, or change in value. In contrast, a real value is adjusted for at least one factor (e.g. inflation).

Primary/secondary market: In primary markets, the public and private sector issue new securities (stocks, bonds) and sell them directly to investors to raise money. Any trading after the initial sale, takes place on the secondary market.

Quantitative easing (QE): A strategy used by some central banks to increase the supply of money by, e.g. purchasing bonds. In the euro area, the ECB has translated this strategy into the Expanded Asset Purchase Programme.

Velocity of money: The rate at which money is used and transferred from one holder to the other. The higher the transfer, or circulation rate, of money, the higher the GDP.

Background

During the financial crisis, the European Central Bank (ECB) decided to counter the economic slump by, amongst other actions, increasing and decreasing the interest rates and the money supply in the euro area. In addition, it launched the Expanded Asset Purchase Programme, to provide liquidity to the markets in a recessionary environment, and to stabilise some Member State economies.

However, many politicians and experts disapprove of the ECB's monetary policy. They accuse the ECB of neglecting its mandate to be independent and non-partisan within the Economic and Monetary Union (EMU) in order to protect its main target, which is mid-term price stability – or, in other words, stable inflation.

The ECB's monetary policy is broadly in line with a Monetarist economic philosophy. Monetarism itself, however, is criticised for strongly advocating free market liberalism and promoting social inequalities, since it adopts a critical stance towards demand-oriented fiscal policy measures, such as economic stimulus packages or minimum wages. The dispute surrounding Monetarism and the ECB triggered a debate on the 'right' economic theory and its practical application to combat recession.

Monetarism: origin and concept

Monetarism is an economic theory mainly shaped by Nobel Prize Laureate Milton Friedman (1912-2006). According to Monetarism, there is a causal relationship between money supply and economic growth. In a case study co-authored with Anna Schwartz (1963), Friedman argues that the Great Depression which began in 1929 was caused by the Federal Reserve and the contractionary policy it followed to combat inflation. While supporters of Keynesian economic theory argue that a lack of private and public investment had led to the 1929 Depression, Monetarists disagree and consider monetary policy responsible.

Friedman's theory bases and supports the quantity theory of money, which postulates the long-term causality between money supply, price stability and national income by taking into account the so-called velocity of money. Monetarism accentuates the relevance of a steady increase in money supply for sustainable economic growth, as well as the importance of price stability – a key element for confidence and investment. In Friedman's famous words, inflation is 'always and everywhere a monetary phenomenon in the sense that it is and can be produced only by a more rapid increase in the quantity of money than in output.'[1] Central banks can control price levels through increasing or reducing the supply of money. In the case of an economic downturn which does not react to adjustment of the interest rate, Monetarism suggests that the central bank must abandon its tight monetary policy and expand the supply of money. In doing so, the national bank avoids a credit squeeze and provides sufficient liquidity to the markets and consumers.

Keynesianism

An economic theory postulated by the British economist John Maynard Keynes (1883-1946). Keynes developed his theory during the 1930s in an effort to explain the Great Depression (1929). Keynesianism became the main economic dogma for many countries up to the 1980s. In contrast to classical economic theory, Keynesianism emphasises the demand side of economics and its relevance for production, consumption and employment. It counters the central argument of classical economic theory, i.e., that market forces correct undesirable economic developments themselves and that no government intervention is needed. Keynesianism considers the state a necessary and important stakeholder in a nation's economy. Countercyclical state interventions through deficit spending, like economic stimulus packages or the increase of wages in order to strengthen purchasing power, are important elements in fighting recession and to achieve equilibrium in the markets.

Implications for economic policy

Countries have, in general, at least four means[2] to face economic challenges: two of them – cutting/increasing public expenditure and cutting/raising tax – are of a fiscal nature. The other two – increasing/decreasing interest rates and direct expansion/contraction of money supply, e.g. through the issue/redemption of bonds and securities – are monetary instruments. Experts are still debating which of these economic policy decisions (used as single policy, in combination, etc.) might be the most effective.[3]

While Monetarism, as its name suggests, considers monetary policy the most effective weapon against an economic slump, Keynesianism argues that poor economic performance is the result of fiscal austerity and cuts in public expenditure. Keynes once said that 'the boom, not the slump, is the right time for austerity at the Treasury'.[4] This statement may have a certain logic, but Keynes was famously unconcerned by public debt ('in the long run, we are all dead').[5] This attitude led to criticism by Monetarists and other supply-oriented economists advocating neo-classical economic theory, who consider Keynesianism as primarily short-term oriented – the temporary benefits provided come at the price of disastrous long-term increase in debt – which can be harmful to the prospects of future generations.

Monetarists therefore reject fiscal measures by the public sector or a state driven 'artificial' increase of nominal and/or minimum wages aiming to strengthen the purchasing power of consumers. They argue that these measures are, above all, politically or socially motivated and that they can increase national debt, fan inflationary tendencies and lead to a successive crowding-out of the private sector through public sector entities. As a result, unemployment rates rise, as the increase of interest rates to combat inflation has a negative impact on borrowings and private investments.[6] A low inflation rate, balanced public budget policy, the (political) independence of central banks and structural reforms are therefore important elements of Monetarist economic policy. However, some market-liberal remarks by Friedman (and his followers) on minimum wages, trade unions, inequalities, or companies (e.g. 'the social responsibility of business is to increase its profits'),[7] led to criticism of Monetarism.

The rise of Monetarism began in the 1970s. Just as Keynesianism was an attempt to respond to the Great Depression, Monetarism can be considered an attempt to reply to the 'stagflation' of the 1970s, when major economies like the United States and Germany were hit by supply shocks (e.g. crude oil price increases). For some experts, there is usually a trade-off between full employment and low inflation, but in the 1970s, in many industrial countries, a high unemployment rate *and* a high inflation rate occurred simultaneously. Keynesian economic theory was not able to explain this phenomenon, baptised 'stagflation' (economic stagnation plus inflation). As a result, many central banks changed their policies towards Monetarism and money supply control. In 1975, the Deutsche Bundesbank was the first central bank to adopt monetarist ideas in its policy-making. The Federal Reserve adopted monetarist policies several years later. Between 1980 and 1987, the Federal Reserve was successful in reducing the rate of inflation from 13% to 4%, but its extreme and short-term oriented contractionary policy also contributed to a severe recession at the beginning of the 1980s, where interest rates reached 20% and unemployment increased to 11%.[8]

The ECB and Monetarism

The independent status of the ECB towards national governments, but also its monetary transmission mechanism and price stability goal are in line with Monetarist principles.

While other central banks, e.g. the Federal Reserve, have a threefold mandate to achieve high employment, price stability and maintain moderate long-term interest rates, the ECB follows only one overarching macroeconomic goal. According to Article 127.1 and Article 282.2 of the Lisbon Treaty on the Functioning of the European Union (TFEU), the primary objective of the European System of Central Banks (ESCB) is price stability. In this context, the ECB has clarified that it aims to maintain the inflation rate below, but close to 2% over the medium term. In these calculations, short-term fluctuations which could affect inflation or growth (e.g. supply shocks, political instabilities, war, etc.) are not included. To control its numerical inflation objective, the ECB employs the Harmonised Index of Consumer Prices (HICP) in a year-on-year comparison.

Ideally, the average rate of increase of the broad monetary aggregate M3 of 4.5% per annum (by taking into account the velocity of money circulation), would deliver around 2% inflation and real GDP growth of at least 2% per annum.

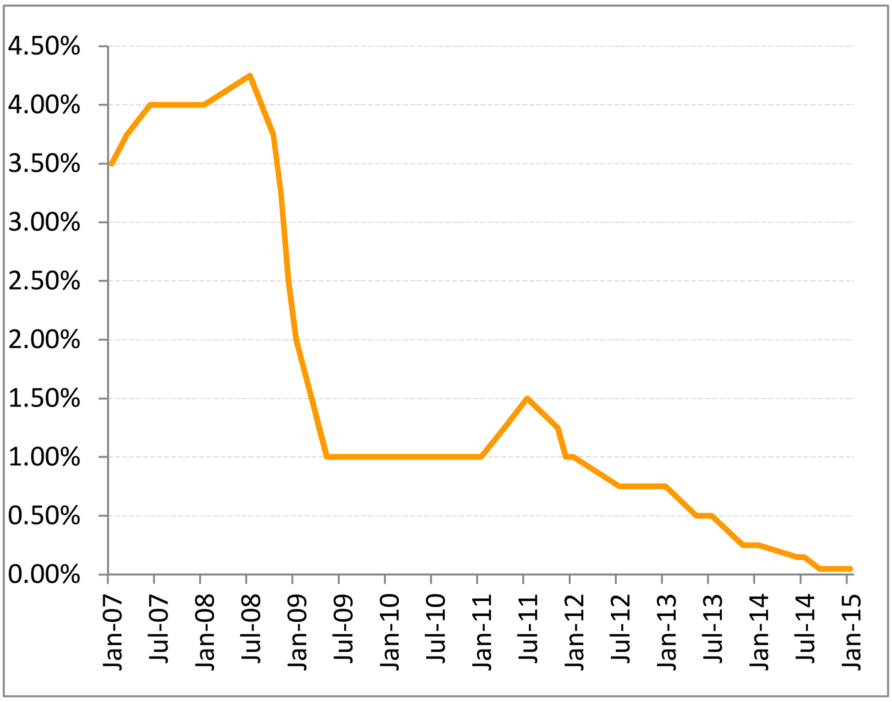
Another important element of the ECB's monetary policy is pursuing a high level of accountability and transparency by explaining its decisions to the public. According to the ECB, a foreseeable and anticipative monetary policy could avoid speculation and stabilise public and private sector expectations. In addition, it could reduce fluctuations in the financial markets.

The ECB and the financial crisis

According to Article 123.1 (TFEU), the European Central Bank is not allowed to purchase sovereign bonds or public debt instruments on the primary market of EMU countries. At the same time the ECB shall, according to Article 127.2 (TFEU), contribute to the stability of the financial system. Confronted with the international financial crisis, the ECB was criticised by some experts who deemed it to have neglected, in order to maintain price stability, its principles of independence and non-partisanship, by co-financing the public debts of certain Member States in the euro area. Other experts maintain that the ECB might have exacerbated the crisis by reacting 'too little, too late'. A third opinion suggests that the ECB demonstrated an innovative use of its mandate and instruments, for example, through the use of non-standard policy measures, to successfully contain the economic and financial crisis in the euro area.

During the crisis, the ECB reacted in a diversified way. Regarding its policy on interest rates in 2008 and 2011, the ECB countered inflationary tendencies by raising its key interest rate for main refinancing operations (MRO), only to lower them shortly after. In 2014, the interest rate on the MRO reached a historic low of 0.05%.

Figure 1 - ECB's main interest rate in per cent per annum (2007-15)



Source: ECB

In addition, regular operations have been complemented by non-standard monetary policy measures such as longer-term refinancing operations (LTRO). LTROs are considered a promising tool in countering the crisis, allowing banks to borrow money for three years at a 1% interest rate. Before the crisis in 2008, the longest LTRO maturity was three months.

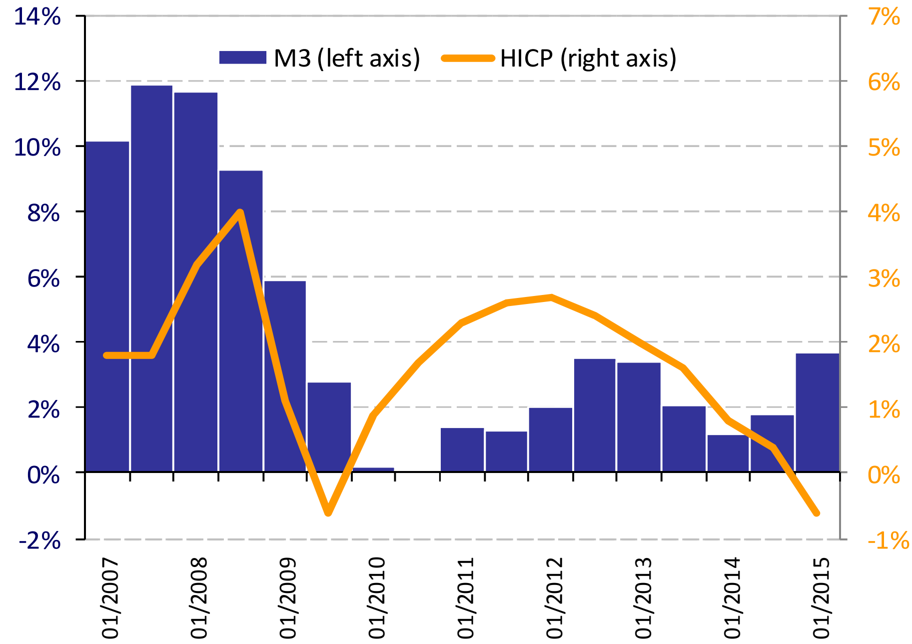
In line with its transparency guidelines, the ECB furthermore announced, in May 2010, the Securities Markets Programme (SMP), to increase the money supply (volume: around €210 billion), by purchasing government bonds of several EMU Member States from secondary markets. The purchase of government bonds was (and remains) disputed within the ECB Governing Council and among Member States, but has undoubtedly shortened the maturity of the respective government debts and their costs of debt liquidation. In September 2012, the Governing Council decided to replace the SMP by another non-standard policy means: Outright Monetary Transactions (OMT).

From the ECB's perspective, OMTs were a 'necessary, proportional and effective monetary policy instrument' to ensure an effective transmission of monetary policy[9] and to maintain price stability.

After the Court of Justice of the European Union (CJEU) approved the legality, in principle, of the OMT programme (January 2015), the European Central Bank announced a large-scale asset purchase. In June 2015, the preliminary rule of the CJEU became final.

By providing fresh money to the markets, the ECB hopes that this will not only boost GDP growth, but stabilise the economies of some Member States in the EMU. Its quantitative easing programme, the Public Sector Purchase Programme (PSPP), began in March 2015 and will last until September 2016. The PSPP amounts to €60 billion per month, and will include bonds and securities issued by European institutions and national agencies.

Figure 2 - Development of M3 and inflation rate HICP in the euro area (2007-15), annual growth rate in per cent



Source: ECB.

As a result of the standard and other non-standard monetary policy measures, the ECB balance sheet almost tripled in size between 2007 and 2012; afterwards it declined, as the LTROs were repaid earlier than expected.

The above-mentioned decrease in the main interest rate and the extension of money supply had, as a consequence, a depreciation of the euro; but had no significant impact on the inflation rate. In this context, not only the supply of money, but its use (for consumption, investments, etc.) has to be taken into account.

In contrast to market-liberal Monetarist ideas on state intervention and solid public finance, European Central Bank Vice-President, Vítor Constâncio recently admitted the relevance of fiscal policy in combatting the economic downturn: 'The truth is that without the significant use of fiscal policy in 2008 and 2009 stimulating our economies and supporting the banking sector, the meltdown of the financial system could not have been avoided'. He added that there is a 'misguided argument that the euro area problem is almost exclusively a supply side question', and emphasised the relevance of accompanying demand-oriented economic policy measures. In addressing the crisis, the ECB has gradually adopted a less ideological and more pragmatic stance towards fiscal measures.

Outlook

The international financial and economic crisis has raised many questions about economic theories and their relevance for monetary and fiscal policy. Monetarism and Keynesianism propose different approaches to counter economic slump; however even their main arguments could be questioned.

Friedman's hypothesis that 'inflation is always and everywhere a monetary phenomenon', for instance, is apparently inappropriate to the euro area, although some differentiation is necessary, since not only the *supply* of money, but also its *use* (in consumption, investments, etc.) has to be taken into account. On the other hand, a central bank policy guided by Monetarism is considered insufficient to combat recession; many scholars and politicians, but also central banks, insist on fiscal policy measures. Several governments in the euro area, e.g. Spain, France, Austria, Germany, but also the USA and China, followed a complementary discretionary deficit spending policy and adopted economic stimulus packages to combat the crisis.[10] Notwithstanding, the problem of increasing public budget deficit will remain as long as governments do not adopt responsible cyclical fiscal policies in times of prosperity (as Keynes proposed), and do not delay necessary (structural) reforms.

Beyond the theoretical debates over Monetarism and fiscal policies as the right way to address the crisis, the European Central Bank has demonstrated a pragmatic and flexible approach in facing the difficult economic and financial situation by, e.g. adjusting and expanding its toolkit. The same holds true for the European Union and its Member States. The crisis led to the creation of both political and economic provisions in the EU – the EU Fiscal Governance or European Fiscal Compact, the European Stability Mechanism (ESM) and the banking union were established.

While both the ECB's regular and non-standard monetary actions helped to calm the sovereign debt markets and to stabilise the economies of affected Member States, the euro area's growth prospects remain weak. The role of the ECB can be questioned; arguably it switched too late from a contracting to an expansive monetary policy, and may have exacerbated the crisis to some extent. According to ECB President, Mario Draghi, the problem for the euro area in 2015 is not price stability, but rather very low inflation. One major problem, both for monetarists and fiscal policy supporters, remains: despite low interest rates, affordable credit and economic stimulus packages; neither consumers nor investors can be forced to increase their spending. Some experts warn that the EMU faces a dangerous deflationary scenario, which could lead to a 'Japanification' of the euro area. Japan has suffered a serious 'deflationary spiral' since the 1990s. In the vicious circle of deflation, consumers and investors wait for a further decline in prices, while their behaviour simultaneously provokes bankruptcies, unemployment and falling nominal wages. These effects reinforce each other and in turn have a negative impact on consumption and investment.

Much data exists on the situation in Japan and in the euro area; however there is little empirical evidence on a solution to the problem. Neither Monetarist nor Keynesian applied economics were able to provide sustainable solutions to the financial and economic crisis in the EMU. The ECB, however, had to react, since an important dimension of policy decision-making is the political and welfare cost of inaction. Whether the ECB reacted too late and too little, or took the right decisions, is still a matter for discussion.

Main references

Keynesian Government Spending Multipliers and Spillovers in the Euro Area, T. Cwik, V. Wieland, ECB Working Paper Series No 1267, November 2010.

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Endnotes

[1] Milton Friedman, Dollars and deficits: inflation, monetary policy and the balance of payments, Prentice Hall International, Englewood Cliffs/NJ, 1968.

[2] For the sake of completeness, there is a fifth, namely the state-driven printing of money through politically dependent central banks, which is, however, not achievable in the euro area.

[3] For an overview of the discussion about the 'right' economic policy, see N. Gregory Mankiw, Macroeconomics, Worth Publishers, New York, 2012.

[4] John Maynard Keynes, How to avoid a slump?, The Times, 12-14 January 1937.

[5] John Maynard Keynes, Tract on Monetary Reform, Macmillan and Co., London, 1924.

[6] For a critical reflection on these causal effects, see N. Gregory Mankiw, Macroeconomics, Worth Publishers, New York, 2012, and in particular chapter 3 on National Income and GDP.

[7] Milton Friedman, 'The Social Responsibility of Business Is to Increase Its Profits', New York Times Magazine, 13 September 1970.

[8] Cf. The Collapse of Monetarism and the Irrelevance of the New Monetary Consensus.

[9] The monetary transmission mechanism describes the impact of changes in monetary policy on market interest rates, asset prices, exchange rates, credit conditions, inflation, and also on the expectations of market participants. For further explication see the EPRS In-Depth Analysis Monetary policy of the European Central Bank.

[10] Concerning the impact of the stimulus packages cf. Keynesian Government Spending Multipliers and Spillovers in the Euro Area.

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