The Fed-ECB Policy Divergence

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A striking divergence

A striking characteristic of the current global monetary environment is the divergence of monetary policy among the two largest economies in the world, the United States and the euro area. The Fed-ECB divergence is most notable in interest rate policy: In December 2015, the Federal Reserve raised policy rates for the first time since the Global Financial Crisis.[1] By contrast, the European Central Bank cut policy rates further into unprecedented negative territory in December 2015 and again in March 2016.[2]

The policy divergence extends beyond interest rate policy. The ECB is currently in the process of implementing an impressive array of unconventional monetary accommodation policies that could significantly expand its balance sheet over the next several quarters. At its March meeting, the Governing Council announced new measures for the provision of liquidity as well as an expansion of its asset purchases from 60 billion euro to 80 billion euro per month until the end of 2017, or beyond. By contrast, the Fed has communicated that it intends to maintain its balance sheet (which has remained roughly unchanged since the end of 2014) at its current elevated size.

Judging by the co-movement of policy across the Atlantic in the first decade of the euro, the current divergence might appear peculiar. Until the end of 2008, the stance of monetary policy in both economies could be summarized by the overnight interest rate (Figure 1). Since policy rates were pushed close to zero by the end of 2008, however, balance sheet policies have become an important additional determinant of the overall stance of monetary policy. At the effective interest rate bound, policy rates no longer suffice to summarize a central bank's policy stance. Additional policy accommodation can be provided by other means, importantly through the provision of excess liquidity and through asset purchases that expand the central bank's balance sheet. The size of the balance sheet of both the Fed and the ECB increased substantially between end-2008 and mid-2012, reflecting crisis management and policy easing measures (Figure 2). By mid-2012, the Fed and ECB balance sheets stood at about 3 trillion dollars and 3 trillion

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[1] Specifically, on December 16, 2015, the FOMC raised the target range for the federal funds rate from 0 to 1/4 percent to 1/4 to 1/2 percent. Information is available on the Fed's website: https://www.federalreserve.gov/monetarypolicy/fomcminutes20151216.htm.

[2] Importantly, the ECB Governing Council lowered the rate on the ECB's deposit facility by 10 basis points to -0.3 percent on December 3, 2015 and lowered it by another 10 basis points to -0.4 percent on March 10, 2016. Additional details can be found at the Introductory Statement and press conference following each meeting, available on the ECB's website as follows:
December meeting: http://www.ecb.europa.eu/press/pressconf/2015/html/is151203.en.html.
March meeting: http://www.ecb.europa.eu/press/pressconf/2016/html/is160310.en.html.

euro, respectively. Much of the Fed's balance sheet expansion reflected purchases of government debt and mortgage-backed securities. The ECB expanded its balance sheet primarily by providing long-term excess liquidity to the banking system and largely avoided purchases of government debt.[3] Despite this difference, between the end of 2008 and mid-2012 both economies benefited from the monetary policy accommodation associated with the balance sheet expansion. However, from mid-2012 on, the two central banks pursued different paths, leading to asynchronized policy ever since.

Policy asynchronization since mid-2012

The first phase of this asynchronization, from mid-2012 to the end of 2014, roughly coincided with aggressive additional policy easing by the Fed that saw its balance sheet rise by 50 percent, from about 3 trillion dollars to the current level of around 4.5 trillion dollars. In contrast, during this period, the ECB pursued a contractionary policy which saw its balance sheet shrink by one third, from about 3 trillion euro to merely 2 trillion euro in late 2014. The contraction of the ECB balance sheet during this period largely reflected the self-liquidating nature of the liquidity programs the ECB had relied on to expand its balance sheet in the earlier period, which the ECB chose not to counteract either with asset purchases or with additional liquidity provision.

The second phase marked the ECB's decision to reverse direction and embark in a form of quantitative easing, including purchases of government debt of (almost all) member states. Interestingly, while ECB communications suggested that the need for additional easing was well recognized at least during 2014, a significant delay was observed in implementing quantitative easing. Government debt purchases under the ECB's Public Sector Purchase Programme (PSPP), only started on March 9, 2015, about three months after the Federal Reserve had stopped its balance sheet expansion.

The policy divergence observed today is largely the result of these earlier policy differences, importantly the ECB's decision to pursue contractionary balance sheet policies after the summer of 2012.

Since the Fed and the ECB have a similar price stability objective, a potential explanation for the difference in policy could be different outlooks for inflation.[4] Figures 3 and 4 present a comparison of the relevant inflation measures for the two

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[3] One notable exception was the limited purchases of government debt of Greece, Italy, Ireland, Portugal and Spain in 2010 and 2011 under the controversial Securities Markets Programme (SMP).

[4] A comparison of the Fed and ECB, including their mandates and policy strategies is presented in Orphanides (2014).

central banks, PCE for the Fed and HICP for the ECB. The Fed has adopted a definition of price stability corresponding to a two-percent inflation rate while the ECB aims for an average of below-but-close to two percent. The inflation objectives of the two central banks are essentially similar. Recent outcomes, however, have diverged notably. Focusing on core inflation measures (Figure 4) shows a significant difference in inflation developments in the two economies over the past three years. But the gap is exactly the opposite of what would have been expected to explain why the ECB was pursuing a contractionary balance sheet policy after mid-2012. The data suggest that both central banks faced disinflationary pressures in the 2012-2014 period. The Fed's expansionary policy over this period managed to contain the decline in inflation to about one and a half percent, and subsequently raise it to about one and three-quarters percent from where it is expected to reach two percent in a few quarters. In contrast, by tightening policy from mid-2012 to the end of 2014, the ECB guided core inflation to levels considerably below two percent—indeed for about two years even below one percent—inconsistent with its definition of price stability. Had the ECB pursued a policy similar to that of the Fed, it would have been far more likely to attain its price stability objective. The ECB's decision to timidly expand its balance sheet during 2015 arrested the decline in core inflation but has been insufficient to robustly secure its rise. The size of the ECB balance sheet remains below the peak it had reached in mid-2012. Core inflation remains below one percent. The recent decisions to ease policy further reflect the ECB's earlier timidity and tightening mistake.

Consequences of overly tight ECB policy

Monetary policy mistakes have real consequences. Figures 5 and 6 compare the paths of GDP and unemployment in the US and the euro area, summarizing the consequences of the differences in policy in the two economies. Compared to the US recovery, the euro area continues to be caught in the malaise of high unemployment and a depressed level of production. While US real GDP has recovered from the recession and is already over 10 percent higher than its 2007 peak, euro area GDP at the end of 2015 was about at the same level as its pre-crisis peak eight years earlier. Similarly, while the US unemployment rate has returned to the 5 percent level that was considered normal before the crisis, the euro area unemployment rate continues to be in double digits, and more than one percentage point above what was seen as normal before the crisis, roughly around 9 percent or lower. Indeed, since mid-2012, euro area unemployment has been higher than at any time since the introduction of the euro in 1999.

To be sure, these differences reflect the consequences of all economic policies, including not only the ECB's monetary policy but also the inept responses of other European institutions and euro area governments to the euro crisis. Whatever the policies pursued by governments, however, according to the European Union Treaty the ECB has the authority and the responsibility to achieve its sole primary mandate of price stability, independent of actions (or inaction) of other European institutions and governments.

Long before the crisis, the ECB had clarified that its price stability objective is defined as an annual rate of inflation close to 2 percent. Why has the ECB been so reluctant to implement the expansionary policy necessary to achieve inflation close to 2 percent over the past several years?

A troubling answer is that the euro area has not been functioning as a single economy since the euro crisis started. This has undoubtedly complicated the central bank's function and put it under immense political scrutiny. At times, the ECB has been called to take decisions at the limit of its legal authority and political legitimacy. The euro crisis has effectively led to the disintegration of the common market in important areas and created an existential threat for the common currency area. In this environment, maintaining a steady policy course, independent of politics, would be challenging for any institution.

The euro malfunction

Whereas the ECB is responsible for setting monetary policy for the euro area as a whole, no institution has the authority or the responsibility to take political decisions in the interest of the euro area as a whole. Conflicting interests among different governments have been driving crisis management decisions. A common pattern during the past several years has been that one government with excessive political leverage has been guiding decisions that are harmful for the euro area as a whole but beneficial for stakeholders supporting that particular government. This has led to vastly different economic outcomes across the euro area since the crisis started.[5] The problem is certainly beyond the ECB's mandate and powers. However, the adverse economic outcomes for the euro area as a whole, and in particular for the most depressed parts of the euro area, reflect both the ECB's overly tight monetary policy and the mismanagement of the crisis by euro area governments.

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[5] The pattern of political decisions that discriminate against the interests of some member states in favor of interests in other member states has been a defining characteristic of the euro crisis. Orphanides (2015) describes how this was achieved at the start of the euro crisis. Baldwin et al (2015) review economic factors that contributed to the crisis and Wyplosz (2014) discusses why the euro crisis became a "near-perfect case of mismanagement."

To get a sense of the great disparity of outcomes within the euro area, Figures 7 and 8 present a decomposition of the performance of euro area GDP and unemployment into two components: Germany, which is the euro area's largest state and represents about one third of euro area GDP, and the rest of the euro area.

The policies pursued since the beginning of the crisis have led to a wide divergence of economic outcomes within the euro area. Judging from the outcomes since the Great Financial Crisis, macroeconomic policy appears to have been managed in a manner that has been close to ideal for Germany but much less than ideal for the rest of the euro area. However, the discrepancy has been so dramatic that even though the rest of the euro area continues to be depressed, the German economy now appears to be somewhat overheated. The unemployment rate in Germany is currently below 5 percent, a level considerably below the pre-crisis consensus of normal. By contrast, the rest of the euro area continues to be in a dire situation, with the unemployment rate exceeding 12 percent, more than three percentage points above pre-crisis norms.

This comparison suggests that even though monetary policy has been consistently excessively restrictive for the euro area as a whole, it has been just about right for the euro area's largest economy and host state of the ECB, Germany. Except that policy is now too accommodative for Germany. Core inflation in Germany is somewhat higher than the euro area average, but still below 2 percent.

These macroeconomic outcomes raise a troubling question for the ECB: Could the ECB's inappropriately tight policy for the euro area as a whole be explained by excessive influence of the German government on the central bank?

The March 2016 ECB policy decisions

The ECB's bold decisions to cut interest rates to unprecedented negative levels as well as expand its balance sheet somewhat more going forward clearly suggest that whatever the influence of the German government may have been on the institution, the low trend of underlying inflation in the euro area as a whole is of concern. The March 2016 decisions include new innovative elements of balance sheet expansion, such as purchases of euro area corporate debt and Targeted Longer-Term Refinancing Operations (TLTRO) at potentially subsidized negative interest rates aimed to promote lending.

Going forward, the implementation of the latest round of ECB policy easing will provide useful information about the capability of the ECB to pursue appropriate policy for the euro area as a whole, even when this policy deviates from the ideal for Germany.

Depending on the details of implementation, the March decisions could lead to the expansion of the balance sheet compatible with the accommodation necessary to raise euro area inflation and bring it in line with the ECB's objective. Alternatively, the implementation may temper the balance sheet expansion which would keep it modest and insufficient for the euro area as a whole, in line with the experience of the past few years.

The additional policy easing would move policy further away from the tightening conditions that appear best suited for the German economy at present. As such, it would also be of interest to see how the unusually public adverse reaction that the ECB's decisions triggered in Germany plays out.

Two very recent examples are useful to highlight the pressure applied by German authorities on the ECB. On April 8 Reuters reported:[6]

> "What the European Central Bank is doing now is for many savers, for little people, for workers, for pensioners, an expropriation, but it is not the ECB's fault," Gabriel, who is also Germany's vice chancellor, said on a visit to Vienna.

The following day, the Wall Street Journal reported:[7]

> The ECB's actions have faced growing criticism in Germany, where the economy and labor market are in robust health, but ultralow rates have hurt savers setting money aside for retirement. … Mr. Schäuble also laid part of the blame for the rise of the populist Alternative for Germany at the ECB's door. … "I said to Mario Draghi…be very proud: you can attribute 50% of the results of a party that seems to be new and successful in Germany to the design of this [monetary] policy," Mr. Schäuble said.

This criticism of the ECB by the German government is unusual not because of its substance (which could have been anticipated) but because it has been so direct and it has been made in public. Ironically, the ECB's actions that have triggered the recent criticism are effectively the delayed but predictable outcome of the ECB's earlier policy mistake—keeping monetary policy too restrictive for the euro area as a whole. Had the

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[6] "Germany's Gabriel says ECB policy expropriates 'little people'," Francois Murphy, Paul Carrel and Angus MacSwan, Reuters, April 8, 2016. http://www.reuters.com/article/ecb-policy-germany-idUSB4N12S022

[7] "Germany's Schäuble: Time Is Near to End Central Banks' Easy-Money Policies," Hans Bentzien, Tom Fairless and Andrea Thomas, Wall Street Journal, April 9, 2016. http://www.wsj.com/articles/germanys-schauble-time-is-near-to-end-central-banks-easy-money-policies-1460220687

ECB implemented the quantitative easing policy that was appropriate for the euro area as a whole in the 2012-2015 period, the euro area economy would have been performing significantly better, inflation would have been higher and closer to the ECB's objective and ECB policy rates would have been higher today. Interest rates in Germany would not have been as low and the "little people" would have been better protected from "expropriation." But criticism from Germany, including legal challenges brought against the ECB in the German Constitutional Court, was a key reason why quantitative easing action was delayed in the first place.

Words vs actions

As much as the ECB tries to communicate that it independently formulates policy for the euro area as a whole, as stipulated in the Treaty, its actions in the past few years have raised questions. The monetary policy that has been pursued by the ECB has restricted growth and employment in the euro area as a whole and has kept inflation too low and inconsistent with the ECB's mandate. By unnecessarily restricting nominal income growth, ECB policy has also exacerbated adverse debt dynamics that have been a continuing source of fragility in the euro area. Had the ECB acted independently to attain its inflation objective for the euro area as a whole, in accordance with the Treaty, policy would have been more accommodative. ECB policy would also have been better synchronized with that of the Federal Reserve. A similar balance sheet expansion to that pursued by the Fed since 2012 would have raised the ECB's balance sheet to 4.5 trillion euro by the end of 2014, which would have facilitated higher growth and employment and would have kept inflation more in line with the ECB's price stability objective for the euro area as a whole. However, pursuing the appropriate policy for the euro area as a whole would not have been ideal for Germany.

The ECB is in an impossible position. The euro area's existential crisis remains unresolved and the ECB is not capable to correct the fundamental political problem that has led to the euro's malfunction.

With headline and core inflation expected to remain considerably below the ECB's price stability objective, the ECB will likely have to maintain accommodative policy conditions for some time, even as the Fed continues its path of gradual rate hikes towards policy normalization. Taking into account that the euro area economy continues its subpar performance, and given the ECB's demonstrated timidity in easing policy, additional easing in the form of balance sheet expansion can be expected by the ECB going forward, while the Fed maintains its balance sheet roughly constant.

In this environment, the Fed-ECB divergence will likely continue for quite some time.

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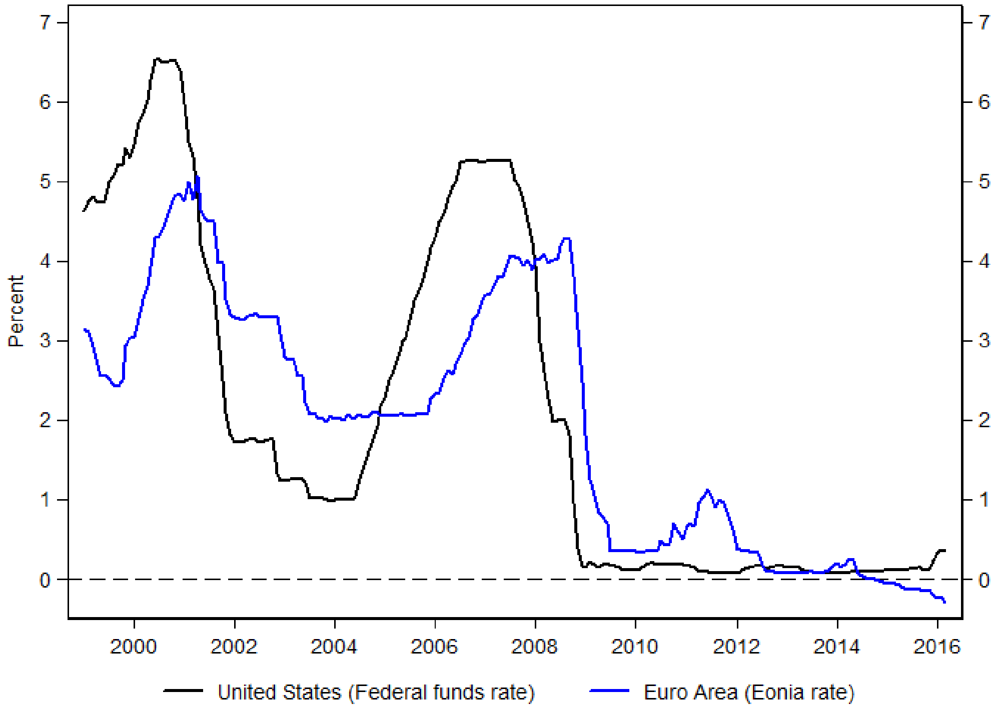

Figure 1: Overnight interest rate for the United States and the euro area.

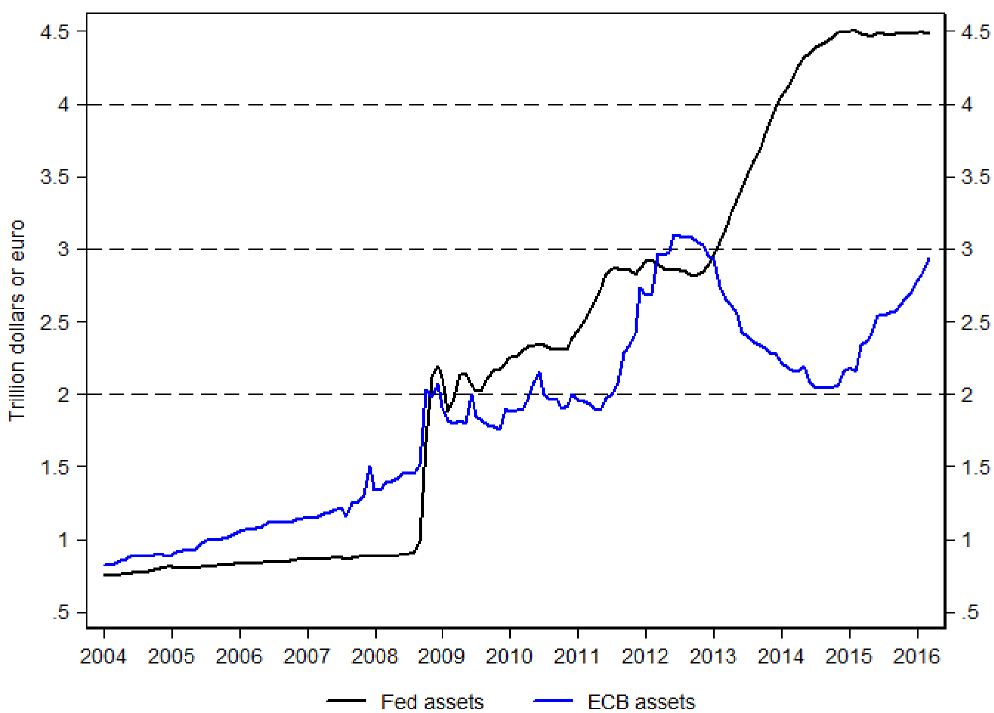

Figure 2: Central bank balance sheet for the United States and the euro area.

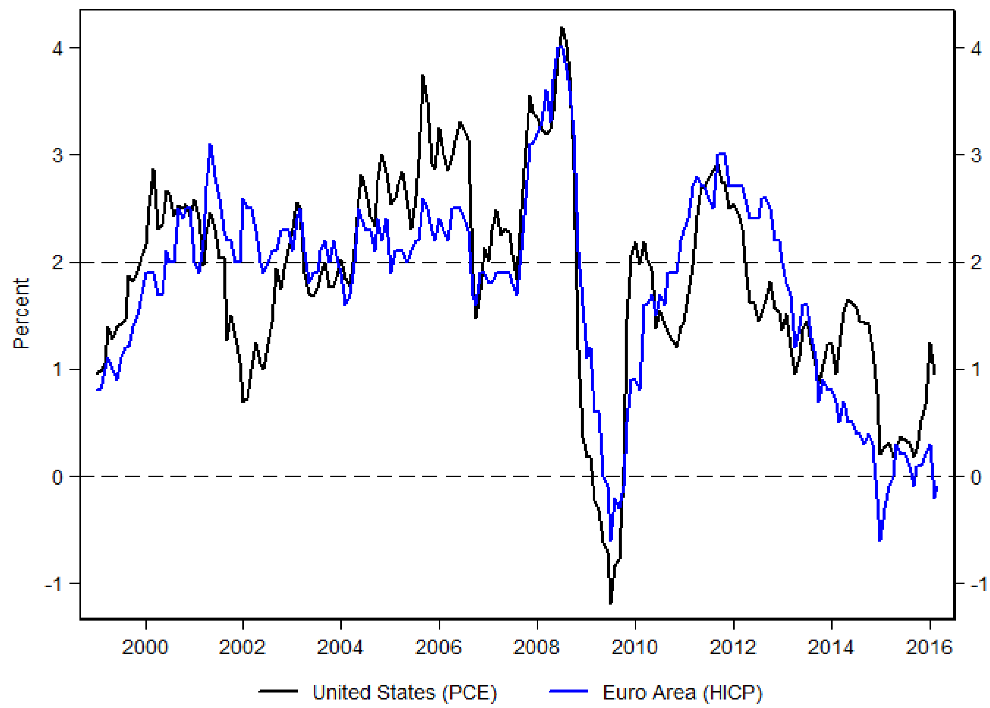

Figure 3: Inflation in the United States and the euro area.

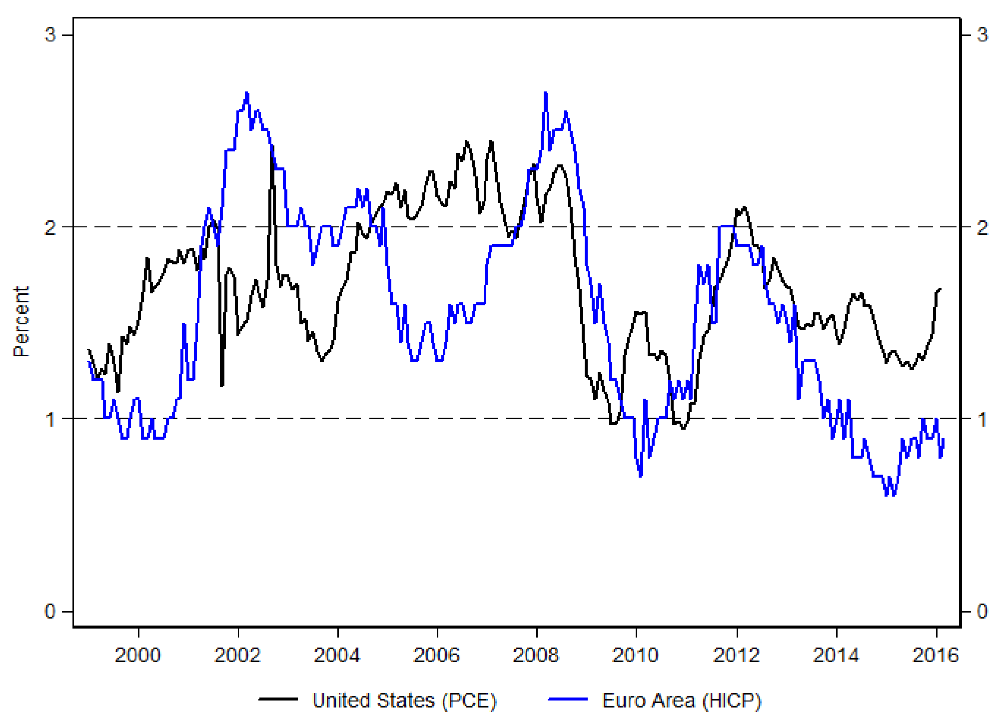

Figure 4: Core inflation in the United States and the euro area.

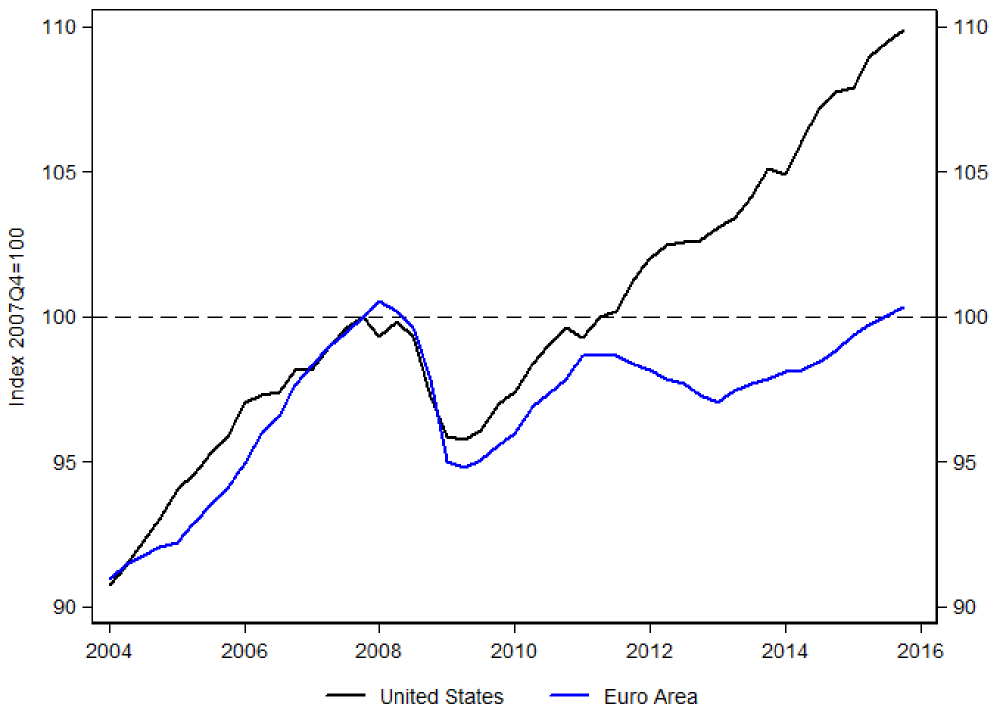

Figure 5: Real GDP in the United States and the euro area. Index: Fourth quarter of 2007 = 100.

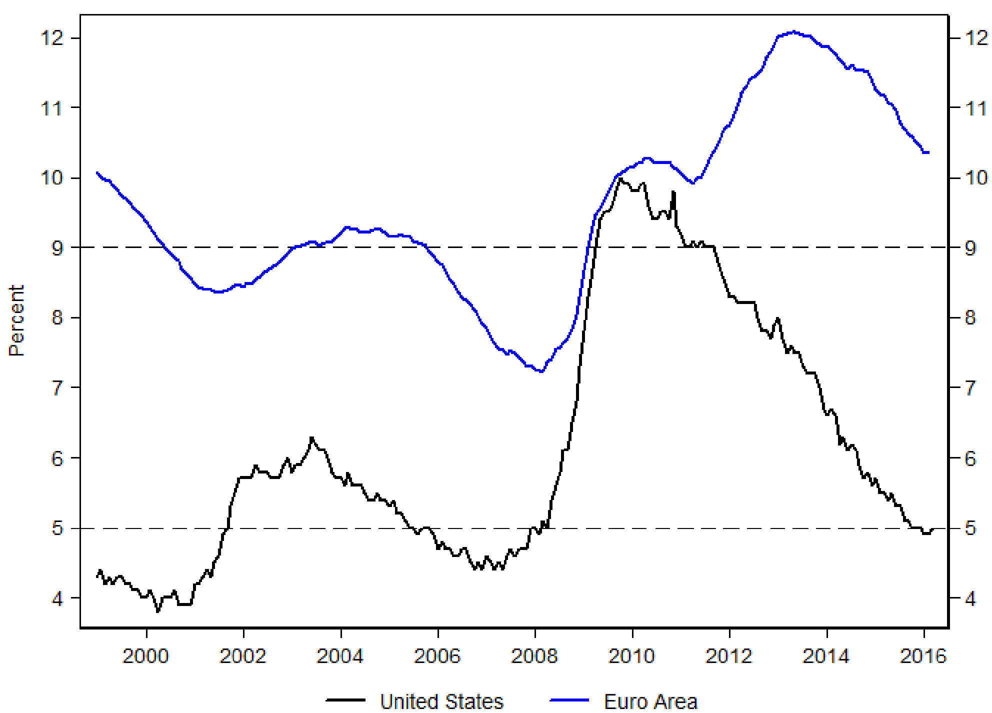

Figure 6: Unemployment rate in the United States and the euro area.

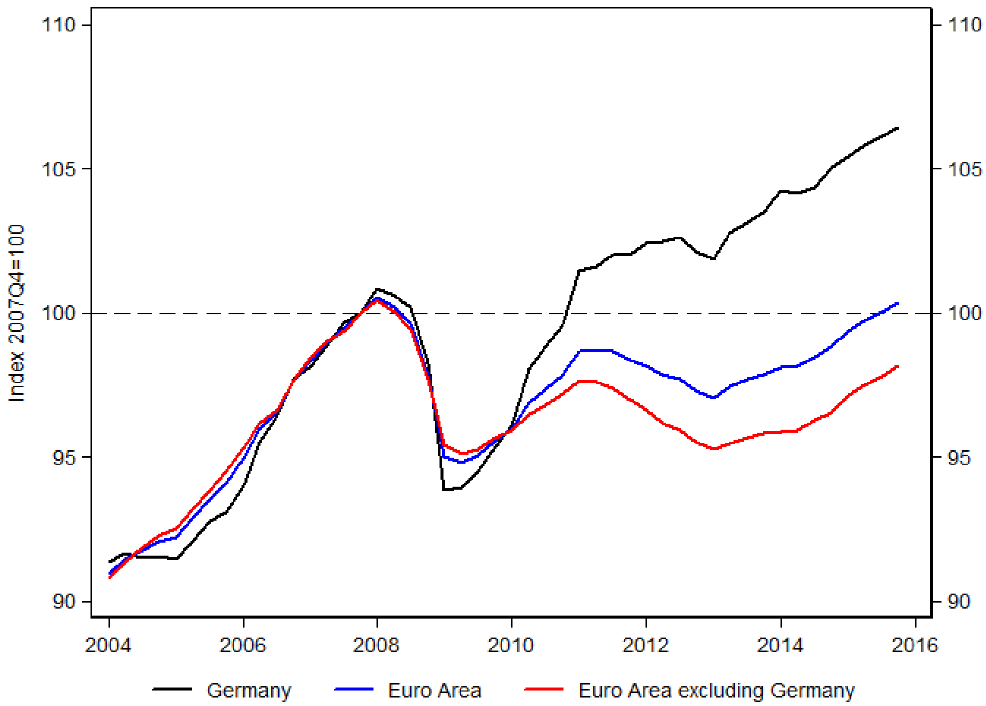

Figure 7: Real GDP in the euro area including and excluding Germany. Index: Fourth quarter of 2007 = 100.

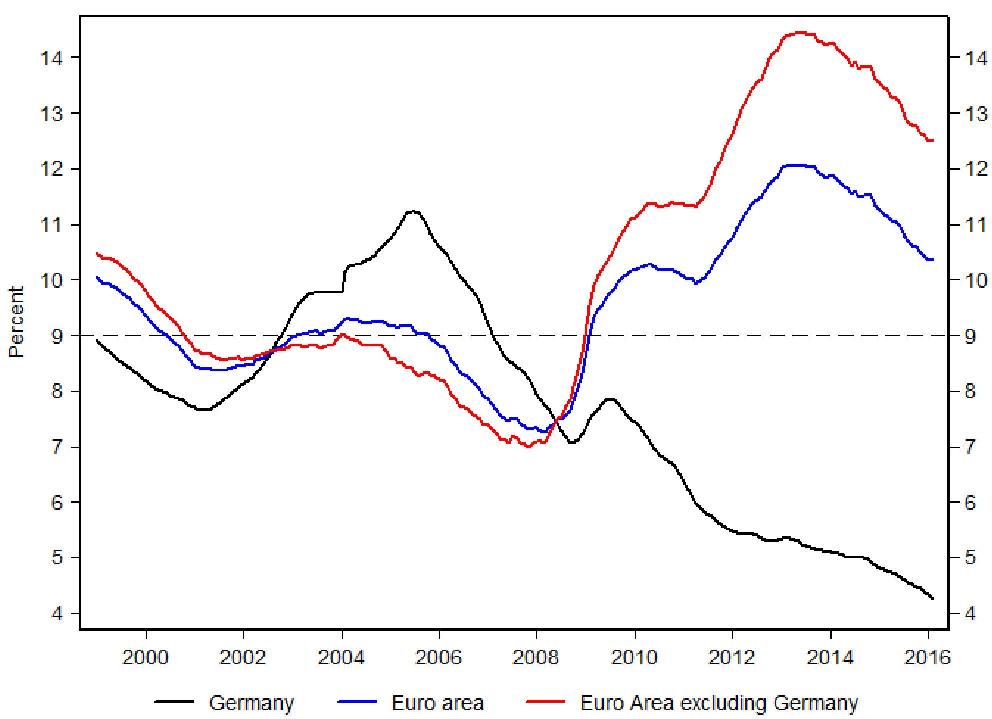

Figure 8: Unemployment rate in the euro area including and excluding Germany.