

REVIEW

On the Need to Renovate the Eurozone

Paul De Grauwe

Issing, Otmar, *The Birth of the Euro*, Cambridge University Press, Cambridge, 2008

Few professors have become as successful a central banker as Otmar Issing. Starting his official career at the German Bundesbank, he became the chief economist of the European Central Bank (ECB). In this capacity he was not only instrumental in the successful launch of the euro, but he also designed the monetary policy strategy that the ECB has been following since its inception. In doing all this, he married theory and practice in a wonderful way. It is therefore a special treat to read Otmar Issing's book 'The Birth of the Euro'.

Nobody is better placed to tell the story of the Euro-saga than Otmar Issing. And what a story it is. Against the advice of most economists, the euro was launched and the Eurosystem was established. Since then, the ECB has established a strong reputation of price stability. With great enthusiasm and pride, Otmar tells us the story of this success. He tells us about the problems and the uncertainties surrounding the launch of the euro; about how he and his collaborators felt as pioneers in establishing a framework for a successful monetary policy strategy. He discusses the academic theories that influenced him in designing the ECB's monetary policy strategy. He defends with some passion the institutions in which the ECB has been embedded, i.e. political independence of the central bank and collegial decision making within the Governing Council. He argues with force that these institutions function well in providing for an accountable and transparent central bank. He identifies the conditions that will guarantee the long-term survival of the eurozone. These conditions are flexibility of wages

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1 and prices to absorb asymmetric shocks and an orthodox fiscal policy as
2 embodied in the Stability and Growth Pact.

3 The institutions surrounding the ECB were not designed by Otmar Issing. In
4 contrast, the monetary policy strategy that the ECB has followed since
5 its inception is his brainchild. That's why I want to focus here on this strategy.

6 The remarkable aspect of this strategy is that it was solidly founded on a
7 body of academic thinking that has now become the mainstream thinking.
8 Only in one domain, i.e. the focus on the money stock, is there a departure
9 from mainstream academic thinking. But this departure, to which I will
10 return, is of secondary nature. In this sense it can be said that the ECB's
11 monetary policy strategy embodies the new orthodoxy of central banking.

12 This orthodoxy can be summarized as follows. First, the *primary* objective
13 of the central bank is to maintain price stability. Throughout his book,
14 Otmar Issing never ceases to repeat this basic truth. Although he is careful
15 not to say it explicitly, he definitely leaves the impression with the reader
16 that price stability should be the *only* serious objective of the central bank.
17 Each time he discusses other objectives (e.g. business cycle stabilization, the
18 exchange rate) so many provisos are added about how dangerous it is to
19 pursue these objectives that the reader is left with the impression that
20 nothing good can come from attempts to do anything other than keeping
21 inflation low. Thus the adjective 'primary' is transformed into 'sole' when
22 discussing price stability as the objective of the central bank.

23 Second, a successful stabilization of the price level is the best contribution
24 a central bank can make to maximize economic growth and to stabilize the
25 economy. In other words, there is no need to explicitly take into account
26 these other objectives. Price stability will deliver these objectives
27 automatically. Stabilize the price level and all the rest will be given to you.
28 With the eruption of the financial crisis in 2007, after ten years of price
29 stability, this act of faith in the benefits of price stability can be called into
30 question. I will return to this issue later.

31 Third, business cycle fluctuations are the result of exogenous shocks in
32 productivity and preferences, combined with slow transmission into the
33 economy. The slow transmission itself is the result of rigidities in labour and
34 goods markets. (The underlying academic model here is the New Keynesian
35 one. It is now embodied in the DSGE-model that is increasingly popular in
36 central banks.) Thus, in order to reduce business cycle fluctuations,
37 structural reform is necessary, aiming at making markets more flexible. But
38 this is the responsibility of governments. The central bank cannot do
39 anything about this. In this sense the central bank is not responsible for
40 business cycle fluctuations.

41 Finally, explicit inflation targeting in which the central bank announces a
42 numerical target is the way to anchor agents' expectations about inflation.

That is also what the ECB has been doing since its inception, succeeding in stabilizing inflation expectations.

These are the four ideas that make up the new orthodoxy and that were given practical content by Otmar Issing's monetary policy strategy. The only departure from the new orthodoxy is the emphasis put by Issing, at least initially, in using the money stock (M3) as a privileged variable providing information about future inflation.

Let me start with a discussion of this peculiar departure of the ECB's monetary policy strategy from the new orthodoxy. Sometimes a picture is worth a thousand words. We show the picture in Figure 1. We observe that apart from a very brief period in 2000–01, M3 growth has permanently exceeded the reference value of 4.5%, and by far. The average yearly growth rate of M3 was 7.4% while inflation amounted to 2.2% a year. The troublemaker was velocity, which declined on average by 3% per year. After ten years it can now be safely concluded that the attempt at using the growth of M3 as an early indicator of future inflation failed miserably.

The question that arises is why money growth has had so little information value for future inflation. The answer is that in a low inflation environment the noise to signal ratio of money growth is very high, i.e. most of the variability of money stock numbers is noise and is unrelated to inflationary dynamics. Most of the noise comes from large portfolio effects

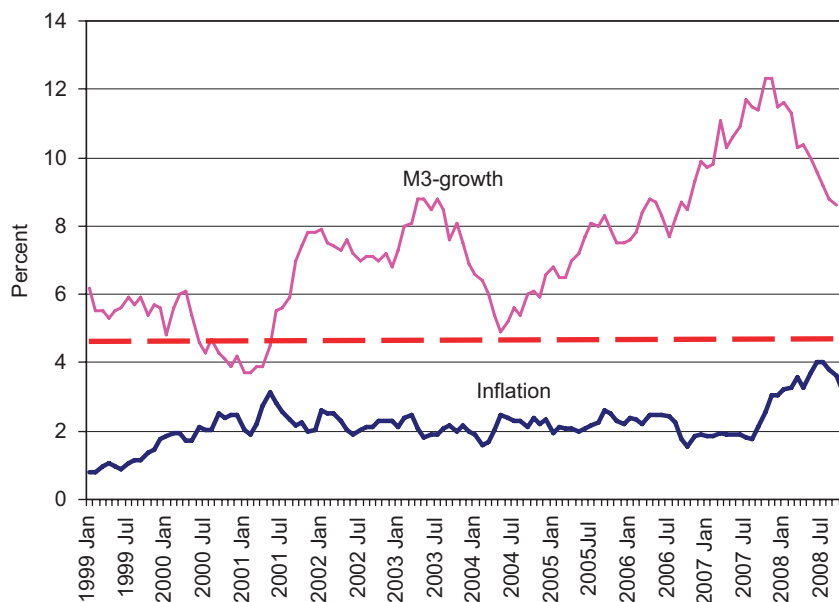


Figure 1: Inflation and money growth (M3) in eurozone

Source: ECB, Monthly Bulletin

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1 and financial innovation. For example, the spectacular increase in M3-
2 growth observed after 2004 is the result of a massive expansion of the banks'
3 balance sheets. This did not really increase liquidity (in the sense of means
4 of payments) to buy goods and services in the economy.

5 This does not mean that M3 together with variables showing the
6 development of total credit in the eurozone may not be good indicators
7 of financial market developments, in particular of the emergence of bubbles
8 and thus future crashes. In fact, and to his credit, Otmar Issing has stressed
9 this in other writings, but surprisingly very little of this can be found in
10 his book. Instead he reiterates the monetarist credo that the best way
11 to control inflation is to control the money stock. He goes so far as to write on
12 page 103: 'The close relationship between the money supply and prices has
13 been proven in countless studies all over the globe and all through history; it is
14 one of the most certain facts in economics – insofar as anything is ever 'certain'
15 in economics.' To prove his point he then reproduces a well-known graph
16 showing how a cross-section of inflation and money growth numbers of 110
17 countries cluster around the 45° line. He fails to mention that the visual
18 impression of a close fit obtained from this graph is exclusively due to the fact
19 that there were a couple of very high inflation countries in the sample. When
20 the same cross section graph is blown up to show the low inflation countries
21 (<5% inflation) nothing is left of the close fit.

22 But all this in a way is a side issue. For all practical purposes, the ECB has
23 abandoned the monetary pillar in its strategy aimed at keeping inflation low.
24 It is time to turn to the other pieces of the new central bank orthodoxy.

25 With the onslaught of the financial crisis the main credo of the new
26 orthodoxy, so forcefully defended by Otmar Issing, i.e. that the central bank
27 should be primarily concerned with price stability and that this will lead to
28 stability in general, can be called into question.

29 Since the 1980s a process of deregulation of the banking system was set
30 in motion in the United States and in Europe allowing banks to be fully
31 involved in financial markets. This coincided with an unprece-
32 dented dynamic of financial innovations, making it possible for banks
33 to develop a new banking model based on securitization. Most econo-
34 mists welcomed these developments, enamoured as they were by the
35 efficient markets paradigm. This paradigm promised that these develop-
36 ments would make everybody better off, and that by spreading the risks
37 over a wider group of people these new developments would actually
38 reduce systemic risks, thereby reducing the need for supervision
39 and regulation.

40 There is now overwhelming evidence that financial markets are not
41 efficient. Bubbles and crashes are an endemic feature of financial markets in
42 capitalist countries. Thus, as a result of deregulation and financial

1 innovations, the balance sheets of banks became fully exposed to these
2 bubbles and crashes, undermining the stability of the banking system.
3 While the balance sheets of the banks exploded, the major central banks,
4 including the ECB and the supervisors, decided to stand on the sideline. The
5 new orthodoxy told them that there was nothing to worry about. As long as
6 they kept inflation low, growth and stability would be guaranteed. The
7 orthodox radar screens of the central banks were built to only show inflation.
8 And since inflation remained low in the midst of unprecedented upheavals
9 in financial markets, central banks should do nothing. The wonderfully
10 efficient financial markets would take care of themselves. This was the time of
11 the 'great moderation' which showed the triumph of the new central bank
12 orthodoxy.

13 How things can change so quickly. Clearly few had predicted this
14 outcome. But the lessons should be clear. The new central bank orthodoxy
15 is in shambles, and thus the ECB's monetary policy strategy as conceived by
16 Otmar Issing also. Central banks have a broader responsibility than
17 keeping consumer prices stable. This broader responsibility includes the
18 maintenance of financial stability. The idea that financial stability will be
19 achieved by just maintaining price stability has been proven to be wrong.
20 Central banks, including the ECB, must do more. In fact it could be argued
21 that the primary objective of a central bank is to maintain financial
22 stability. The objective of price stability should be seen as secondary to
23 the maintenance of financial stability. This implies that the central bank should
24 be willing to use its policy instruments to fight emerging bubbles. Bubbles are
25 always followed by crashes, and these almost always put a lot of pressure on
26 the banking sector, because the latter is often involved in the emergence of
27 bubbles. Because the central bank provides an implicit insurance to the
28 banking system through its lender of last resort responsibility, exploding
29 balance sheets of banks also threaten the balance sheet of the central bank.
30 And because the Treasury provides the ultimate guarantee for the central
31 bank, failure to contain bubbles threatens the independence of the central
32 bank. This is probably the strongest argument that should convince
33 independent central bankers to care about bubbles in financial markets.

34 Clearly, not only the central banks bear the responsibility for maintaining
35 financial market stability. The central banks' instrument kit is too small to
36 bear the full burden. Supervisors and regulators are equally, if not more
37 important in maintaining financial stability. But this does not absolve the
38 central banks from their own responsibilities.

39 I conclude that the monetary policy strategy of the ECB, as conceived by
40 Otmar Issing, will have to be changed drastically. The one-dimensional
41 focus on price stability cannot be maintained. The ECB will have to take a
42 wider responsibility than just maintaining inflation below but close to 2%.

1 Let me turn to another prominent topic in Otmar Issing's book. This is
2 the question of whether the Eurozone must become embedded in a stronger
3 political union. The view defended by Otmar Issing is the following. The
4 level of political union achieved in the Eurozone is just fine. There is no
5 need to move towards more political union to sustain the monetary union.
6 In fact such a political union, e.g. in the form of a European government that
7 would counterbalance the ECB (a very French idea), is dangerous, as it
8 would undermine the political independence of the ECB.

9 All one needs to sustain the Eurozone, according to Issing, is to improve
10 price and wage flexibility and to follow the prescripts of the Stability and
11 Growth Pact (SGP). Wage and price flexibility allow the Eurozone members
12 to cope with asymmetric shocks. The latter cannot be dealt with by the ECB,
13 as it has only one interest rate to 'fit all'. The SGP provides the necessary
14 flexibility to deal with the consequences of recessions, provided the member
15 countries abide by the rule that they should maintain a balanced budget
16 over the business cycle. If these two requirements are met, the eurozone can
17 weather the storms of asymmetric shocks and recessions.

18 I have my doubts. Let me concentrate here on the SGP and focus on its
19 poor institutional foundation. The peculiarity of the Eurozone is that while
20 monetary policy has been fully centralized, spending and taxation are still
21 very much the responsibility of national governments and parliaments. That
22 is also the level at which democratic legitimacy is vested. As a result, these
23 spending and taxation decisions are backed by an elaborate process that is
24 deeply embedded in national democratic institutions.

25 The SGP now imposes top-down an extensive control and sanctioning
26 system on the net effect (budget deficit) of this democratic decision-making
27 process by institutions that are perceived to lack the same democratic
28 legitimacy. Lawyers will undoubtedly object that the SGP is the result of a
29 Treaty that has been ratified by the same democratic institutions, the
30 national parliaments, so that it has the same legitimacy as the national
31 parliaments. This is undoubtedly true from a legal point of view. It is not
32 from a political point of view.

33 When the Commission starts an excessive deficit procedure, which aims
34 at forcing national governments to cut spending and/or increase taxes, it
35 bears no political responsibility for these decisions. In fact, the national
36 governments do. When these follow up on the Commission's procedure
37 and cut spending and raise taxes, they are the ones who will be judged by
38 their national electorates, and who face the threat of being punished by
39 the voters at home. In contrast, the European Commission at no time faces
40 the prospect of being voted away. Thus from a political point of view,
41 the European Commission, which initiates the control and sanctioning
42 procedure of the SGP, lacks democratic legitimacy, because there is no

1 mechanism to make the Commission accountable before an electorate for
2 its actions.

3 This lack of accountability of the Commission makes the SGP
4 unsustainable. Each time a conflict arises between the Commission and
5 the national governments, the former is bound to lose. This is also what
6 happened in November 2003, when France and Germany disregarded the
7 SGP. It will happen again when conflicts arise between the Commission and
8 the national governments. Thus, it can be concluded that the SGP is a fragile
9 institutional construction that is unlikely to lead to its objective.

10 This problem will continue to exist as long as the nation-states maintain
11 their sovereignty over spending and taxation, and as long as those who
12 decide about spending and taxation are made accountable for decisions
13 before a national electorate.

14 The institutional problem with the SGP is part of a larger governance
15 problem within the Eurozone that can only be resolved by further political
16 union. The major governance problem of the Eurozone is that while national
17 politicians continue to bear the full political responsibility for unfavourable
18 trends in unemployment, key instruments to deal with this problem, including
19 monetary policy, have been taken away from them and have been transferred
20 to European institutions that bear no political responsibility for their
21 decisions. It will not be sufficient for the ECB to invoke the central bank
22 orthodoxy, claiming that a central bank has nothing to do with the movements
23 in output and employment, to solve this problem. The problem remains on the
24 table because everybody, except the new classical economists, knows that in
25 the short run central banks can certainly affect output and employment.

26 Otmar Issing has written a fascinating book telling the story of the birth of
27 the euro and the eurosystem. Although he remains modest about his own
28 contribution, there is no doubt that he has been an important actor in the
29 construction of this new monetary regime in Europe. What should be clear,
30 however, especially since the eruption of the banking crisis, is that the
31 European monetary construction is not yet finished – in fact that part of the
32 construction will have to be renovated.

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