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19 May 2013

Online at <https://mpra.ub.uni-muenchen.de/47085/>

MPRA Paper No. 47085, posted 20 May 2013 01:04 UTC

**Do the Central Banks always do the right thing for their
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ABSTRACT

The general aim of the paper is to address the doubts that too often the Central Banks' tools and operations don't fit for a *fine tuning* of the economies, and this is even more true in harsh times. The paper begins with an overview on the great failures respectively of the Federal Reserve, the so called "golden silence" in the 1929 Great Crash, and of the European Central Bank during the second great contraction, the 2008 Financial Crisis. Then I critically appraise the so-called "Two pillar approach", a methodological tool employed by the ECB for assessing the risks to price stability. I survey the literature on the subject with the purpose of going at the roots of the "technical" difficulties. The first outcome emphasizes the existing disagreement between the criticisms and the proposed solutions. The second outcome is the unanimity of the opinions that the inflation target chosen at 2% by ECB for the Eurozone is too low, thereby making the whole MPS excessively restrictive. I conclude observing that the "core" inflation-target of 2% is in fact at the very basis of the ECB non-intervention policy. For a simple and sobering reason: even if between 2003 and 2008 the stock market bubble was growing at unreal rate, since the inflation target wasn't in any jeopardy, the European Central Bank didn't do anything. Maintaining the goal of price stability was much more important than assuring financial stability, thereby preventing the Financial Crisis.

Keywords: Monetary Policy – Central Banking – European Central Bank – Inflation

JEL-Code: E52 – E58

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Mankind has not succeeded in evolving a satisfactory monetary system in several millennia. Here again, despite our greater scientific understanding of monetary matters, I doubt that a final solution will emerge by the end of the next century.
Milton Friedman (1991)

1. Introduction

The role of monetary policy has not always been the same over time. It is constantly evolving according to different economic climates and economic theories. The central banks at their earliest stage, had to provide, as their main objective, funds to governments and make order to the note issue¹. Then, in the twentieth century they moved to stabilize the financial markets and to peg the currency to gold such as in the Gold Exchange Standard System or to the Dollar as in the Bretton Wood System which lasted from 1944 till 1972.

In the latter period, according to the Keynesian theory, the role of monetary policy was bounded to only support the fiscal policy, providing cheap money for government spending so as to support the aggregate demand as well as the economy during the period of the Great Depression starting in 1929. In this economic environment, in which “you could lead the horse to water, but you could not make him drink”, the monetary policy was pushed to the background, leaving the fiscal policy playing the major role. But as the economic climate changed, the monetary policy’s role changed as well. After more than two decades of cheap money and the practical unsustainability of an expansionary fiscal policy in the long run, leading to a high level of inflation and big governments’ budget deficit, the monetary economics regained its role.

The starting point was the reassessment of the quantity theory of money by Milton Friedman, who brought the role of money to shine again and challenged the primacy of the Keynesian macroeconomic policies’ design². By then, theoretical bases started to develop inside what came to be known as “monetarism” and now, they have taken root in the day to day procedures and practices implemented by almost all the central banks all around the world.

The variety of policy choices granted by the Phillips Curve³ was not more feasible if in the long run the curve became vertical because constrained by what Friedman christened “the natural rate of unemployment”. Lastly, the new disease appeared in the 1970s – the stagflation – seemed to the most confirm Friedman’s doctrine.

The modern monetary approach is grounded on the idea that the money is neutral in the long run, that is, changes in the money supply can only affect the level of prices and not the level of output, so that maintaining price stability is the only way for central banks to stimulate the economic activity and employment⁴. The most notable exception to this view is the Federal Reserve which aims to promote the goals of maximum employment, stable prices, and moderate long-term interest

¹ Fisher S. (1995), “Modern Approach to Central Banking”, National Bureau of Economic Research, Working Paper No. 5064, Cambridge, p. 1

² M. Friedman (ed.) 1956, “The quantity theory of money: a restatement”, in M. Friedman (ed), *Studies in the Quantity Theory Of Money*, Chicago University Press, Chicago

³ Bill Phillips of the London School of Economics in 1958 analyzed the relationship between inflation and unemployment that went used to trade off some less unemployment at the expenses of higher inflation.

⁴ ECB, “The monetary Policy of the ECB 2011”, May 2011, p. 55

rates. However, beyond this partially different approach of the American Federal Reserve, which puts more emphasis on the output growth and rate of unemployment, almost all the other central banks such as the European Central Bank, the Bank of England, the Reserve Bank of New Zealand, the Reserve Bank of Australia, and the Bank of Canada have the price stability as main goal.

According to this, the point of discussion among the economists moved from what monetary policy can do to make the right choice concerning the most coherent goal of monetary policy and the most suitable tools to achieve the target. In fact now the attention is more focused, on the one hand, on what a possible inflation target could be: if it should be comprehended between a values' band or it should be a fixed target. Alternatively it can be focused on the kind of rules that should be followed to reach the target more easily, such as the money stock growth, the Taylor rule⁵, the inflation expectations, or even more if the central bank's independence will increase the efficiency of its operations or not.

Despite of all these theories and rules, the central banks have not always succeeded in doing what they were seeking: in fact often they have failed their targets, contributed to hamper the economic recovery, and even worse, to the burst of speculative bubbles and resulting financial crisis. According to this overview, the paper will be divided into five parts.

After the methodological background presented in the Introduction (section 1), the second section briefly remember the historic example of what can be defined a great failure of the Federal Reserve System: the Great Crash of the 1929 and its contribution to hamper the economic recovery of the United States in the 30s.

The third section is an example of what can be defined an ordinary – usual – failure by a central bank of reaching its policy target.

The fourth section deals with the Two Pillar approach adopted by ECB for implementing its Monetary Policy Strategy. Here both technical and core problems will be addressed.

In the fifth section – conclusive remarks - we investigate the hypothesis showing a strict relationship between the central banks' behaviors, especially in the Eurozone and UK, and the evolution of the stock market's bubble which crashed in 2008 and pushed the European economies into the strongest recession after the 1929.

2. The Great Failure Of The Federal Reserve System In The 1929 Great Contraction

It is clear that in the past the central banks have failed their targets, but it is also true that they have hampered, many times, the economic recovery of a country⁶.

One of the most notable examples was the Great Depression in 1929-1933 when the Federal Reserve pursued a deflationary policy reducing the quantity of money in circulation by one third in the United States, so as exacerbating the effects of the economic crisis⁷. The monetary policy strategy implemented by the Federal Reserve in those years is a clear testimony of wrong

⁵ J.B. Taylor, (1993), "Discretion versus policy rules in practice", Carnegie-Rochester Conference Series on Public Policy 39, pp. 195-214

⁶ See C.P. Kindleberger, R. Z. Aliber, (2005), *Manias, panics and crashes: a history of financial crises*, Palgrave Mcmillan, Basinsgtoke.

⁷ Friedman, M. (1968), "The Role of Monetary Policy", *The American Economic Review*, Vol. 58, No. 1, p. 3

management of its power and its duties. As Milton Friedman has written “the Great Contraction might not have occurred at all, and if it had, it would have been far less severe, if the monetary authority had avoided mistakes, or if the monetary arrangements had been those of an earlier time when there was no central authority with the power to make the kinds of mistakes that the Federal Reserve System made”⁸.

In addition he concluded saying that “every other major contraction in this country has been either produced by monetary disorder or greatly exacerbated by monetary disorder”⁹. According to this, we can highlight two main ideas, respectively, the crucial role given to the monetary policy in affecting the economic activity and the importance to pursue the right policies at the right time, such as countercyclical expansionary policy during the period of the Great Depression.

Galbraith, in his well-known book *The Great Crash 1929*, in the chapter dedicated to role played by the Federal Reserve System, adds to this point some illuminating remarks.

The most surprising is that before the autumn’s Wall Street crash, the Federal Reserve Board and the Federal Reserve Banks do not take any measures to curb speculation. The simple power to fix eventual margin requirements in the stock exchange transactions was given to the Federal Reserve Board only in 1934 by the *Securities Exchange Act*.

Illuminating and, at the same time, unsettling is the Galbraith’s interpretation of this behavior:

In fact, the Federal Reserve was helpless only because he wanted to be...

Actually, not even new legislation, or the threat of it, was needed. In 1929, a robust denunciation of speculators and speculation by someone in high authority and a warning that the market was too high would almost certainly have broken the spell. It would have brought some people back from the world of make-believe... The very effectiveness of such a measure was the problem. Of all the weapons in the Federal Reserve arsenal, words were the most unpredictable in their consequences. Their effect might be sudden and terrible. Moreover, these consequences could be attributed with the greatest of precision to the person or persons who uttered the words. Retribution would follow. To the more cautious of the Federal Reserve officials in the early part of 1929 silence seemed literally golden¹⁰.

However the Federal Reserve wasn’t the only central bank having pursued wrong monetary policies such as boosting inflation, or exacerbating recession. Many other central banks made the same mistakes, maybe even greater, but they did not appear so relevant and so harmful for their countries and for the global economy because their relative economic weight and powers were not as heavy nor as powerful to affect the economic activity than the Federal Reserve’s ones. A possible recent example of this is the European Central Bank, which can be compared to the Federal Reserve both for power and resources at its disposal.

3. Ordinary Failures Of Monetary Policies: The Performance Of The Major Central Banks

As we have already said, almost every central bank has a common goal, maintaining price stability. According to ECB, price stability can be defined as “a year-on-year increase in the harmonized index of consumer prices for the euro area, below, but close to, 2% over the medium-term”¹¹. Using this

⁸ Ivi, p. 12. See also Friedman M., Schwartz A.J. (1963), *A Monetary History of the United States, 1867-1960*, Princeton University Press, Princeton, N.J.

⁹ Ibidem.

¹⁰ J. K. Galbraith, (1954), *The Great Crash 1929*, Penguin Books Ltd, Harmondsworth, p.59.

¹¹ ECB, “The monetary Policy of the ECB 2011”, May 2011, p. 64

standard we can evaluate the performances of the four main central banks, the Federal Reserve, the Bundesbank, the Bank of Japan and the Bank of England during the period 1960 and 1999.

Table 1: Inflation Performance (average annual CPI inflation)

Time Series	USA	Germany	Japan	UK
1960-1999	4.6	3.2	4.7	6.9
1982-1999	3.5	2.3	1.5	4.7
1990-1999	3.0	2.3	1.2	3.7
1993-1999	2.5	2.0	0.6	2.6

Source: Bonfinger (2001, p. 293)

According to the table 1, we can see that the Bundesbank during the period 1960 till 1999 had the best performance compared to others, nevertheless it failed to maintain the price stability close to the target of 2 %.

If we reduce the length of time for our analysis, and we focus on the period starting in 1982, after the collapse of the Bretton Wood System, characterized by floating exchange rates, we can see that the performances, on average improved, but were still too far from the benchmark of 2 %. Almost all the countries overshoot the target, showing a higher inflation than 2 %, and only Japan experienced a deflationary process at the same way harmful.

I want to stress the point that both positive and negative deviations from the target, according to the central bank's loss function developed by Svensson, are evaluated on the one hand with the same weight, because deflation is supposed to be costly for the society as well as inflation, and on the other hand with the squared principle, that is, the further the deviation is from the target, the higher is the weight in the function¹². According to this, only the Bundesbank during the period of 1993-1999 succeeded in achieving the inflation target of 2 %.

In addition, according to the widely acceptable monetary policy's duties, a central bank should not only be concerned with price stability in the long run, but also it has to stabilize the economy from demand and supply shocks in the short run. In fact to offset depressive economic cycles, it is always possible to have a trade-off between inflation and unemployment in the short run, which will turn, in the long run into a higher inflationary pressure¹³.

Therefore a central bank can choose according to the Svensson function a possible trade-off between inflation and output.

$$L_t = \frac{1}{2} [(\pi_t - \pi^*)^2 + \varphi((Y_t - Y^*)/Y^*)^2]$$

In fact if it gives to φ a value of 0, the central bank is concerned only with inflation, on the other hand if it gives a value of 1, the central bank weighs equally inflation and output¹⁴. According to the latter hypothesis, $\varphi = 1$, we can evaluate the performances from both point of views, long run inflation rate, and short run output fluctuations.

¹² Bofinger, P. (2001), *Monetary Policy: goals, institutions, strategies and instruments*, Oxford University Press, p. 128.

The loss function can be written as follows: $L_t = \frac{1}{2} [(\pi_t - \pi^*)^2 + \varphi((Y_t - Y^*)/Y^*)^2]$

¹³ Friedman, M. (1968), "The Role of Monetary Policy", *The American Economic Review*, Vol. 58, No. 1, p. 11

¹⁴ Bofinger, P. (2001), *Monetary Policy: goals, institutions, strategies and instruments*, Oxford University Press, p. 128

Looking at table 2, we can see that Germany loses its first position of best performance that it had for the inflation targeting according to table 1. In fact during all three periods analyzed, Germany is the second top performer in 1982-1999 after Japan, in 1990-1999 after USA, and the third performer during 1993 and 1999 after Japan and UK. This let's us state that the Bundesbank was much more concerned with inflation than output fluctuations, meaning that, it has preferred pursuing a monetary policy more strict to price stability - a deflationary policy - than an accommodating one to stabilize the output from different sources of shocks.

Table 2: Annual Social Welfare Loss

Time Seies	USA	Germany	Japan	UK
1982-1999	7.1	5.6	5.5	15
1990-1999	4.0	5.0	7.3	9.5
1993-1999	2.5	2.2	1.7	1.9

Source: Bonfingher (2001, p. 294)

We can conclude that to evaluate the performances of a central bank we have to consider both the characteristics of its primary goal, and the expectations for the growth path of its country. However according to this analysis, we have noticed that all the central banks investigated during the period 1982-1999 have failed to achieve the inflation benchmark of 2 % as well as minimizing their social welfare loss function.

4. The Two Pillar Approach of The Monetary Policy Strategy of The ECB

4.1 The methodological framework

The European Central Bank's (ECB) Monetary Policy Strategy (MPS) can be explained by dividing it into two elements: a quantitative definition of price stability and a two pillars approach for the analysis of the risks to price stability.

The former refers to the specific definition of price stability that was announced in 1998 and then refined in 2003 as referred previously as – an increase in the Harmonized Index of Consumer Prices (HICP) for the Euro area, below, but close to, 2% over the medium term.

The latter is a tool based on an economic analysis and a monetary analysis - the two pillars – designed “to organizing, evaluating and crosschecking all information relevant for assessing the risks to price stability”¹⁵.

According to the ECB's MPS, the economic analysis aims at “assessing the short to medium-term determinants of price developments, with a focus on real activity and the cost factors driving prices over those horizons, while the monetary one is “founded on the relationship between money growth and inflation over the medium to longer-term horizon and exploits the fact that monetary trends leads inflationary trends”¹⁶.

These two perspectives are complementary even if the ECB gives a prominent role to the monetary analysis as the main tool to assess the price development.

The criticism of the ECB's MPS have a wide spectrum, going from the decision-making process of

¹⁵ ECB, “The monetary Policy of the ECB 2011”, May 2011, p.69

¹⁶ Ivi, p. 9

ECB, labeled as too independent from the political consensus¹⁷, to more technical criticisms as those concerning the M3 growth target, labeled as too narrow. The first pillar of its MPS - the economic analysis – has been critiqued in turn because too general to serve as a framework to facilitate the internal decision processes and to structure the dialogue with the public so as to enhance the transparency, accountability and hence the credibility of monetary policy¹⁸.

In addition to these arguments, the most common and easy reason why the ECB is so criticized is that it is said to be excessively tight and restrictive. This point of view can be summarized in a too low inflation target, which is too bounded to follow in a depressed economic situation, as it is facing the Eurozone after the financial crisis of 2008s.

According to this, there are different opinions on what has to be changed to improve the accountability and the effectiveness of the ECB's MP and also on what has to be done to boost the economic recovery of a stagnant Euro area that is going to grow at a negative GDP rate of -0.4 in 2013 and it has experienced -0,6 % de-growth rate in 2012¹⁹.

Often these views are conflicting as well as the different monetary theories have been during the last century and before, so to objectively appraise the ECB's MPS it is necessary to focus on both sides of the coin, and not only on the negative one.

Conclusion: The ECB's MPS has remained under persistent criticism since the beginning of its mandate in 1999. These criticisms deal with two main lines of discussion, the ultimate target - the core - and the tools used to achieve it - the technical.

To begin the discussion, I'm going to start from the latter - the tools used to achieve the price stability - focusing on the main criticism concerning the excessive reliance on the M3 growth and its role in the two pillars strategy.

4.2 Tools Used By ECB's Monetary Policy Strategy: Technical Criticisms

More precisely, these technical objections concern: the lack of a precise definition of the target, the lack of bands within which inflation should be held, the lack of a precise definition of what medium-term means, the structural and theoretical weakness relates to the way that the target was chosen, and the excessive reliance on the money stock growth M3 as main tool to assess the risk to prices stability in the medium-term.

The literature concerning the topic is large, involving many leading figures of the profession and many distinguished economists. Here we will present the opinions and the discussions of Bonfingher (2001), Goodhart (2006) and De Grauwe (2007), prominent specialists of monetary issues – without neglecting the ECB justifications for its praxis.

According to this, we must begin by saying that both De Grauwe, Goodhart and Bonfingher emphasizes the fact that money stock growth is an unreliable indicator to asses risks to price stability. They, respectively, underline some issues concerning the relationship between money stock trend and inflation trend.

¹⁷ Goodhart, C.A.E. (2006), “ The ECB and the Conduct of Monetary Policy: Goodhart's Law and Lessons from the Euro Area “, *Journal of Common Market Studies*, Vol. 44 N.4, p. 9

¹⁸ P. Bonfingher, (2001) , “ The Monetary Policy Framework of the ECB”, Universitat Wurzburg, p.5

¹⁹ Eurostat Forecast, 05/2013.

De Grauwe states that in a low inflation environment money stock loses its predictive value and this is even more true in presence of financial innovation and volatility of the money circulation's velocity²⁰. According to the fig. 1A we can see how the money growth is linked to the respective growth of the inflation rate, but in the fig. 1B we can see how this relationship is denied.

Fig. 1B Inflation and Money Growth at High Frequency

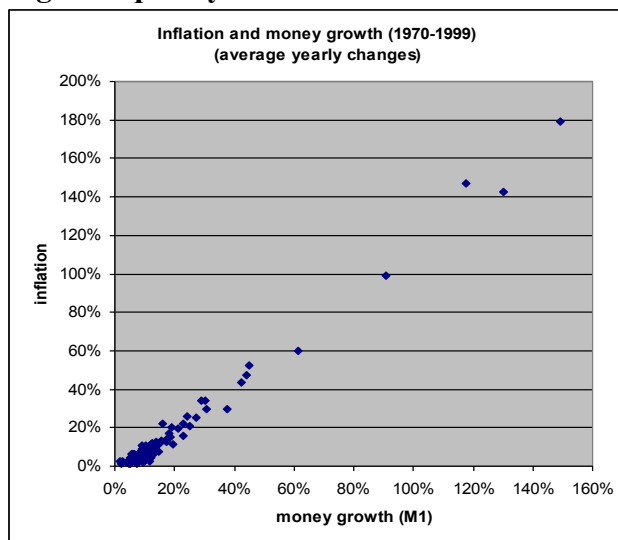
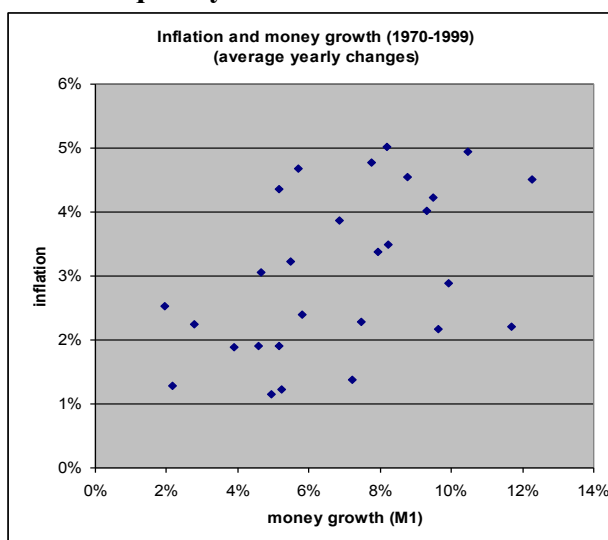


Fig. 1A Inflation and Money Growth at Low Frequency



Source: De Grauwe (2007)

Goodhart observed that during 2001-2003 and 2004-2005 the money stock grew much higher than the reference value of 4.5%, but the inflation didn't increase; on the contrary it decreased between 2001-2003, remaining just a bit over the threshold of 2 %. This indicates that money growth is an unreliable indicator also in the medium-term when some destabilizing events happen simultaneously.

In fact according to fig. 2A and 2B we can see that there seems to be no correlation in those years between money stock trend and inflation trend. This is explained by Goodhart in two ways: he refers first to the point of view of Greiber and Lemke²¹ which stated that financial uncertainty seems to raise the demand for money, and therefore, only when the uncertainty passes can the M3 growth be used again as reference indicator assessing future price stability²². In addition he states that the rapid expansion of M3 in 2001-03 wasn't accompanied by a similar fast growth in bank lending to the private sector, which meant there would be no excessive inflationary pressure. So if the money stock grows, but this is not transferred to the real economy, the inflation forecast is not fulfilled.

²⁰ P. De Grauwe, (2007), *Economics of Monetary Union*, Oxford University Press, Chapter 9: Monetary Policy in the Eurozone.

²¹ Greber C., and Wolfgang L, (2005), "Money Demand and Macroeconomic Uncertainty," Deutsche Bundesbank Discussion Paper 26 (Frankfurt: Deutsche Bundesbank); they investigated the American and European macroeconomic uncertainty building up an index explaining the fluctuations in broad money demand.

²² Goodhart, C.A.E. (2006), "The ECB and the Conduct of Monetary Policy: Goodhart's Law and Lessons from the Euro Area", *Journal of Common Market Studies*, Vol. 44 N. 4, p. 4

To conclude Goodhart also refers to his corollary that affirms that “variables that become the cynosure of policy lose their predictive value, whereas variables that are no longer treated as policy measures may regain predictive value”²³. In practice he emphasizes the fact that now that inflation is under control and that inflation expectations are well anchored to it, then in this new environment, the variables commonly used to assess the risks to price stability as the money stock could lag even further behind changes in the output gap²⁴.

Fig. 2A Money Growth in the Eurozone

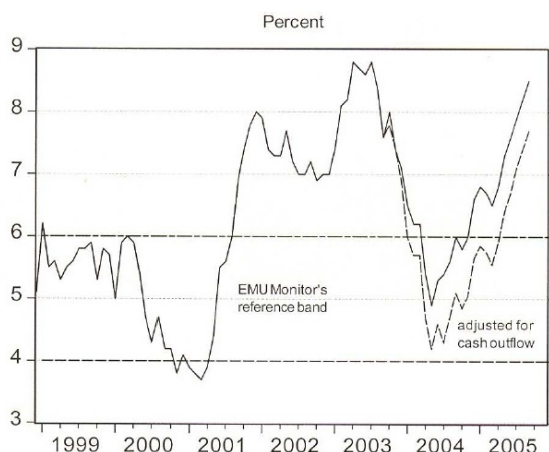
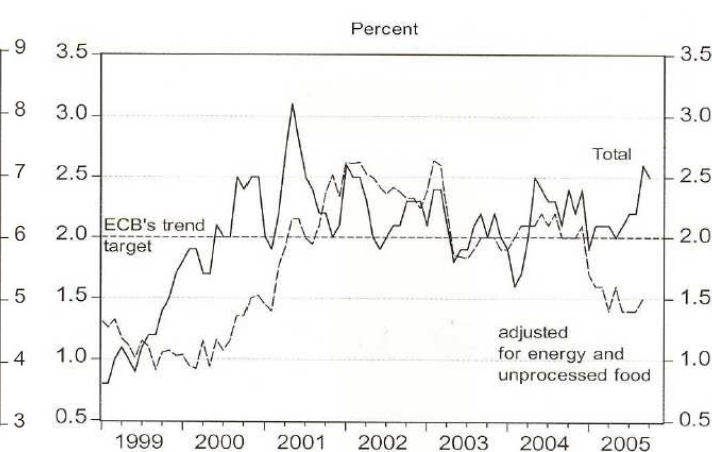


Fig. 2B The Eurozone HICP



Source: Goodhart, 2006, p. 28

According to Bonfingher, another reason for which the money stock is a low quality indicator is that the medium-term orientation gets lost. It happens because the ECB compares the three-month moving average of annual growth of M3 with its reference value so as losing the medium-term orientation²⁵.

After having emphasized that the money stock growth is not a reliable indicator to assess the risks to price stability, we have to discuss which other options are better substitutes than the money stock targeting.

According to De Grauwe, the inflation targeting is superior to money stock targeting because it uses information of all variables, including the money stock, that will affect future inflation, therefore substituting the intermediate target - the money stock - with an inflation forecast²⁶. In practice De Grauwe suggests to the ECB a monetary policy similar to that adopted by the Bank of England.

Nevertheless, not everybody has the same point of view; in fact Bonfingher says that “it seems to be not very likely that by adopting the procedures of the Bank of England, the ECB would substantially enhance the ex-ante accountability of its policies”. Moreover strong supporters of inflation targeting like Bernanke conceded that “Overall, though, we must admit that the economic performance of the non-targeters over the period considered is not appreciably different from that of inflation-targeters”²⁷.

²³ Ivi, p. 15

²⁴ Ibidem.

²⁵ P. Bonfingher, (2001), “The Monetary Policy Framework of the ECB”, Universitat Wurzburg, p. 3

²⁶ P. De Grauwe, (2007), *Economics of Monetary Union*, Oxford University Press, Chapter 9: Monetary Policy in the Eurozone.

²⁷ Ivi., p. 12

In addition to these reasons, De Grauwe adds that since all the inflation-targeting countries have implemented this policy when they have already reached a low inflation threshold, then there is no real evidence of the contribution of inflation targeting in a disinflation process²⁸.

Bonfingher suggests another rule, simpler and easier to use, to enhance the credibility and accountability of the ECB. He states that the ECB's MPS should pass to one pillar, only the economic one, and include the monetary analysis in this pillar so as to enhance its forward-looking dimension of the ECB's accountability²⁹.

Furthermore, he adds that the ECB should use private inflation expectations in relation to its inflation target as a simple rule for its own decisions as well as for its dialogue with the European public and the European Parliament, because they are a crucial determinant of future inflation.

4.3 ECB's Defense of its Technical and Strategic Choices

According to this, we have comprehended that, even between the critics, there isn't a full agreement on the alternative strategy the ECB should pursue. Even more, we have understood that they don't agree also on the benefits that the alternative strategies are going to bring to the improvement of the monetary policy.

Therefore to get a full perspective on the issue concerning the technical field of criticism, we have to investigate how the ECB justifies its choices concerning its MPS.

The ECB in its Report 2011 indirectly answers to this issue; in fact it states that neither the monetary targeting nor the direct inflation targeting are possible alternatives to the two pillars strategy. The ECB admits that both the monetary targeting and the inflation targeting are not optimal alternatives. For the following reasons:

Monetary Targeting. It doesn't consider "the existence of information in macroeconomic variables other than money, which are important for monetary decisions aimed at price stability", in addition "some uncertainties about empirical properties of money in the euro area were created by the institutional and behavioral changes associated with the transition to monetary union, and more generally by the possibility that special factors might temporarily distort monetary developments"³⁰. According to this, the ECB is stating that it is not advisable to rely exclusively on monetary analysis.

Inflation Targeting. Firstly, "focusing entirely on a forecast inflation figure does not provide a comprehensive and reliable framework for identifying the nature of threats to price stability". Secondly, the fixed horizon of the forecast (two years) is somewhat arbitrary and in many circumstances doesn't appear to be optimal because many factors such as asset prices imbalances that affect inflation beyond the chosen horizon need to be taken into account. Thirdly, it is difficult to integrate the information contained in the monetary aggregates into inflation forecasts that are based on conventional macroeconomic models. Finally, the ECB takes the view that relying on a single forecast would not be appropriate, given the considerable uncertainty relating to the structure of the euro area economy³¹.

According to the motivations brought by the ECB to support its strategy - the two pillars - we can state that the bank seems to be aware of the risks of an excessive reliance on the money stock targeting - the monetary pillar - and it has also clear that a direct inflation targeting seems to be not optimal for the bounded horizon of the forecast. But given this, to avoid these issues, it pursues a

²⁸ Ibidem.

²⁹ Ivi., p. 16

³⁰ ECB, "The monetary Policy of the ECB 2001, May 201, p. 70

³¹ Ibidem.

monetary policy that, as Bonfingher writes, seems to be “a look at everything strategy”. In fact to conclude, the two pillars approach pays too much attention on the money stock trend, and the economic pillar simply states that the ECB is going to look at all relevant variables without missing any crucial information.

4.4 The Criticisms To The Core Of ECB’s Monetary Policy Strategy

The other line of criticism - the core - focuses on the basis of the ECB’s MPS: in fact its supporters emphasize unanimously that in the Eurozone the inflation target chosen close to 2 % by the ECB, is too low, so as making the MPS excessively tight and restrictive.

Linked to this issue, it is also argued that when symmetric shocks occur, the ECB has easy time to stabilize the economy, but not when the asymmetric ones happen. This is due to different growth stages and different economy’s structure of the European countries, which, for this reason, are more prone to asymmetric shocks than the symmetric ones³².

Therefore the asymmetric shocks paralyze the monetary policy strategy of the ECB so that it results controversial among the members of the Eurozone, incapable of improving the economic situation of a country without harming the economic growth of another one. The output growth differences ultimately lead to big inflation differentials among the member states so that the desired interest rate of a country differs from another country that face a different output growth³³.

These endemic booms and busts within the Eurozone economies could be offset by a high rate of labor mobility, which may bring the labor force from countries facing recession to those experiencing a boom. This process would increase the demand of labor in the booming countries so as pushing up the marginal wage per unit of labor, ultimately reducing and therefore stabilizing the new higher level of productivity in the country. In the end the process itself would act as a countercyclical policy so as to revert the occurred economic idiosyncrasies as well as offsetting the negative effect of the monetary policy stance.

Although in theory the labor mobility seems to be the solution, in practice, it doesn’t work cause of the huge cultural barriers existing in the European Union such as the different language between members. This crucial issue, in the end, makes the members of the EU-27 face different speed of growth so that the growth rate differentials instead of decreasing, exacerbate. This bring us back to the core of the problem, the growing fear that ECB is implementing a MP for the interests of few members³⁴ instead of doing the right thing for the weaker economies, those who really need a help.

³² P. De Grauwe, (2007), *Economics of Monetary Union*, Oxford University Press, Chapter 9: Monetary Policy in the Eurozone.

³³ According to De Grauwe and Goodhart this is a big problem for the ECB’s MPS because beyond the risk of deflation for some countries, it also creates large differences in real interest rates, which in turn generate self-reinforcing internal imbalances. Goodhart, C.A.E. (2006), “ The ECB and the Conduct of Monetary Policy: Goodhart’s Law and Lessons from the Euro Area “, *Journal of Common Market Studies*, Vol. 44 N. 4 p. 17

³⁴ I want to stress the fact that Germany and France accounts respectively 30 % and 21 % of the Euro Area GDP, almost half of the pie. Given the weighted average method (based on the GDP weight of each country on the total of the Eurozone GDP) used to decide the monetary policy strategy of the ECB, the level of interest rates is massively influenced by the needs of these two states. Two states out of seventeen influence the ECB monetary policy strategy more than what the other fifteens do. This makes the ECB monetary policy being country dependent, thereby exacerbating the inequalities between Eurozone members, which, as previously said, already suffer from the insurmountable cultural barriers existing between them.

However, on the other hand, as Goodhart underlines, the MPS of the ECB, by most of its criteria has been extremely expansionary³⁵. Many economists answer back to this statement by saying that the ECB should focus more on the real growth and less on the inflation, letting the latter float at higher values. In fact as De Grauwe affirms, the true inflation rate is overestimated by 0.5% to 1.5% and according to this he suggests that the right target value should be comprehended between 2% and 3%, adopting some flexibility around the new target in a symmetric way as already implemented by the Bank of England (2.5% with some leeway above and below it)³⁶.

To this strong criticism, the ECB counters that according to the neutrality of money that is a “widely accepted and empirically validated proposition, in the long run, the central bank cannot influence the economic growth by changing money supply”, in fact “a change in the quantity of money in the economy will be reflected in the change in the general level of prices”³⁷. In addition its supporters confirm that the benefits of maintaining price stability are the only way (indirect) for the central bank to stimulate the economic activity and employment in the long run.

But this very conservative position seems no longer shared even by the IMF. In fact, in its latest World Economic Outlook (2013) it openly criticizes the position of those central banks that reduce their actions to the attainment of the inflation-target only:

A more far-reaching approach would complement the inflation target with an explicit mandate to stabilize output. In this dual-mandate framework central banks' decisions would be based not only on their views about inflation, but also on direct measures of output and unemployment gaps. Central banks would thus have more discretion to allow inflation fluctuations if addressing them would exacerbate cyclical downturns³⁸.

5. The Responsibilities Of the ECB and Of the BOI In The Recession Of 2008: A Diagrammatic Explanation

To conclude the analysis, I'm going to investigate the hypothesis concerning the possible relationship between the speculative bubble started in 2003 and burst in 2007-2008, and the relative monetary policy adopted by the main central banks, focusing on the Bank of England and the European Central Bank. This case study, in my opinion, is very revealing of the attitude of the central bankers beyond the technical rules adopted. Amazingly, we will discover that the old style

³⁵ Goodhart, C.A.E. (2006), “ The ECB and the Conduct of Monetary Policy: Goodhart’s Law and Lessons from the Euro Area “, Journal of Common Market Studies, p.7

Here follows the criteria quoted by Goodhart:

“ 1) Both nominal, and real, interest rates have been at historic low levels. 2) M3 Growth and recently bank lending to the private sector have been surging well above their reference values. 3) The inflation rate, as measured by the head-line CPI, has consistently averaged over 2 % since 2000. 4) The short-term interest rate has been held somewhat below that consistent with a standard Taylor-rate estimate. “

³⁶ P. De Grauwe (2007), “ Economics of Monetary Union ”, Oxford University Press, Chapter 9: Monetary Policy in the Eurozone.

³⁷ ECB, “ The monetary Policy of the ECB 2001, May 2011, p. 55. According to the ECB’s MPS maintaining price stability: 1) Supports higher living standard, 2) Improve the transparency of relative prices, 3) Reduce inflation risk premia in interest rates, 4) Avoid unnecessary hedging activity, 5) Reduce distortions of tax systems and social security, 6) Increase the benefits of holding cash, 7) Prevent the arbitrary redistribution of wealth and income, 8) Contribute to financial stability (Ivi, p. 57)

³⁸ IMF, *World Economic Outlook. Hopes, Realities, Risks*, April 2013, Washington, p.94.

of the Directors and Governor of the U.S. Federal Reserve Board on the eve of 1929 crash – the “demoralizing silence” – is always in.

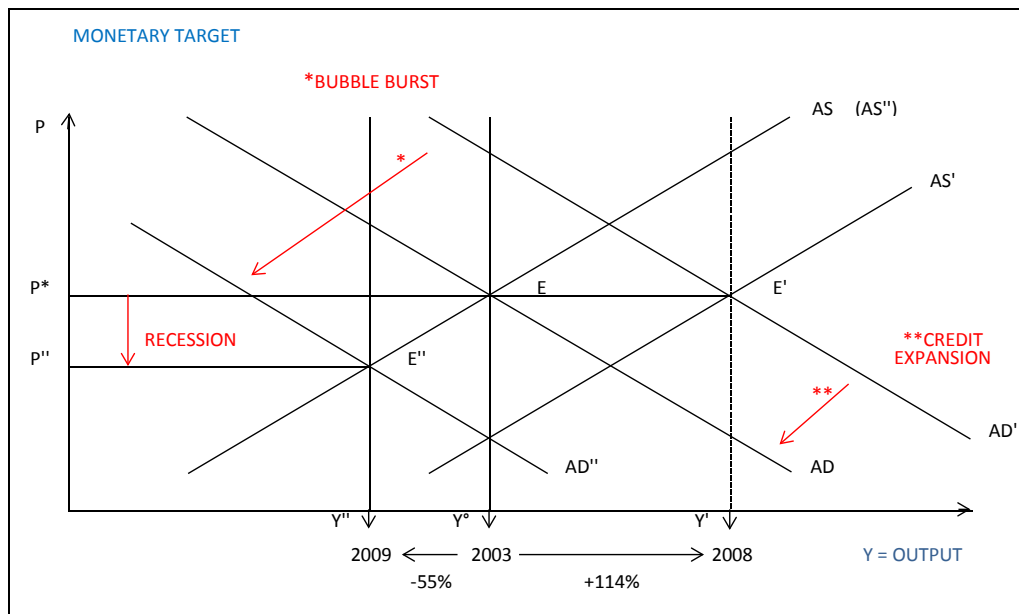
I will try to capture the essence of what happened in 2008 with a simple graphic representation of comparative statics.

This hypothesis has been developed in the recent years according to the growing concern for price stability as the only target for the central banks’ monetary policy, as we have explained in the previous section 4. In fact central banks, since the beginning of the twentieth century, have moved their focus from financial stability to price stability, looking at the former only as possible indicator to assess the inflation’s risk.

The hypothesis can be explained as follows: the external shock provoked by the stock market bubble was the effect of optimistic beliefs of investors and of excessive credit creation, to foster the *animal spirits* of the markets.

This bubble kept on growing for five years, and when it burst, created the worst world recession since 1929.

Fig. 1 Supply Shock: The Financial Crisis of 2008



According to fig. 1 we can see that the bubble and its linked optimistic expectations are set in motion from point E (2003) towards to point E’ (2007).

This process leads to an increase of the stock prices and to a decrease of the cost of capital. This provokes in turn, the shifting of the aggregate supply curve down, from AS to AS’.

The rise of the assets’ value produces a temporary “wealth effect”, which together with the credit expansion makes the aggregate demand shift to the right, from AD to AD’. According to these two simultaneous shifts of the AS curve and AD curve respectively to AS’ and AD’ the new equilibrium moved from E to E’.

This process accumulated energy for almost five years before bursting. In fact, according to fig. 2, the STOXX-50 Stock Price Index for the Euro-zone showed an increase between 2003 and 2007 about 114%, a rise of 23 % per annum.

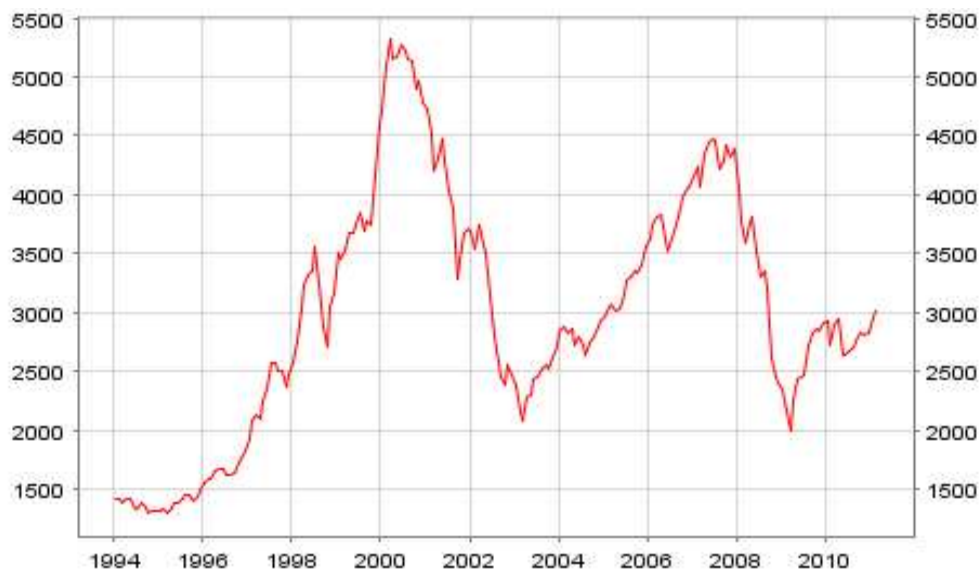
The fact is that the speculative trend of the stock market could be easily detected as shown by the graph. If it is compared with the stock market downturn of 2002, which was the evidence of the internet-bubble bursting, the similar sharp rise in the STOXX-50 till 2007 was a clear proof of the market's speculative behavior.

The problem was that the monetary policy of the Central Bank, oriented to fix the price stability at level P^* , wasn't scared of this artificial assets creation because the inflation target was still kept at the same level P^* thanks to the shifts of both curves to the new equilibrium E' . The target wasn't in any jeopardy, and so the Central Bank didn't make any interventions.

As we can see by figure 1, the broken line passing for point E' states that the new output level is unsustainable and temporary because it derives from the credit creation mechanism and by the virtuous cycle of optimistic expectations.

But when the bubble burst in 2008, thanks to the excessive level of debt reached, both curves AD and AS shifted sharply to the left respectively to point $AS''(=AS)$ and AD'' , but instead of keeping the initial level E, they overshoot the point, and jumped to point E'' , creating recession as well as financial and banking crisis. This overshooting created a loss of 55 % in STOXX-50 index in one year, bringing it back to the level of 2001.

Figure 2: STOXX-50 Stock Index



Source: http://www.stoxx.com/indices/index_information.html?symbol=sx5E

This example has shown us the bounded inflation target of Central Banks, which were aware of the situation involved, the double-digit growth rate of banks' loans between 2006 and 2007, but however they didn't do anything. According to them, the price stability was more important than preventing a crisis worldwide.

Conclusions

“Will it be 1929 all over again?” For longtime after, this was the most popular doubt for Americans when they fear for their prosperity, as remind us Galbraith at the end of his warhorse book on the 1929 crash.

This paper has used different methodological approaches to evaluate the distances existing between the current monetary system and the role played by the monetary institutions at the time of the Great Contraction. The European Central Bank has been the institution examined to assess the effectiveness of its Monetary Policy Strategy. The general aim was to answer to the doubts that too often the operations of the Central Banks don't have instruments for a *fine-tuning* of the economies, especially in hard times.

We used an historic approach, in section 2, to support the evidence that in the Great Crash not so much the lack of legislation but the “golden silence” of the Federal Reserve has been the problem. And afterward, in the 30s, the “mistakes” (Friedman) of the FED exacerbated the economic recession. If this has become a kind of archetype of what in history is meant as a “great failure” of a monetary authority, in section 3 we present a brief case of “ordinary failure” by comparing the inflation performance of the leading central banks in the decades from 1960 to 1999. In section 4, we critically appraise the so-called “Two pillar approach”, a methodological tool employed by the European Central Bank for assessing the risks to price stability (and choose the actions to achieve it).

Among the large literature concerning the subject, the paper surveys the contributions of Bofinger (2001), Goodhart (2006) and De Grauwe (2007) with the purpose of going at the roots of the “technical” difficulties on the effectiveness of the Monetary Policy Strategy implemented by ECB. The first outcome is the statement that – apart to agree that the money stock growth is an unreliable indicator to assess the risks to price stability – there is disagreement both on the criticisms and the proposed solutions.

The second outcome is the unanimity of the opinions that the inflation target chosen at 2% for the Eurozone – the “Second Pillar” of the MPS – is too low, thereby making the whole MPS excessively restrictive. Here it must be recognized that inside the countries of Eurozone – and just for the fact of having adopted the Euro – the same costs of the Gold Standard are experienced in terms of transmission of depressions between countries of the same currency area. In this sense, it is confirmed here a crucial point made clear by the pioneers of the monetary discipline after the master-paper of Robert Mundell *A theory of Optimum Currency Area* (1961)³⁹.

Finally, in section 5, we analyze the sequence in the behavior of the relevant macro variables that led to the 2008 crisis. Through a simple exercise of comparative statics, we observed that the “core” target of 2% assumed as a pillar of the MPS is in fact at the very basis of the ECB non-intervention policy from 2003 to the bursting of the bubble in 2008. For a simple reason: according to the ECB appraisals, the inflation target, in the period, wasn't in any jeopardy.

This can be considered a kind of litmus test - in a real case of strong emergency – of the operational ineffectiveness both of the devices and strategies in the arsenal of ECB. But this standpoint on the 2008 crisis is sobering.

Adding together the collected evidence of the five sections, we can answer to the question posed by the title of the paper that at least the ECB - among the others leading central banks - is far from doing the-right-thing-at-the-right-time, that is, being a reliable instrument of economic policy for the Eurozone.

This conclusion brings new water to Galbraith's warning concerning the right people's fears for their prosperity. At the same time, the arguments here carried out support the conclusion reached,

³⁹ R. Mundell, “A Theory of Optimum Currency Area”, *The American Economic Review*, Vol. 51, N.4, 1961. Mundell writes: “Under the gold standard depression in one country would be transmitted, through the foreign-trade multiplier, to foreign countries. Similarly, under a common currency, depression in one region would be transmitted to other regions for precisely the same reasons. If the gold standard imposed a harsh discipline on the national economy and induced the transmission of economic fluctuations, than a common currency would be guilty of the same charges” (Ivi, p.660).

more recently, by Reinhard and Rogoff (2009). In the Preface of their book – *Eight Century of Financial Folly* - they issue a warning against what they call “this-time-is-different-syndrome” which spreads across the world after the Second Great Contraction of 2008.

The essence of the syndrome consists in the following phenomenon:

Financial professionals and, all too often, government leaders explain that we are doing things better than before, we are smarter, and we have learned from past mistakes. Each time, society convinces itself that the current boom, unlike the many booms that preceded catastrophic collapses in the past, is built on sound fundamentals, structural reforms, technological innovation, and good policy.

This should certainly be a source of concern for policymakers. But the gains from the monetary union between the European economies may lie outside the common gains from trade. The motivation for the creation of the Eurozone may be more political than economic.

I want to conclude quoting the following lecture note of Erik Pentecost.

Monetary policy has always been a fascinating area of economic policy because of the nature of banking – a sector which lends long but borrows short – which makes for potential for periodic crisis endemic to the system. Economists who claim to have solved the problem or who offer monetary policies or institutional reform which purport to offer complete security from crises are nothing less than idiots. The practice of monetary policy is a practical art, which unfortunately, many academic economists do not appreciate and who therefore try to reduce it to a handful of very simple rules. Thus many financial crises are underpinned by the earlier adoption by bankers of some overly simple economic theory and never was this more true of the 2008 financial crash⁴⁰.

I want to emphasize the fact that Central Banks have also the responsibility to provide liquidity, supervision and regulation of the financial sector, so that financial stability should be placed at the same level as price stability. Although the former is much more complicated to assess, three useful indicators can be used: asset prices diverge from fundamentals, credit availability and market functioning experience distortions and ultimately the aggregate level of spending exceeds the economy’s ability to produce.

The ECB as well as the major Central Banks in the world were conscious in the years before the Financial Crisis of the excessive credit creation and the asset prices deviations from their fundamentals, but nothing was done.

The reasons why the no-acting strategy was put in place have been already discussed – the wrong focus and the wrong tools – nevertheless another reason can be taken into consideration, the one Stiglitz in its latest book - *The Price of Inequality. How Today’s Divided Society Endangers Our Future* - remarks as one of the main causes of the growing level of inequality. The nature of the financial sector, which, exploiting but also shaping the market inefficiencies, is seeking even higher capital rents to the detriment of the whole society⁴¹.

In this context where *the survival of the fittest* plays a key role in the unequal redistribution of the wealth within society, the Central Banks have the duty to readdress the Supervision and the Regulation of the financial sector – filling the inefficiencies of financial markets - thereby making them retaking the relevant role they deserve.

⁴⁰ E. Pentecost, (2011), “ The Conduct of Monetary Policy; Price Stability and Financial stability: A Trade Off? ”, University of Antwerp, Mimeographed, p. 20

⁴¹ J. E. Stiglitz, (2012), *The Price of Inequality. How Today’s Divided Society Endangers Our Future*, W.W. Norton & Company, New York.

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