



ON MONETARY POLICY PULLING AND PUSHING A STRING: WHY THE ECB NEEDS TO CUT INTEREST RATES AS SOON AS POSSIBLE

Autumn 2007 report from the ETUC on the macro – economic policy mix in the euro area

I. Introduction

The world financial crisis erupting over the summer has changed the discussion on monetary policy. Whereas the ECB had been set on increasing policy rates prior to the subprime crisis, policy rates are now being kept on hold and the ECB has been injecting massive liquidity into overnight money markets.

Nevertheless, the question needs to be raised whether this is sufficient. The analysis from the ETUC in this note shows that it is not: The ECB is seriously underestimating downwards risks to growth. To ward off a higher than expected slowdown, interest rates in the euro area need to be cut right now. If the ECB does not act and keeps a 'wait and see' attitude as it did in 2001, we run the risk of the euro area economy getting pushed back again into a prolonged slump with growth falling and remaining below 2%.

II. Recalling the basics: Why monetary policy should act today to address tomorrow's problems.

It is a well known fact that monetary policy has serious time lags and that it takes one to two years or even longer before changes in interest rates work their way through the different transmission channels before ending up in higher or lower aggregate demand and economic growth. The existence of these time lags imply that monetary policy should be forward looking: Future shocks to growth and slowdowns as well as upturns of the business cycle need to be anticipated well in advance by the central bank so that, when the future change in growth is about to occur it is matched at the same time by the impact on demand of monetary policy decisions taken some time ago.

Why is it so important for monetary policy to keep economic growth on track over time?

Consider what happens if monetary policy does not involve itself with 'time matching' and waits instead for the economic shocks to unfold themselves before acting. In that case, the economy gets fully exposed to the economic shock for one or more years. During this time, growth will be spiralling downwards (in case of a negative shock). However, poor growth performance over a longer period of time may in turn lead to negative expectations and negative confidence effects becoming entrenched. If this happens, the economy gets caught in a trap of low growth/low confidence, with households and investors keeping each other ransom. Households will be waiting on investors to invest and provide new jobs and income prospects while at the same time investors are postponing these investments because they in turn are waiting on households to spend money before investing. It is very difficult for monetary policy to escape from this kind of dead-lock. Even if liquidity is massively injected and interest rates are reduced, household and investors' worries about future jobs' and demand prospects will continue to dominate spending and investing decisions.

Is all of this far-fetched? Not at all. In fact, the euro area has gone through a scenario exactly like this over the first half of this decade. In 2000/2001, after hiking interest rates and triggering an economic slowdown, the ECB took on a 'wait and see' attitude. Interest rates were eventually reduced but in slow and hesitating way. Meanwhile, the economic slowdown and negative expectations got entrenched so that interest rate cuts, when they finally happened, had a less than desired effect. This 'catch-22' situation lasted for a couple of years until fiscal policy finally hit the right demand button by shifting consumer expenditure and household construction forwards into 2006 (German VAT hike), by shifting investment decisions forwards into 2006 and 2007 (German temporary tax measures) and by the French budget responding to social riots beginning 2006 by massively expanding job schemes.

So, to avoid a repeat of a policy in which the ECB itself paints itself into a corner and substantially reduces its own possibilities to 'kick-start' growth, a forward looking monetary policy with timely cuts or changes in interest rates is essential. Here, one can compare with to the famous quote of J.K Galbraith saying that monetary policy can pull a string but that it's much more difficult to push a string. Applied to the situation described above, it means that monetary policy should pull the string when this is still possible and before negative expectations having become entrenched and put the central bank in a situation in which all it can do is to try the impossible of 'pushing the string'.

III. The case to cut interest rates: Three weddings and a funeral

What do we find when applying these basic principles of monetary policy to the present situation?

Three major shocks impacting negatively on demand and growth over the coming quarters can be identified clearly. At the same time, underlying growth dynamics should not be overestimated. This implies that euro area growth performance is less robust than generally assumed and will be dragged down further by these three combined negative demand shocks. Thereby, the scene is set for an unwarranted slowdown in growth, pushing growth substantially below 2% and annihilating the catch-up in growth and jobs realised over 2006.

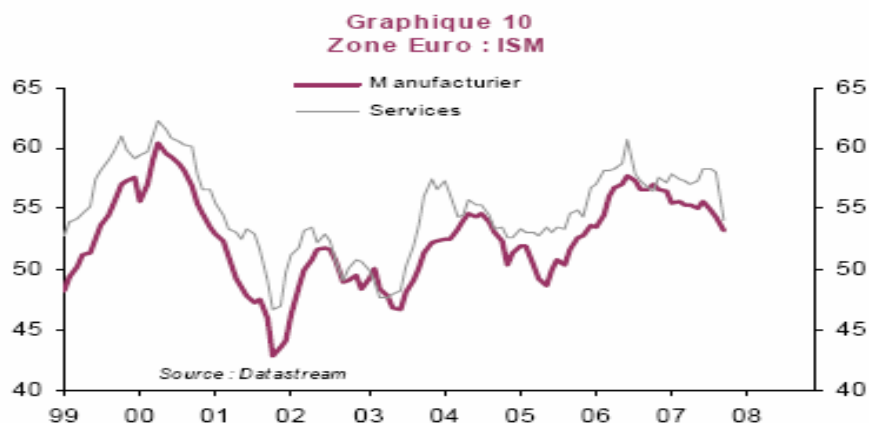
A. Underlying growth dynamics are not that robust: The slowdown is already there

To be sure, the 2.9% growth rate registered over 2006 and spilling over into the first quarter of 2007 (0.9% q-on-q growth) is indeed impressive. But it is plain wrong to think that a one year spurt in growth means that such growth performance can be taken for granted and will automatically repeat itself over coming quarters.

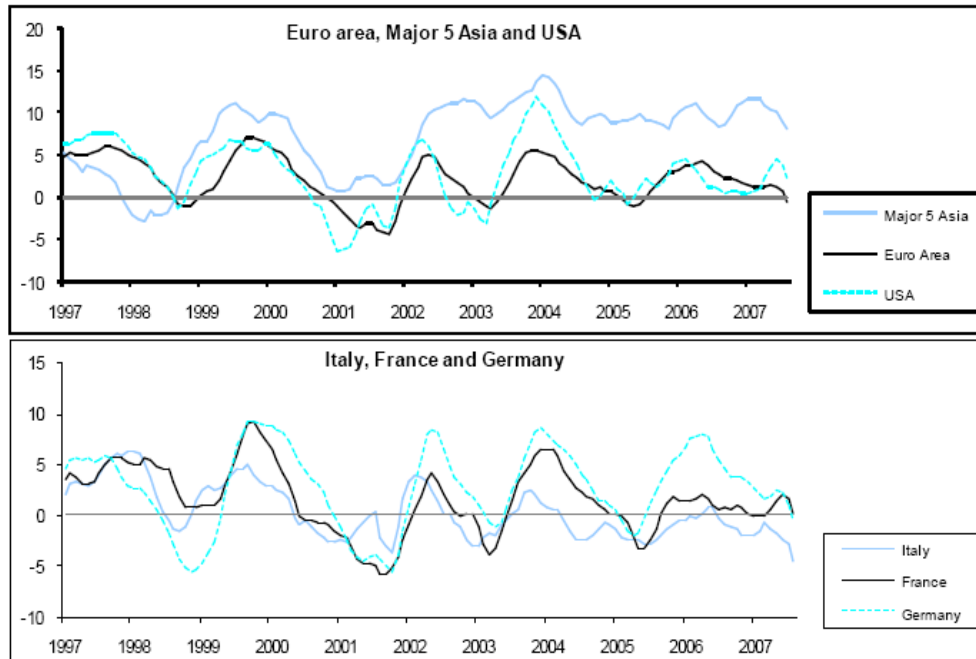
Firstly, the 2006 growth spurt is to a major extent the result of extraordinary demand measures being taken by a coordinated fiscal policy stance by Germany and France, as described above in point II. However, these measures are temporary and will no longer boost growth in 2007 and 2008. In fact, since part of consumption, construction and investment demand in particular in Germany has been brought forward from 2008 and 2007 into 2006, even a certain backlash in demand may occur.

Secondly, policy has changed. From end 2005 on, interest rates have been tightened. This does not come without a cost to growth. In particular, the interest rate hikes over the first half of 2006 are now starting to show up in economic performance. Indicators tracking purchasing intentions of managers in industry and services (PMI's) are turning the corner, with a pronounced fall in Germany. Leading indicators for industrial production (OECD composite leading indicator) are conveying the same message (see following graphs).

Graph I: PMI indicators

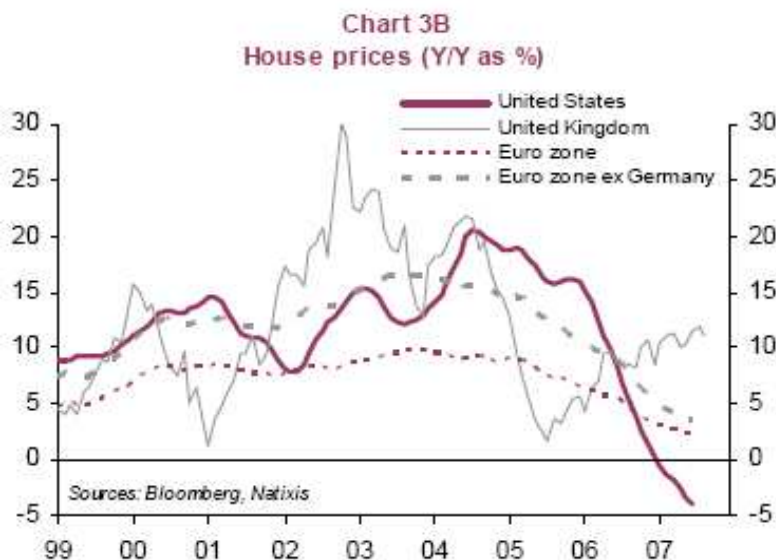


Graph II: OECD leading indicator, 6 month change



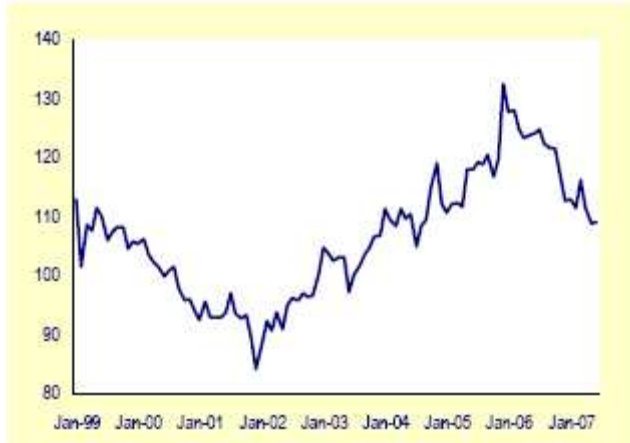
Moreover, and importantly, the housing bubble has started to deflate. Housing price increases have come down from spectacular two digit growth rates only two years ago and are now close to zero growth. At the same time, quantities on the housing market are also adjusting downwards, with residential building permits in the euro area falling from its peak beginning 2006 (see following graphs).

Graph III: House price growth decelerating sharply...



Graph IV: ... and construction activity slowing down as well

Graph 3: Residential building permits, euro area
(Index 2000=100 – Jan 1999 – June 2007)



Source: Commission services.

Given the fact that construction activity has been supporting overall growth in the euro area (and in Spain and Ireland in particular) over the past period by 0.2 to 0.4% each year (Commission figures), we now already have a construction based slowdown on our hands. This also has implications for wage formation, both for the euro area as a whole as well as for those countries where financial innovation techniques produced a particular strong housing boom by linking mortgage lending rates to three month interbank lending rates (Spain for example). In other words, the inflationary wage danger, if there ever was one, has already disappeared. Monetary policy has already done its job of pricking the debt and housing price bubble in particular in those countries experiencing such a bubble and with that the eventual possibility of an acceleration of wages and inflation in those same countries.

B. Demand shock number one: More impact of past monetary tightening yet to come

If, at present, the euro area economy is already coming down from high growth rates of 2.9%, what can be expected for coming quarters? One factor working to reduce demand and growth rates in near future has again to do with the time lags of monetary policy. If interest rate hikes from the first half (or first three quarters) of 2006 are already now producing a turnaround in growth, then a further and sharper turnaround is still in the pipeline, coming from

interest rate hikes which occurred in the more recent period covering end 2006-first half of 2007.

Here, the question needs to be raised whether the ECB is not running the danger of getting engaged in producing a 'monetary overkill'. A related question is what exactly the ECB is pursuing as its objective. Indeed, it is one thing to bring housing prices (and the related build up in debts) down from two digit growth rates to growth rates closer to zero, thereby also cooling down some euro area economies where growth perhaps indeed risked getting out of control. But the picture radically changes if the ECB also has the objective of correcting 'past exuberance' and actually staging a **fall** in housing prices so that these asset prices are brought back closer to their initial level.

If indeed some ECB board members have this strategy in their mindset, then three things need to be stressed:

- Ensuring price stability and stabilising the economy form the mandate of the ECB. This does not include attempts to mimic markets and to set the absolute price of individual goods, let alone the price of individual assets.
- In contrast with the US, where monetary policy has overshoot and housing markets and construction are collapsing (there is now a stock of 4 million unsold houses in the US, worth several years of construction activity), the housing market in the euro area is simply cooling down but not (yet) shrinking. We should keep it that way and avoid the trend of cooling down to overshoot in Europe as well into a shrinking of construction activity.
- Finally, the lessons from Japanese deflation need to be taken into account. At the beginning of the nineties, the Japanese central bank also pricked the housing bubble by hiking interest rates. Not content with the fact that housing prices were simply stable instead of falling, the Japanese central bank held interest rates high despite the fact that the economy had already gotten into a slowdown. The end result was a worsening of the crisis, tipping the Japanese economy into deflation, a situation which is now lasting for about a decade and from which Japan has major difficulties to escape from. **The ECB however does not want to repeat that deflationary experience for the euro area.**

C. Demand shock number two: A structural bias for the euro to appreciate

In the period 2003-2004 and 2006-2007, the euro has been appreciating against the dollar, leading to a rise in the effective euro exchange rate and already reducing cost competitiveness of euro area exporters.

However, several structural forces are working together to produce further weakening of the dollar and a stronger euro in coming years:

- With construction activity in the US falling and with a stock of 4 million unsold houses, the US is in for a sizeable and prolonged slowdown in economic growth. The Federal Reserve will react to that (as it already has) by cutting interest rates and by accepting a further fall in the dollar. In fact, economic policy discussion in the US widely agrees on the need to have a falling dollar as a policy answer to the US slowdown and the only disagreement here seems to be whether the dollar should fall by 30 or by 60% and whether this fall should be immediate or protracted.
- After the subprime crisis, the appetite of international investors for dollar denominated asset backed securities has dwindled, impacting negatively on the international demand for dollars
- The huge external deficit if the US works in the same direction: a cheaper dollar and an expensive euro.
- Foreign currency reserves, held by central banks in the world, will continue to shift from dollars into euros, as they have done in the past (see table). And, perhaps even more so now, central banks in the world expect further dollar depreciations and with Asian (Chinese) central banks pressed by the US to let the dollar fall or else face political retaliation and anti-dumping initiatives.

Table I: Structure of foreign currency reserves held by central banks, in %

First quarter	US dollar	Euro
2002	71.6	19.7
2003	67	24.7
2004	67.5	23.6
2005	65.3	25.2
2006	66.3	24.7
2007	64.2	26.1

This has important implications for monetary policy inside the euro area. If there's a structural for the euro to appreciate, then there also needs to be a corresponding bias in monetary policy to be expansionary. More expansionary monetary policy than otherwise would be the case is both possible as well as necessary :

- Possible because a bias for the euro to appreciate means the euro area is importing disinflation so that price stability is guaranteed.
- Necessary because domestic demand needs to be beefed up to compensate for the losses in demand coming from reduced competitiveness.

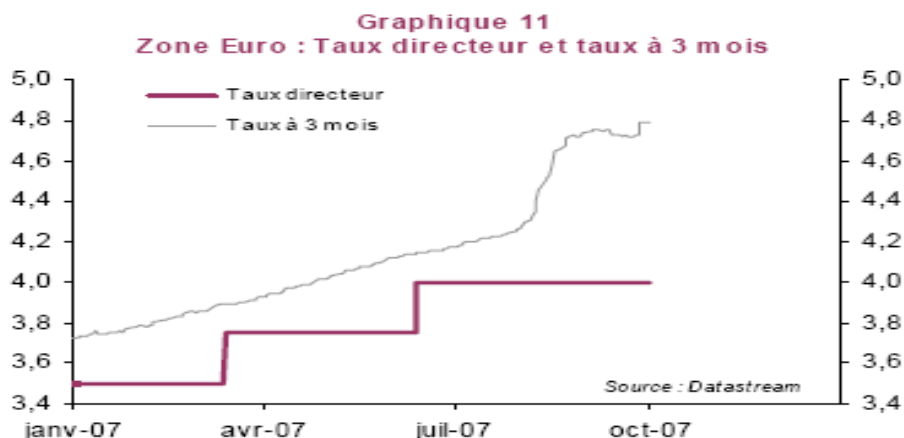
D. Demand shock number three: Fall out from the subprime financial crisis

On top of all of this comes subprime as a third negative shock impacting on future expected aggregate demand dynamics.

To start with, the subprime crisis has had the immediate effect of pushing three month money market rates up by 40 to 50 base points. Whereas the spread between three month interest rates and the ECB's repo rate is normally about 10 to 20 base points, the spread has now shot up to 50 to 70 base points.

In other words, what money markets have been doing since August is to tighten monetary conditions substantially. Even if the ECB has renounced on increasing its repo rate, the effective interest rates paid on the market has shot up anyway. Put differently, the ECB did not need to hike interest rates because the market has done that in its place, in this way even producing a 50 base point hike (see graph V). Notice here the different reaction from the Federal Reserve, cutting policy interest rates beginning September and in that way ensuring that, despite higher spreads, effective market interest rates returned to the level before the subprime crisis hit.

Graph V: Euro area: The same means more



But, unfortunately, there's even more to subprime. Subprime not only has a cost side (the price of interest), it also has a quantity side (credit squeeze). With subprime, general risk aversion has

increased, leading banks and other financial actors to tighten credit standards. Moreover, with banks incurring losses on subprime, on asset backed securities, on investments to be sold immediately because of liquidity problems, bank's capital gets destroyed. In turn, this triggers banks to adopt tighter lending standards in order to continue to respect capital requirement ratios imposed by the Basle II agreement. There are already indications of banks changing their lending behaviour. Merrill Lynch for example reported in September that two thirds of lending officers in the US and Europe are in the process of cutting credits.

Again, the dimension of time lags involved is to be noted. From past experience it appears that it takes about 12 months before a tightening of credit standards shows up in a wave of company defaults. So, if the ECB is keen on counteracting the impact of this on aggregate demand (as it should be), then, again, interest rates need to be cut right now.

Will subprime and the related financial turmoil go away out of itself? No, the subprime crisis is likely to stay, certainly in the next year or two. This can be deducted from the pattern of so-called 'resets'. It is these 'resets' which are at the basis of the whole subprime debacle. US mortgage agencies have used 'predatory' practices to sell mortgages to households unable to afford these and they have done so by granting 'grace periods': During the first two years of the 30 year mortgage loan, no or reduced interest needed to be paid. These 'grace periods' are gradually coming to an end, triggering so called 'resets' of interest rates. Households now finding it unable to afford the full mortgage payment default on their loan, causing shockwaves of losses on asset backed securities throughout the entire financial system of the world. **The bad news unfortunately is that the volume of US mortgage loans coming up for a 'resets' will continue to increase all throughout this year and well into 2008 (see table). More unexpected losses in the banking world and continuing distrust amongst financial players will therefore remain with us for quite a while.**

Table II: Amounts of subprime loans coming up for a 'reset' (billion of dollars)

2007 Q1	41
Q2	57
Q3	86
Q4	112

2008 Q1	118
Q2	108
Q3	114
Q4	77
2009 Q1	31
Q2	14
Q3	20
Q4	23

IV. Conclusion: Rounding up the case for a cut in ECB interest rates

This note has shown that the case for the ECB to cut interest rates right now is actually quite overwhelming. It is based on the standard but basic insight that monetary policy should look ahead and get in front of the economic curve in order to stabilise the macro-economy. If underlying growth is already weakening substantially, and if on top of that demand will be shocked further in coming quarters by past monetary tightening still in the pipeline, by the structural trend for the euro to appreciate, by the fall out from the subprime crisis, then there is no excuse not to cut interest rates immediately.

