# Summary on
# The ECB and Its Watchers IX

### *held at September 7, 2007 in Frankfurt Main*

*The 9th ECB and Its Watchers Conference held on September 7, 2007 was the first conference without Otmar Issing on the ECB side of the debate. Compared to previous years, in which panel discussions dominated the agenda, this year's program followed a new format with a series of debates between two or three speakers, in all but one case involving a European policy maker. "The strong representation of the ECB Board and Governing Council at this year's conference provided a clear signal that the ECB remains committed to this aspect of its communication strategy and dialogue with ECB watchers in academia, financial markets and the media," according to conference organizer* ***Volker Wieland****.*

*Indeed the conference took place at a significant time concerning the discussions on ECB monetary policy strategy, adequate policy responses to diverging unit-labor costs, and budget consolidation in Europe. Importantly, the ongoing liquidity crisis and credit crunch in the U.S. and Europe and respective policy recommendations received particular attention.*

As the first speaker, ECB President **Jean-Claude Trichet** addressed the audience with a presentation on the "Euro Area and its Monetary Policy". Trichet began by explaining that from time to time exceptional situations may require exceptional decision making by central banks such as "refinancing the money market to help it normalize its functioning" with respect to the liquidity crisis. However, as critical as such activity may be to the markets, he reminded the audience that it makes up only a small part of the central bank's tasks. In the current situation, Trichet encouraged critics to "resist the temptation to focus on the drama of emergency medicine," and trust the policy makers' ability to monitor the "new facts" (i.e. economic shocks) as well as the "regularities" (i.e. the deep structure of the economy), which could lead to possible adjustments in the long-run.

Trichet pointed out that these regularities and new facts tend to drive the long-run outlook. He demonstrated that since January 1, 1999 output in the euro zone has not only been in line with that of other countries but inflation has also been lower and quite steady in comparison. Furthermore, the euro area has experienced remarkably low volatility concerning inflation and de-trended output, implying that "EMU has kept inflation in the vicinity of levels consistent with our objective, without this having caused abnormal swings in business conditions," according to Trichet. He went even further by saying that in spite of the nominal rigidities evident in the structure of the euro area, the ECB seems to have been able to "improve the inflation-output volatility trade-off by eradicating intrinsic persistence from the economy."

Trichet concluded that the ECB does not simply measure the performance of the economy "by the strength or weakness of any particular piece of incoming news" in the last couple of months, but continues to investigate and focus on the economic trends given the evidence it gathers on a continuous basis. As volatile financial markets give cause for increased uncertainty, the ECB stays alert, collects further data and examines the information in order to draw further conclusions. The ECB president reassured the audience that "by acting in a firm and timely manner we will ensure that risks to price stability over the medium term do not materialize and that medium term inflation expectations remain firmly anchored in line with price stability."

## The Role of Money in Monetary Policy

In the debate about the role of money in monetary policy, **Jürgen Stark** (ECB) stressed enhancing the ECB's monetary analysis, because it has proved the best possible strategy to conduct policy for the euro area. "To stay fit for the future," Stark underlined the importance of improving and broadening money demand models, as well as assigning a more important role for money and credit in the development of general equilibrium models. In addition, he pointed out that they aim to enhance transparency and robustness of summary indicators derived from broad monetary analysis concerning the risks to price stability. On this context, he suggested deepening the cross-checking framework in order to strengthen the monetary pillar.

Stark criticized that some of the academic ECB observers had failed to give adequate advice on how to achieve price stability. In the standard New Keynesian Model, money does not have a special role to play in monetary policy. However, this is false. In the transmission of monetary policy, the ECB has found money aggregates to play a significant role in achieving price stability. Its approach aims to assess financial data as well as broader economic aggregates and to create empirical models explaining variability in money and price developments. It includes informed judgments and forms the basis for a consistent, analytical framework. Stark reiterated that the monetary pillar will not be eliminated from the ECB's strategy, but used increasingly to conduct euro area monetary policy in the future.

In response to Jürgen Stark, **Paul De Grauwe** (K.U. Leuven) took the opposite stance on the role of money in monetary policy. Although he admitted, that it had been a great success of the ECB to anchor the inflation rate at around 2% since 2000, De Grauwe observed that money growth fluctuated to a great extent during the same period. In fact, money growth exceeded the reference value of more than 4.5% most of the time. In short, "M3 has had zero power in predicting future inflation in the euro zone since 1999," according to De Grauwe.

The reason for the rapid money growth, which does not affect inflation, may not necessarily be a sign of too much liquidity creation. De Grauwe instead noted that "it may reflect the new activities of banks, which have been issuing longer-maturity liabilities back by shorter-maturity assets." The developments of the past months are such that hedge funds have taken the role banks used to hold of borrowing short and lending long. On the one side, the ECB should worry about such trends of liquidity, but it looks at the wrong indicator in the money aggregate M3. This, in turn, implies that it does not get the right signals about inflation. On the other side, the ECB should not be concerned, because the increased creation of liquidity by hedge funds does not make groceries more expensive i.e. influence the CPI. However, hedge funds create liquidity by buying assets and hence, create asset price inflation. It is such asset price inflation that the central bank should be concerned about according to De Grauwe.

## On Signaling the Future Interest Rate Path

The second debate dealt with the question of how central banks should signal their intentions regarding future interest rates. **Axel A. Weber** (Deutsche Bundesbank) opened the discussion by reiterating the continuous effort by central banks to improve communication, in particular concerning the determinants of monetary policy decisions as well as policy objectives and strategy. However, Weber questioned the case for publishing future interest rate intentions. Central bankers rightly hesitate to communicate an interest rate path due to the risks involved in making a premature commitment, due to the complications in achieving consensus in decision making by committee, and due to complications in ensuring that the path is consistent with

overall process implied by the chosen strategy. Weber notes that if proper signaling of future intentions fails due to these complications then policy effectiveness may deteriorate substantially.

Weber stressed that central banks should indicate their intentions for the future interest rate by first improving communication on policy objectives and strategy so as "to increase their influence over longer-term rates and therefore enhance policy effectiveness." Second, policy success relies on the private sector's ability to detect and understand the changing environment, in which to expect a general policy path of the central bank. Third, the private sector must comprehend the "systematic response" to new data. Fourth, communicating the interest rate path may be beneficial in theory, but may come at a high cost when put into practice. Last, research verifies that the euro zone has been doing well in directing market expectations.

**Charles Wyplosz** (HEI Geneva) complimented the ECB on its communication strategy of the past several months and pointed to the overall progress central banks have made in practice and research. Wyplosz did, however, hint at different views with respect to transparency and, like Axel A. Weber, explained the arguments for and against a central bank communication strategy being too transparent. Developing approaches for revealing the expected interest rate path currently represents the "frontier" of central banking. Central bankers are always asked what the interest rate will be. Sufficient statistics would include all forecasts and model assumption used by the decision makers. They would also incorporate policy preferences and the range of uncertainty. Nevertheless, there needs to be a clear distinction between transparency and commitments, because the interest rate path can change with new information and appraisal. There is also a difference between expectations and commitments due to uncertainty and alternative possibilities. Finally, Wyplosz reminded the audience that some central banks are not entirely independent but are influenced by politicians.

The last speaker in the second debate was **Julian Callow** (Barclays Capital), who presented the *Barclays Capital Investor Survey of Central Bank Communication* (August 2007) carried out for the purpose of this debate. In the survey 1183 Barclays clients from different geographical and professional backgrounds answered a list of questions, focusing on their understanding of central bank communication. Generally, these clients believed that central banks should communicate their future policy intentions to financial markets. All in all, participants responded that they understand and have confidence in the major central banks' objectives. The ECB as well as the Federal Reserve System received similar results on the questions asked. Overall, the ECB appears to have done well in communicating to financial markets according to this survey.

## Diverging Unit-Labor Costs in Europe and The Proper Policy Response

**Lucas Papademos** (ECB) opened the debate on this topic by focusing on the causes and consequences of inflation and competitiveness divergence in the euro area as well as needed policy responses. He emphasized that the dispersion of unit-labor cost growth in the EMU has declined substantially in the last fifteen years and "although it is still appreciable, it is not unusually large and it is broadly in line with that observed in other monetary union."

Nevetheless, there exist unfavorable trends regarding competitiveness for some EMU countries, where unit-labor growth divergences are considerable and such developments will, in turn, affect growth and employment. According to Papademos, these unit-labor cost growth divergences are significant and a clear understanding of their causes is required. This can be achieved by first analyzing the individual components of unit labor costs—typically exceptionally strong wage growth, low productivity growth or both combined. Examples of such developments are Greece,

Italy and Portugal. Secondly, further causes become visible by studying the unit labor cost trends in various sectors of the economy. Between 1999 and 2005, unit-labor growth has been higher in the service sector in most euro countries. "Thus, the key factor behind the stronger unit-labor cost growth in the services sector compared to industry appears to be weak productivity growth in services, which may reflect, among other things, the fact that this sector is relatively less exposed to international competition," summarized Papademos.

Understanding the causes of diverging labor-unit growths as well as considering its consequences allows policy makers to respond accordingly. Countries like Germany have already achieved higher productivity growth and increased non-inflationary employment by initiating new reforms, carefully setting wages and keeping up stability-oriented fiscal policies. Other European countries should follow in these footsteps.

From the Ministero dell'Economia e delle Finanze **Ignazio Angeloni** reviewed the significant stabilization of unit-labor costs after the implementation of the euro. Before 1999 the average dispersion of unit-labor costs in the private services sector had been 2.2%. After January 1, 1999 the average dispersion decreased to 1.5%. Yet there are some divergences in that Germany and Austria have relatively low unit-labor costs, whereas Spain and other countries experience very high unit-labor costs consistently since 1999. Germany in particularly, seems to stand out against other euro trading partners and benefit from better competition. "There is an issue not a problem," according to Angeloni, who sees not only price but also quality competitiveness among the EMU countries. Some countries have pick up on the rules of monetary union while others less so.

With respect to finding the adequate policy responses, Angeloni proposed functioning national and international labor markets, which are flexible, mobile, transparent and competitive. He also recommended consistent public sector leadership on the national level as well as appropriate monetary policy on the international level.

Following Lucas Papademos and Ignazio Angeloni, **Joachim Fels** (Morgan Stanley) signaled the diverging development in cost competitiveness in the euro area since 1999 and noted the significantly lower unit-labor costs in Germany in comparison. Nevertheless, he also illustrated that the wage levels give a different perception in that hourly compensation in manufacturing is exceedingly high, particularly in Germany. Wage growth is diverging more than productivity growth in the euro area. Furthermore, there exist big deviations in price levels from absolute purchasing power parity.

According to Fels, the conclusion for monetary policy in this case is twofold. If there is confidence in convergence, these trends present exactly what should happen and the ECB need not be concerned. Yet, if the focus is on the different price levels and there is too much pressure on the high cost countries, it may be necessary to resist inflationary pressures.

### Successful Budget Consolidation in Europe<br>Questioning the Revised Stability and Growth Pact

In the fourth debate of the ECB and Its Watchers conference, **Pervenche Berès** (European Parliament and Committee on Economic and Monetary Affairs) began presenting some basic facts on the issue of budget consolidation in the euro area. Before the Stability and Growth Pact had been reformed, exactly thirteen countries had to follow an Excessive Deficit Procedure in 2005. At this point, only seven countries must follow such a course of action, which are namely Italy, Portugal, the U.K., the Czech Republic, Hungary, Poland as well as Slovakia. She further

highlighted that in 2006 the EMU's average budget deficit had been 1.6% compared to the 2.5% in the previous year. Despite such progress, Berès questioned whether such improvements will continue to be achieved in the future, particularly given the financial unrest of the past months.

"Since the introduction of the new rules coincided with an economic upswing, it is hard to make an accurate assessment at this stage," implied Berès with respect to the reform really improving the budgetary difficulties of the countries. She advised observing a full economic cycle in order to analyze how the reformed Stability and Growth Pact performs in an economic downturn. Regardless of such reservations, Berès stressed a number of key points: recent budget deficit improvements show that the reform was a significant first step, fiscal policies which are not cooperative will not be successful in the future, further moves are necessary and improved governance needs to be accomplished in the euro area.

**Teresa Ter-Minassian** (IMF) also posed the question whether the budget consolidation in Europe shall continue. According to her, those EMU countries which have not yet met their medium-term objectives, have committed to accelerated correction. However, the increased tax revenues may trigger unnecessary spending. There are still a number of European countries that carry very high public debt and the convergence to meet the Maastricht criteria might be very slow. Key issues such as an aging population as well as climate change and globalization, may lead to considerable long-term spending pressures. The medium-term objectives are not insignificant, but they do not suffice to guarantee long-term sustainability. Like Pervenche Berés, Ter-Minassian agreed that the reform of the Pact was a first, positive step. She advised to "consider aging-related expenditure pressures in the medium-term objectives, strengthen incentives to avoid pro-cyclicality in good times and to allow counter-cyclicality in bad times."

**Wolfgang Münchau** (Eurointelligence) agreed that the revised Stability and Growth Pact has been working well under the boom conditions in the past two years. Nevertheless, he debated that the ultimate test of the pact will not be on a technical point, but rather whether there is a political commitment behind it in the future. As France is heading for a 3% budget deficit at the height of the economic cycle, Sarkozy's proposals on industrial, competition and fiscal policies should be taken very seriously compared to the German fiscal consolidation plan. The euro zone finds itself back in the situation of the early 1990s, with conflict between the two largest EU countries, which raises the question of sustainability. Furthermore, Münchau considered economic diplomacy as a means to improve economic policy coordination. In the past years, Europeans have focused on developing the economic system. In the future, they need to develop political consensus on the basics of economic policy.

**Liquidity Crisis and Credit Crunch in the United States and Europe -**
**The Policy Makers' Response**

An important item on this year's ECB and Its Watchers agenda was the concluding debate on the recent financial disruptions in the United States and Europe. **Stephen Cecchetti** (Brandeis University) opened the discussion. He termed the crisis "the crisis of collateral" or "crisis of un-collateralized lending," in which nobody knows what the collateral really is anymore. Its warning signals are mounting risk premia, the dramatic decline in the readiness to accept collateral of uncertain quality and the move of borrowers from direct issuance to bank credits. However, for Cecchetti the origins of the crisis were badly functioning supervision, inadequate regulation of sub-prime mortgage creators and the complicated design of securities too complex to assess.

U.S. policy makers have responded to the crisis in several ways: the Federal Reserve has officially intervened through open market operations as well as lowering the discount rate in the

month of August. Furthermore, Cecchetti showed evidence that the Federal Reserve also lowered the federal funds rate unofficially for a while. Noteworthy is also that for the first time the Federal Reserve accepted any security as collateral on August 10 for the $35 billion worth of repos it engaged in that day. What came in as collateral were mortgage-backed securities, whereby the Federal Reserve encouraged financial market participants to value mortgage pools sensibly, speculated Cecchetti. With respect to the discount rate, banks have been very reluctant to borrow from the Federal Reserve in the past. This is so because of the stigma involved, which tied frequent borrowing automatically with bad bank management. At this time, the reason is the simple fact that borrowing from the Fed is too expensive, in addition to information disclosure: somewhere along the line it will sink through who has borrowed and how much. This leaves the question whether central bankers have the right equipment to deal with the crisis.

**Michael Dicks** (Barclays Wealth) started by presenting his approach to analyzing market developments. He prposed to partition shifts in asset prices into a component that might be termed 'warranted' by fundamentals and a component that is not. Such an attempt is best developed in a formal framework or model. He argued that the "current economic and financial market conditions warrant the rare situation of 'big values' being placed on the 'unwarranted' shifts. And that ought to mean shifting policy in a meaningful fashion, compared with what was formerly required or planned."

Dicks considered lessons learned from the U.K.'s housing experience during the 1980s and 1990s and their potential application to the United States today. He explained that a period of financial market consequences had lead to an expansion of home ownership rates, in particular for those nearer the bottom of the income scale, as well as an increase in debt-income ratios for the household sector, especially for first-time buyers. Dicks further noted a rise in house prices (nationally) that appeared to push their level above what was warranted (in terms of traditional models of house-price determination) and an associated boost to consumer spending via wealth effects .

Dicks pointed out that with the benefit of hindsight: "we would not have put so little weight on housing, as a driver of consumption, and thus been quicker to recommend the Treasury raise rates (during the 1980s' 'boom') and cut them (during the following 'bust'),". He projected that "the housing marking slowdown is likely to turn out to be more painful than generally expected" and offered a cautionary message for policy makers in that traditional models are likely to turn out overly optimistic regarding consumption and growth. He concluded "Policy makers ought to cut rates to offset the surprise and don't be surprised if the surprises are serially correlated."

*At this year's conference, the CFS welcomed 16 renowned speakers from government, academia, private banks and institutions, international organizations and central banks to present their answers to these key issues. More than 200 participants actively took part in the conference along with a new record number of 60 media and press representatives to report on the event.*

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