The ECB should focus on the threat of deflation rather than maintaining austerity

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The European Central Bank will hold its latest policy meeting today. Ahead of the meeting, **David Woodruff** *writes that while growth has resumed in the Eurozone, there are still serious problems across the single currency area, with unemployment at exceptionally high levels in several countries. He argues that the ECB's primary focus should be on preventing deflation, and that it should look beyond a narrow preoccupation with deficit reduction and austerity policies.*

Today, the European Central Bank will hold a particularly significant policy meeting. The macroeconomic situation in the Eurozone remains exceedingly grim. Growth has resumed, but very anaemically. Overall unemployment remains near record highs, and youth unemployment is catastrophic. Meanwhile, with prices rising at only 0.5 per cent a year, and falling outright in some countries, the risk of the Eurozone sliding into deflation is real. Even if deflation is avoided, enduring 'lowflation' would be a major macroeconomic drag.

So, will the ECB act? Bundesbank head Jens Weidmann, who has consistently argued for restrictive monetary policy, caused a stir recently when he suggested that he would be open to quantitative easing (in which the central bank buys securities to inject money into the economy and promote borrowing for investment). One obvious context for his remarks is the strength of the euro. Germany's strong economic performance in the midst of the Eurozone disaster has been possible because it has directed exports away from the currency bloc to markets further abroad. A stronger euro threatens this.

There is, however, a second and more political context for Weidmann's remarks. Although Eurozone countries responded to the financial crisis with a sharp rise in deficit spending in 2009, since then the emphasis has been on cutting budget deficits through austerity. Austerity has gone hand-in-hand with an effort, spearheaded by the ECB and the European Commission, to impose a neoliberal agenda (cuttingly and impressively analysed here by Fritz Scharpf). In effect, Europe has had its own version of what the Tories are attempting in the UK, where calls for fiscal austerity enable an attack on the welfare state.

Mario Draghi, Credit: World Economic Forum (CC-BY-SA-3.0)

The Tories have accompanied this with an effort to minimise the growth consequences by more or less open support for a dovish central bank policy (exemplified by the appointment of Mark Carney has head of the Bank of England). In Europe, too, loose central bank policy has done something to compensate for contractionary fiscal policy, though the ECB has not been as active as its UK and US counterparts. ECB policy has encouraged banks to buy securities, including government debt, which could be used as collateral. The ECB has also intervened to hold down interest rates on Spanish and Italian bonds in the face of market panic, and through its Outright Monetary Transactions policy has promised to do so in the future. While ECB sovereign debt purchases were not a monetary policy measure (the purchases were sterilised – the ECB sold an equivalent amount of other assets to negate the monetary effects), they did contribute to some blunting of the pressures for austerity emerging from high interest payments.

However, the 'austerity/neoliberalism plus loose monetary policy' formula has always been riven with more political tension in the Eurozone than in the UK. Leaders of the ECB – both Mario Draghi and his predecessor Jean-Claude Trichet – have strongly supported the austerity/neoliberalism agenda, but have not been able to rely on an organically pro-austerity government in the Tory mould. Fearing that loose monetary policy may reduce the pressure to pursue this agenda, the ECB leadership has sought ways to make monetary relaxation implicitly or explicitly conditional on adoption of particular policies (for convincing evidence of this point, see Neil Irwin's *The Alchemists*). In this effort, Germany's reluctance to see any monetary easing has offered the ECB critical leverage. In effect, the ECB has played 'good cop' to Germany's 'bad cop', threatening to defer to German tight-money leanings if it does not get its way.

Over the past 18 months, Eurozone monetary policy has drifted to a more restrictive stance. As banks repay the ECB's liquidity loans, the result is a significant quantitative tightening. Meanwhile, to the consternation of Germany and 'austerians' at the European Commission and the ECB, both Italy and France are demanding a slower pace of deficit reduction in the aftermath of recent political upheavals.

This is, then, the political context of the ECB's decision this week. I suspect that Weidmann and other supporters of austerity are grappling with a political dilemma they find very difficult. Should monetary policy be loosened to ease the political difficulties of austerity (a shift towards the UK model)? Or would such a shift, in the absence of any implicit political conditionality, on the contrary sacrifice a chance to bring French and Italian leaders to heel?

Weidmann's remarks suggested he was seeking to square the circle; he emphasised that government bonds should not be among the assets purchased for quantitative easing. I do not know how the ECB will decide. But the record to date suggests that the decision will, unfortunately, be made in light of its political implications for the austerity agenda, when the urgent and overriding concern should be the threat of deflation.

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