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Monetary Policy, the Promotion of Growth and the SGP in an ageing society

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Executive summary

Economic theory tells us that even when mainly concerned with price stability, a central bank should target economic activity. This because on one side the effects of monetary policy on prices pass through economic activity, and on the other economic activity is a good indicator of expected (and future) inflation. Hence, I believe that there is room for a more proactive policy on the part of the ECB. This would also help to cancel the feeling of inertia that the public has about past monetary policy.

A more flexible interpretation of the Stability Pact would increase the room for manoeuvre of fiscal policy to counteract country specific shocks and asymmetric effects of the unique monetary policy of the EMU. As such, it would help balance the European policy mix, that today places too much emphasis, and consequently too much burden on the ECB. If part of the job of stabilizing the economy is done by fiscal policy, the pressure on the ECB will decrease. On the contrary, in the present situation when a strict application of the SGP call for a procyclical fiscal policy, monetary policy has to act both to reshuffle the economy and to compensate for the restrictive fiscal policy, which may be impossible at a too low rate of inflation.

Finally, it is hard to tell, in present circumstances, how monetary policy will be affected by the problem of ageing society in Europe. It may be that inflationary pressures will be dominant, calling for a more restrictive role by the ECB; but it may as well be that, if mass unemployment persists, ageing of the society will have deflationary effects. We have to conclude that monetary policy today should aim, even more convincingly, to full employment.

How much leeway is there for a more proactive policy on the part of the ECB with regards to promoting economic growth ?

The treaty of Maastricht assigns to the European Central Bank (ECB) the task of "a single monetary policy and exchange rate policy *the primary objective of both of which shall be to maintain price stability* and, without prejudice to this objective, to support the general economic policies in the Community" (Maastricht Treaty, art. 105.1A, emphasis added). The narrowness of the scope for monetary policy, as delineated by the treaty, is a controversial choice that has been widely debated especially since the European economy has entered its slump in 2001. It is well known, for instance, that the course taken in the US is different: The price stability and growth objectives have equal dignity in the US Federal Reserve statute, as designed by the Humphrey-Hawkins Act of 1978. I will not enter into this debate here, as I have tackled the subject many times[1]. Instead, here I will focus on the two related questions of how is the price stability objective better dealt with, and whether in the current situation there is room for growth enhancing measures by the ECB.

(Cf. Figure 1)

Figure 1 reports the evolution of actual and core inflation since 1996. Inflation in the Euro zone has been steadily decreasing from 1996 to 1999, the year of launching of the euro. Starting from the summer of 1998 the euro zone has been subject to a series of price shocks that opened a gap between actual and core inflation. The East Asian crisis and it aftermath caused a drop in the rate of inflation, whereas the change in its core components was more limited. From October 1999 to October 2000 actual inflation has increased because of essentially three phenomena: the depreciation of the euro, the increase in the oil price, and the increase of food prices due to animal diseases. The increase in actual inflation caused a vigorous response by the ECB. In the same period (October 1999 to October 2000) the main refinancing rate (also plotted in figure 1) was brought from 2.5% to 4.75%. Since then, inflation has more or less stabilized, while since the summer of 2001 interest rates have gradually been brought down, presumably in response to the growth slowdown[2].

Thus, figure 1 calls for two considerations. The first is that economic activity has been an objective, albeit an hidden one, of monetary policy, at least since 2001.

The second consideration is more interesting for our present purposes, and stems from the rate of price increase of the year beginning in October 1999. The ECB seemed to react to short run inflation hikes, instead of taking a more appropriate forward looking stance. Even

[1] See for example Fitoussi and Creel, *How to reform the European Central Bank*, Cer, 2002.

[2] I say presumably because this was never officially admitted by ECB officials, who kept referring only to inflation. I have discussed elsewhere (Briefing Paper no **1 2003**) the inconsistency of this behaviour that may have harmed the ECB credibility.

when confronted with the inflation objective alone, a forward looking Central Bank needs to target expected rather than current inflation, and hence to focus on long run indicators. Economic activity is one of the indicators of expected future inflation, and hence should be taken into consideration even if the Central Bank task was interpreted in the most restrictive way. In other words, the effects of monetary policy on inflation pass through the level of activity, that as a consequence has to be taken into account in designing the policy.

To summarize, the answer to the question, in general terms, is certainly that there is some leeway. The ECB should more explicitly and actively target economic activity; this either because - as is desirable - growth becomes an objective *per se*, or because it is an indicator of future inflation.

As for the question of whether the ECB should intervene *now*, the answer is more tricky. In fact, the estimated delay for the effects of monetary policy measures on the economy are nine to eighteen months, so that it is legitimate to ask whether acting today would be useful and/or effective as current forecasts are predicting that growth would have resumed at this horizon. I believe that it is, as the forecast is that of a "soft" growth (about 1.7%) and that the ECB should lower rates, or at least not increase them when most probably the Federal Reserve will increase its Funds rates in the spring. This for essentially two reasons: The first is that for almost a decade, with the exception of a few quarters, we have witnessed a growth differential with respect to the United States; and according to all forecasts this gap will persist in the upcoming recovery phase. And the second is that in spite of its rate decreases, the ECB has given to the public the feeling of being too inertial, and of often following, in a dampened way, the policy decided by the Fed. For both reasons, a strong and autonomous pro-growth policy in this moment would be welcome.

The SGP and Monetary Policy

The second question is whether a more flexible interpretation of the Stability and Growth Pact (SGP) would affect the conduct of monetary policy. The answer is in my opinion yes, and in a positive way.

The theory of currency unions assigns to monetary and fiscal policy well defined tasks. The first is supposed to react to common shocks, by means of changes in the common interest rate. The latter, decentralized, has on the other hand to take care of asymmetric shocks. Furthermore, even when admitting a country specific role for fiscal policy, the current consensus emphasizes the working of automatic stabilizers, characterized by no delays (in decision and in implementation) and not subject to biases and political motivation as would be discretionary policy. Nevertheless, a further role for fiscal policy is to counterbalance asymmetric effects of monetary policy. In fact, the same nominal interest rate may yield a low real rate, and hence prove to be expansionary in a country characterized by high inflation (say

Ireland), and on the other hand have contractionary effects in a country with low inflation (say Germany). As shown in figure 2, the dispersion of inflation rates in the 12 Euro countries has substantially decreased during the phase of convergence to the Maastricht criteria; but since the inception of the euro, it has remained constant. In other words, the single currency has not reduced inflation dispersion, and hence it has not solved or attenuated the problem of asymmetric effects of the unique monetary policy.

(cf. figure 2)

Among the many undesirable properties of the SGP, as a consequence, we have to consider the constraints it poses on national governments in the attempt to react to asymmetric effects of interest rate changes. In general, too strong a constraint on government action in bad times will weaken their determination to act virtuously in good times; the consequence of such a phenomenon is that fiscal policy will be less countercyclical (or at the limit even procyclical) than it should be.[3] An interesting and quite unnoticed consequence of these constraints is that the traditional division of labour between monetary and fiscal authorities has been altered, and the ECB has been given "too much" power. By too much I mean that on one side it has been given the possibility to reprimand member states because they did not keep their books in order[4]. On the other hand, by forcing fiscal policy to inactivity the SGP has shifted the burden of stabilization policy to monetary policy, that has often been held responsible, more than it should have been, for the slowdown in growth and for the lack of policy responses.

Finally, the asymmetry between an independent monetary authority, and a group of constrained and decentralized fiscal authorities has *de facto* made unthinkable any attempt to set up coordinated policies that have proven so successful in the United States across the 199Os. Coordination in the EMU, between a unique monetary authority and a plurality of fiscal policies is a serious challenge. If we add to the picture the constraints embedded in the SGP, the task becomes impossible unless we mean by coordination a paralysis of fiscal policy.

A more flexible application of the SGP would undoubtedly attenuate these problems. More active fiscal policies would release some of the pressure from the ECB that would be free to focus on its main tasks, price stability and Europe-wide shocks. Sharing the burden with member states, the Bank would stop being the scapegoat for the lack of growth in Europe. Furthermore, a more important role for fiscal policy in the European policy mix would reduce the asymmetry and help tackle the difficult task of coordination.

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[3] Notice that the alleged "room of manoeuvre" given by the 3% limit to public deficit is not really reassuring. The budget balance of the United States, in response to the slowdown of 2001, passed from a surplus of 1.4% of GDP to a deficit of 4.6% of GDP; a change of 6 percentage points. Even if in the year 2000 the average deficit in the Euro zone had been nil, the Stability pact would have prevented a similar activism in Europe.

[4] The latest example is the editorial in the November 2003 issue of the ECB monthly bulletin (on line at http://www.ecb.int/pub/pdf/mb200311en.pdf).

Monetary policy in an ageing society

The third question, the effects of an ageing society on monetary policy, is the harder to respond. An increase of the percentage of old people in the population may be seen as increasing the long term inflation pressures through three channels:

The first is the increase in pension liabilities, that sooner or later will translate in increased figures for actual deficits and debt. This would have inflationary effects over the long run. But in fact, this first argument is somehow defused by the recent developments in all major countries that have acted, or are acting, to reform their pension systems with the explicit aim of guaranteeing the financial sustainability and hence a reduction of pension liabilities.

The second channel through which an ageing society may increase the inflationary pressures is a decrease in the rate of saving of households. In fact, retired workers have by hypothesis a higher propensity to consume, which may lead to an increase in the pressure of demand. But this second argument is at odds with observed evidence. In fact, in most ageing societies national saving, whatever its level, exceeds national investment, which leads to an accumulation of foreign assets[5]. This is typically the case of Japan, whose external surpluses are remarkable, but also of Europe.

The third channel through which inflation may resume is the increased tightness of the labour market, induced by the reduced ratio of working age population to retired workers. But once again, our societies today seem far away from a labour shortage situation. In fact, the risk is quite the opposite: As the reformed pension systems will be in place, a mass of workers in the upper age bracket (55-65 years) may end up (unless full employment becomes a truly pursued objective of economic policy in Europe) unemployed but without having fulfilled all the criteria for a decent pension. Then the risk of inflation may well turn into a situation of generalized deflationary pressures, due to unemployment and/or insufficient purchasing power of the olders.

Hence the final answer to the question is that it is hard to tell what the challenges of an ageing society to monetary policy will be. If economic policy and institution will be able to accompany this process and to smoothen it, most probably there will be no sensible effects. If instead we are heading towards an ageing society of mass unemployment, then the sustainability of the social system will be in danger, and there might not be much that monetary policy can do, except to help combating unemployment.

[5] The income flow of these assets is then an important part of the pension disbursement

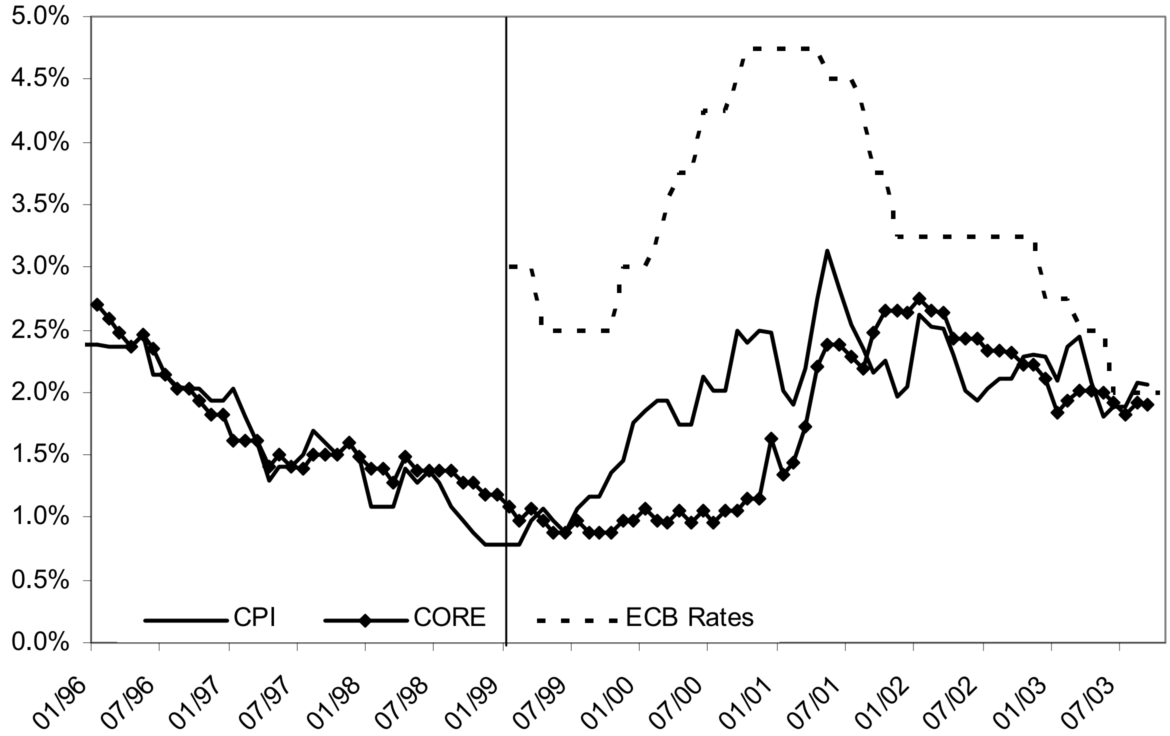

Figure 1: Actual and core inflation in the Euro area, and ECB main refinancing rate.
Sources: ECB and Eurostat

Figure 2: Standard deviation of unweighted inflation rates in the 12 Euro zone countries
Source: Eurostat