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The ECB' monetary policy strategy and structural reforms

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There is a mounting discontent in Europe about the conduct of macroeconomic policy in the euro area and especially its policy mix, in the broad sense of the term – the combination of monetary policy, fiscal policy *and* structural reforms. If the proof of the pudding is in the eating, the weak economic performances of the euro area since 2001 is a testimony that some thing has gone wrong with the reaction of public policies to the financial, confidence and geopolitical shocks which have hit the world economy. In the three years period – 2001-2003 – the average growth rate of the zone would be of about 1%, and the forecast for 2004 is not that of a bright rebound, but of a soft recovery (1.8%). Of course, one can argue that we should not expect from economic policies more than they can deliver. They act at the margin, and they can't prevent much of the consequences of, say, the explosion of a financial bubble which will go its way through the private sector, policy reactions notwithstanding.

The actors in the policy debate held different views which may be expressed in a sketchy way as follows. The monetary policy authorities think that the responsibilities lie with the governments (bad management of fiscal policies of which high budget deficits are a consequences), and the resistance of societies to structural reforms. The governments think that they lie with the central bank (delayed and weak responses to shocks) and also with societies (the difficulty to implement reforms). The average citizen think that all actors have a share of responsibilities: fiscal and monetary authorities by not reacting enough, and the private sector by opposing reforms and/or by trying to escape the burden of adjustment to shocks.

In a nutshell each actor reproaches to the others to be insufficiently flexible, if by flexibility we mean the capacity to adjust quickly to new informations. And all of

1 See Fitoussi 2002a

them are rights, but in a different degree. In a former briefing paper1, I tried to show how the stability pact should be reinterpreted to allow for a greater degree of "flexibility" of fiscal authorities. Here, I will focus on structural reforms and the new ECB's monetary strategy.

Structural reforms

The plea for structural reforms is twofold: they will allow the economy to operate at a higher degree of activity; they will increase the self regulatory functioning of a market economy, reducing the scope and the need for macroeconomic policies. The reference model describes an economy with perfect competition and rational expectations. In such a model full employment is always a characteristic of the temporary equilibrium, and rational expectations lead to the ineffectiveness of monetary policy. Hence the central bank should focus on price stability and can achieve it at no costs if it is credible. Departures from perfect competition will increase the equilibrium rate of unemployment, without giving to the central bank the opportunity to act to reduce it, but with mounting pressures from governments and societies towards the bank so as it acts in a more expansionary manner. If the bank succumbs to this pressures, the result would be an acceleration of inflation. The reasons is simply that markets imperfections lead to an increase in the non accelerating inflation rate of unemployment (NAIRU).

This framework lead to emphasize the role of institutions in economic performances, especially labour market institutions. These institutions lead to diverse rigidities which explain the departures from the reference model and bad economic outcomes. This vision has two major (and related) flaws: The first is that it is based on a simplistic application of the welfare theorems, by which a perfectly competitive market will always reach the most efficient price/quantity allocation. It is simplistic because the step from the theoretical result to the policy prescription is wider than one could think, and has to be taken cautiously (as was done by the founders of general equilibrium theory). First, even assuming that market forces were able to attain the maximum efficiency, there would still exist a problem of equity in the distribution of the resources. A democratic society may have a legitimate taste for redistribution and for the implementation of a costly system of safety nets; in this case the strict optimality notion delivered by the free market ideology may not coincide with a broader notion of social welfare, as the democratic process may lead the society to trade some of the efficiency in favour of higher social cohesion. Furthermore, it may be argued2 (Fitoussi 2002b) that democracy and political adhesion of the population to the economic government of a society can actually enhance efficiency, guaranteeing the flexibility, transparency and consensus that would be missing when ruling according to the strict application of a doctrine. In this sense, the political process and the market would be complements rather than substitutes. This complementarity is even more striking when we realize that the efficiency of the market outcome strongly

1 See Fitoussi 2002a

2 I did so at length in, *La règle et le choix*, Seuil 2002.

depends on a number of assumptions that are rarely observed in the real world, from perfect competition to complete markets and information. The long and widely studied list of "market failures" gives a scope for public intervention that may not be overlooked only because we also observe "government failures". In particular, a number of institutional rigidities that we observe in the European labour markets can be explained by the different bargaining power of workers and entrepreneurs. In its *Wealth of Nations* Smith had already highlighted the problems that this asymmetry could cause. The norms on labour protection can then be seen as a legitimate outcome of the democratic process, aimed at re-establishing some fairness in the bargaining process. The following paragraphs will tackle, more in detail, the debate on institutions and labour market performance.

The influence of institutions, especially labour market institutions, on labour market performances has been a long debated question at least since the twenties. I remember a paper by Jacques Rueff published in 1931, whose title was self explaining: “Unemployment insurance cause of persistent unemployment”, in which the author was trying to explain the increase in unemployment in the twenties in the United Kingdom. Simple correlations convinced him that there was no other cause of the evolution of unemployment in that country. Of course we have done a lot of technical progress in dealing with data since then, but that the question is still debated today shows that almost a century of hard and rigorous research has been unable to settle the debate.

According to most studies of which the one realized by Stephen Nickell and associates (2003) is representative “the equilibrium level of unemployment is affected first by any variables which influences the ease with which unemployed individuals can be matched to available job vacancies, and second, by any variable which tend to raise wages in a direct fashion despite excess supply in the labour market”. These variables includes the unemployment benefit system, the real interest rate, employment protection, active labour market policy, union structures, the extent of coordination in wage bargaining, labour taxes etc..(terms of trade, shifts in trend productivity growth). But it is fair to say that until now, there is no convincing evidence that labour market institutions are responsible for the high level of unemployment in continental Europe or the disappointing macroeconomic performances of Europe during the nineties. What is striking is the weak, to say the least, explanatory power of the institutional variables, especially those considered as being the more important, namely the benefit replacement rate and employment protection. That the latter may have ambiguous effects has long been recognized in the literature: the fact that firms are more cautious about hiring, because of strong labor protection may increase the efficiency of the matching process. But what has not been recognized is that the same may be said for the workers. The fact that unemployment benefit allows the unemployed to search for a job better suited to their skills and expectations, may also increase the efficiency of the matching process. Certainly labor productivity could be greater if the worker has the feeling that his job is corresponding better to his desire (Fitoussi 2003). There is thus a hiatus between usual recommendations and the weaknesses of the evidence to support them. At best empirical studies are able to explain second order of importance effects of institutions on unemployment.

Economic outcomes are more easily explained by the big shocks that OECD countries have suffered: changing trend in productivity growth, the oil shocks, the important increase in the real rate of interest. Besides, structural reforms in the countries which implemented them, do not appear to have played an important role either3.

This is why a new empirical strategy has been developed which consists to study the interaction between shocks and institutions (Cf. e.g. Blanchard and Wolfers, 2000, or Fitoussi and Phelps, 2001). Institutions which may be innocuous in normal time can matter in case of shocks, because they prevent adaptation to these shocks. There are two reasons why the interaction strategy seems more appealing. First unemployment rates in the OECD countries had risen roughly in unison from the mid-seventies to the mid 1980s. Thus all the favoured candidates to explain the phenomenon are OECD-wide shocks. Second labour-market institutions may have mainly played a role in propagating these shocks rather than originating the shocks4. The welfare state had its origins well before the rise in unemployment at the beginning of the 1950s when Europe was enjoying low unemployment and generally good labour-market performance.

Moreover, a better understanding of the early shocks that drove unemployment to new heights in previous decades in Europe can possibly help save some institutions that, by making up for failures in insurance markets and training, may be worth keeping. Finally, the institutions reflect a social contract that arises from a democratic process. In this process there are winners and losers so structural reform is unlikely to lead to a Pareto-improving outcome, even one supported by a majority of the electorate5. And former research showed that it is hard to explain change in unemployment by change in institutions.

We come thus to the second flaw of the 'structural reform argument': The assumption that the free market paradigm is always superior to any other institutional arrangement, an assumption that is not supported by the data, nor by common sense. Two recent studies independently conducted on the subject6, reached the same conclusion out of a sample of 19 OECD countries. In market democracies, the institutional structure is not a powerful factor in explaining economic performances. Capitalism is sufficiently robust to accommodate rather different institutional settings. That conclusion is at odds with the common wisdom according to which the diversity of institutional structures plays a

3 See Fitoussi, Jestaz, Phelps, Zoega (2000).: "Roots of the recent recoveries: labor reforms sound public finance or private sector forces?, *Brookings papers on economic activity*

4 See Krugman (1994) on this point : "Competitiveness: a dangerous obsession", *Foreign Affairs*. 73(2): 28-44.

5 See Cohen and Saint-Paul (1997) discuss the case of employment protection. "French Unemployment: translatlantic perspective", *Economic Policy* 25:267-91.

6 See Fitoussi, Passet (2000) : "Réduction du chômage: les réussites en Europe", *Conseil d'Analyse Economique* 23, La Documentation Française ; and Freeman (2000) : "Single peaked vs diversified capitalism: the relation between economic institutions and outcomes, NBER Working Paper 7556.

determinant role in explaining both unemployment and growth. And indeed empirical evidence in favour of such a thesis appears at best very weak. If we had in each decade followed common wisdom we would have recommended to every countries in the world to follow the French institutional model in the 60s, the Japanese one in the seventies, the German one in the eighties, and the US one in the 90s. The nationality of the model of the present decade (the years 2000s) is still unknown7.

The diversity of the institutional framework in OECD countries shows that institutions are the outcome of a political process anchored in the specific history, culture and anthropology of the country, rather than a way to increase efficiency. If for example, the labour contract which emerged from the world war II was open ended and of indefinite duration despite the cultural diversity of the countries concerned, it may be just because after a war, the solidarity between social groups had to be reassessed. My second remark is thus that there is a strong presumption that institutions are endogenous. Structural measures are usually taken to cope with a problem, in a sense which is not necessarily the one economists would recommend. Rising unemployment in Europe in a period where stabilisation policies were aimed at disinflation and at maintaining monetary parities, has lead to structural activism to alleviate the pain of the unemployed. There is for example in France a clear causal relation between restrictive policies, mounting unemployment and the 1997 law on the reduction of working time – the 35 hours week. And in the US, the increase in the generosity of employment benefits has followed the collapse of financial markets and September 11.

Some active labour market policy have also the (unintended?) effect of putting the blame almost uniquely on the side of the workers, who are considered as inclined to adopt a passive behaviour when confronted with unemployment or an egoistic behaviour when they are insiders. What is striking is that in Europe the advocates of orthodox macroeconomic policies (the stability pact and the single objective for monetary policy) are recommending incredibly interventionist structural policies which in a way are more limitative of the freedom of people that any kind of classical demand policy.

The ECB's monetary policy strategy

7 As Solow remarks at the end of Keynes Lectures: "If pure unadulterated labour-market reform is unlikely to create a substantial increase in employment, then the main reason for doing it is anticipated gain in productive efficiency, however large that may be. But if we respect the wage earner's desire for job security, and it seems at least as respectable as anyone's desire for fast cars or fat-free desserts, then an improvement in productive efficiency gained that way is not a Pareto-improvement. More labor market flexibility may still be worth having – and I think it is – but then the losers have a claim in equity to some compensation. The trick is to find a form of compensation that does not cancel the initial gain in labour-market flexibility."

They are two readings of the press release about the new ECB's monetary policy strategy. The first, sympathetic, will focus on what seems to be a radical departure from the initial strategy taking into account the most voiced criticisms about this strategy:

■ ***a point target of 2% for the inflation rate***, i.e an objective equal to the upper bound of the preceding definition: "the governing council agreed that in the pursuit of price stability it will aim to maintain inflation rates close to 2% over the medium term." Note that this change represents a real progress in two directions with respect to the past. A point target is an unambiguous and symmetric definition; and second the target has been chosen at a higher level that the implicit target that one could deduct from the reference growth rate of the money supply used by the ECB (1.5%). Furthermore the press release lays out the reasons why it is so: "This clarification underlines the ECB's commitment to provide a sufficient safety margin to guard against the risks of deflation. It also addresses the issue of the possible presence of a measurement bias in the HICP and the implications of inflation differentials within the euro area". Even if the three arguments have not the same weight, they all effectively imply an increase in the inflation target. The first and the third are linked through the Balassa-Samuelson effect – the convergence of price levels between countries with different levels of development which implies the persistence of inflation differentials – but also because the exchange rate parities at the outset of the launching of the euro were characterized for some countries by an overvaluation and for others by an undervaluation of their currencies. If the inflation objective is too low, it will thus impose on the more developed countries an inflation rate close to zero or even a risk of deflation if it happens that the currency of these countries have been overvaluated. Germany is obviously a case in point. The second argument, the possibility of a measurement bias in the HICP, is quite distinct as it has better to be clarified the soonest possible. It should require as that has been done in the US the establishment of an independent committee to review the question and to suggest new methods of measurement.

■ ***The two-pillar monetary-policy strategy is de facto evolving towards a one pillar strategy***, through the downgrading of the first pillar (the money supply M3). As was underlined in my last briefing paper, the ECB has been following until now, at least in theory, the strategy called of the "two pillars", heritage of the compromises that underlie its creation; on one side, it was supposed to target money growth (the "reference value" is 4.5% per year[8]); on the other hand, it had to take into account a composite indicator of inflationary pressures. In practice, the money growth objective was not followed, and the ECB simply focussed on the second pillar. But this ambiguity between the strategy the Bank was supposed to follow and the one it actually implemented, was a nuisance for the transparency of its acts, the effectiveness of its communication strategy, and finally damaged the ECB in its quest for credibility. The flaw with the first pillar has been extensively analysed in the many reports by the ECB watcher group and practically by all economists who have evaluated the strategy. The change is thus welcome. "The Governing Council wishes to clarify communication on the cross-checking of

8 This may be arrived at by summing potential output growth, estimated at 2.5%, the target inflation rate, say 1.75%, and a trend shift in velocity of about 0.5% per year.

> information in coming to its unified judgement on the risks to price stability. To this end, the introductory statement … will start with the **economic analysis** to identify short to medium-term risks to price stability …. The Governing Council also decided to no longer conduct a review of the reference value on an annual basis." All that amounts to say that the money supply will play almost no role in the decisions for setting the interest rate, although it may be taken into consideration as one of the numerous elements allowing to assess the risks to price stability. The fact that monetary analysis may be useful to assess medium to long term trend in inflation is not really under dispute, nor is it essential to fix short term interest rates.

One may conclude from this first, sympathetic reading, of the press communiqué that in changing its strategy in this way, the ECB has proven its capacity to ear well grounded criticisms and thus that it is much more pragmatic that one would like us to believe. If this interpretation is correct, then the new strategy would allow for a more "flexible" monetary policy, i.e. both more reactive and more proactive.

There is though a second reading of the press release, pointing to its contradictions (see e.g. Paul de Grauwe: "*The central bank that has missed the point*", The Financial Times, May 13, 2003), and to its omissions. There is in effect a contradiction in the press communiqué as far as the definition of price stability is concerned. The Governing Council begin by confirming the definition which it announced in 1998, namely "price stability is defined as a year-on-year increase in the Harmonised Index of Consumer Prices (HICP) for the euro area of below 2%." And it is after this confirmation that the new definition that I considered as a point target of 2% followed. How can we reconcile this two definitions, the first being asymmetric, the second symmetric. For Paul de Grauwe, "instead of creating clarity, the ECB has managed to create confusion about its true intention." That is unfortunate, as a pragmatic move may be interpreted as an incapacity to decide about such fundamental a point as a final objective of economic policy. How the markets could anticipate monetary policy if it is not sure about the objective the ECB is pursuing? The Committee of economic and monetary affairs of the European parliament should ask for more clarity in its next hearing of the president of the ECB. The omissions concern mainly the other ingredients of an inflation targeting procedure, as has been repeatedly emphasized in a number of briefing papers, especially those of Svensson. According to Christopher Sims (2003), "economists should recognize that they have a history of proposing simple "nominal anchor" prescriptions for monetary policy that have eventually proved not to be very useful." So we should not consider inflation targeting as The *deus ex machina* which always and everywhere will lead to a correct monetary policy. It is an improvement because it enhances goal and model transparency which is by itself desirable both for efficiency and democratic reasons. The other omission concerns the ways the ECB would participate to the pursuit of other objectives of economic policy according to its mandate. After all almost nobody expect that the inflation rate could be significantly higher than 2% in the two years to come, that is we are in a situation were the participation of the bank to the other objectives of the government will not prejudice its primary objective. So according to its statute it has to act.

But these clarifications can't perhaps be made in a press release, and we should await the first implementation of the new strategy and the reading of future monthly bulletins.

Concluding remarks and summary

In the policy debate, each actor is reproaching to the others a lack of "flexibility". The stability pact reduce the reactivity of fiscal authorities, as has been emphasized in my December 2002 briefing paper. In this briefing paper I focus on the ECB and structural reforms.

The "new" ECB's monetary policy strategy represents a real progress. First the objective for price stability becomes a point target of 2% for the inflation rate, i.e. it is symmetric and higher than the implicit target of the former strategy. Second the two-pillar monetary strategy is de facto evolving towards a one pillar strategy, through the downgrading of the first pillar (the money supply). One may only regret that the press communiqué contains also the old definition of price stability witch can lead to some confusions. If one disregard the contradiction in the press release regarding the inflation objective the new strategy could allow for a more flexible monetary policy, that is both more reactive and more proactive.

For several years the ECB has been advocating structural reforms implying that they would have a decisive impact on price levels and on growth potential, through an increase in flexibility. I developed the argument along two lines. The first is that the theoretical argument in favour of structural reforms, notably in what concerns the labour market, is weak. It relies on too a simplistic application of the welfare theorems, and above all it does not take into account the necessary interaction between the democratic process and the market process which is the characteristic of a modern capitalistic society. The second is that the long debated question of whether labour market institutions affect growth performances and unemployment is empirically unsettled. The evidence is often weak, and even when institutions seem to explain some features of unemployment, their effect is of a second order of importance. Furthermore, capitalism appears from different empirical analyses as a flexible system, capable to accommodate different institutions at different moments of time. This goes against the tendency to invoke a single recipe (structural reforms, reduced role of the government) for each country at every time.

The above considerations lead to a strong conclusion: It does not exist a single superior institutional arrangement, and more specifically, it is impossible to advocate always more flexibility in the name of a technical argument. The role of the government in the economy, the balance between efficiency and equity considerations, the institutional setting that is given to a society are fundamentally political choices; and as such should never be entrusted to a technical body.

We should thus better think twice before recommending to governments to change *such essential thing as the social contract on the basis of weak, uncertain and even contradictory evidences. That does not mean that structural reforms are not needed, but that they are much more complex to design and to implement – if one wants to avoid adverse effects – that the slogan "be more flexible" would want us to believe.*

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