The irresponsible ECB

By Jürgen Stark
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Ultra-loose monetary policy stopped being appropriate long ago, and is especially inadvisable now, with the global economy – especially the developed world – experiencing an increasingly strong recovery. As recent stock-market turbulence shows, refusal to normalize policy faster is drastically increasing the risks to financial stability.

The Dow Jones Industrial Average's recent "flash crash," in which it plunged by nearly 1,600 points, revealed just how addicted to expansionary monetary policy financial markets and economic actors have become. Prolonged low interest rates and quantitative easing have created incentives for investors to take inadequately priced risks. The longer those policies are maintained, the bigger the threat to global financial stability.

The fact is that ultra-loose monetary policy stopped being appropriate long ago. The global economy – especially the developed world – has been experiencing an increasingly strong recovery. According to the International Monetary Fund's latest update of its *World Economic Outlook*, economic growth will continue in the next few quarters, especially in the United States and the eurozone.

Yet international institutions, including the IMF, fear the sudden market corrections that naturally arise from changes in inflation or interest-rate expectations, and continue to argue that monetary policy must be tightened very slowly. So central banks continue to postpone monetary-policy normalization, with the result that asset prices rise, producing dramatic market distortions that make those very corrections inevitable.

To be sure, the US Federal Reserve has moved away from monetary expansion since late 2013, when it began progressively reducing and ultimately halting bond purchases and shrinking its balance sheet. Since the end of 2015, the benchmark federal funds rate has been raised to 1.5%.

But the Fed's policy is still far from normal. Considering the advanced stage of the economic cycle, forecasts for nominal growth of more than 4%, and low unemployment – not to mention the risk of overheating – the Fed is behind the curve.

Other advanced-economy central banks, still stuck in extreme crisis mode, are doing even worse. Neither the Bank of Japan nor the European Central Bank has provided any indication that it is set to tighten monetary policy, even though economic conditions today are totally different from those that prevailed during the crisis and subsequent double-dip recession in the eurozone.

The ECB, in particular, defends its low-interest-rate policy by citing perceived deflationary risks or below-target inflation. But the truth is that the risk of a "bad" deflation – that is, a self-reinforcing downward spiral in prices, wages, and economic performance – has never existed for the eurozone as a whole. It has been obvious since 2014 that the sharp reduction in inflation was linked to the decline in the prices of energy and raw materials.

In short, the ECB should not have regarded low inflation as a permanent or even long-term condition that demanded an aggressive monetary-policy response. The problem is that ECB officials have become excessively focused on ensuring price stability by meeting a short-term inflation target, defined broadly as "below, but close to, 2%," with the specific goal being 1.9%.

This is out of line with the intentions of the ECB's Governing Council, as enunciated in

2003, after an evaluation of the previous four years of monetary policy. At that time, the ECB confirmed the definition of price stability it adopted in 1998, but clarified that it aims to maintain the inflation target over the medium term, while recognizing that a central bank cannot control inflation with enough precision to establish a specific rate.

The ECB's policy is also out of line with economic reality: the eurozone, like most of the rest of the global economy, is experiencing a strong recovery. Yet the ECB will probably view the recent stock-market turbulence as confirmation that it should maintain its current policies.

Although the Governing Council seems convinced that expansionary policies remain vital to support GDP and employment growth, and to keep deflation at bay, that seems unlikely. Indeed, insofar as the impact of these policies on the recovery can be reliably measured, it is probably modest – definitely not worth the €2.3 trillion ($2.8 trillion) in assets purchased since April 2015, not to mention the other consequences of maintaining zero or negative interest rates.

One of those consequences is that the ECB's policy interest rate has lost its steering and signaling functions. Another is that risks are no longer appropriately priced, leading to the misallocation of resources and zombification of banks and companies, which has delayed deleveraging. Yet another is that bond markets are completely distorted, and fiscal consolidation in highly indebted countries has been postponed.

So the benefits of the ECB's policy are questionable, and its costs indisputable. The current ECB policy is thus simply irresponsible, as is the utter lack of any plan for changing it.

In this sense, the ECB's Governing Council is, consciously or unconsciously, following the Nobel laureate economist Paul Krugman's 1998 advice that the Bank of Japan "credibly promise to be irresponsible" when nominal interest rates are already at zero and monetary policy is in danger of becoming ineffective. The central bank, Krugman declared, should stoke inflation through ongoing monetary expansion, in order to reduce real interest rates.

Krugman repeated this recommendation a few years ago, when he, along with former US Treasury Secretary Lawrence H. Summers, revived the theory of "secular stagnation." But discussion of that theory has now ended – and for good reason. It is time to end the ECB's irresponsible expansionary policies as well.

Today, monetary policy has become subordinate to fiscal policy, with central banks facing intensifying political pressure to keep interest rates artificially low. As the recent stock-market turmoil shows, this is drastically increasing the risk of financial instability. When more – and more severe – market corrections take place, possibly affecting the real economy, what tools will central banks have left to deploy?

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