

THE BANKER'S VIEW

American finance: Will it entrap the ECB?

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The Euro zone's exceptionally poor economic results for the second quarter had justified the ECB's strategy, but they also served to expose a diagnostic error that could (and the risk has grown ever more sharply) bring about a rethink of the bank's actions and erode its credibility.

Justifying a strategy: It is the ECB's doctrine that growth is not possible without low inflation. Price stability permits the maintenance of purchasing power, coupled with only a slight increase in the cost of wages. This is an essential condition for the production sector's competitiveness and helps maintain a low level of long term interest rates. Controlled inflation, therefore, favours the growth of three elements of end demand; consumption, investments, and exports. And, in fact, the high inflation of the second quarter brought about a massive drop in household consumption.

But, the growth breakdown resulted from other causes, too, and there laid the diagnostic error. Several times, the ECB's management had claimed that the Euro zone would suffer far less than would the USA from the effects of the financial crisis, born as it was in the States. This opinion was not absurd, given that the Continent's situation in the banking, financial and housing domains seemed on the whole much healthier than that of the USA. This failed to take into account the American financial sphere's ability, seemingly intact, to export its bubbles, in particular while at the bursting stage. One consequence of this is a severe fall in stock markets - which are more influenced by what happens across the Atlantic than by the fundamentals of the Euro zone - while another is a collapse in the housing market. In this context a severe depression in the production sector follows. The most recent events do more than confirm this assessment, since the European banking system, even though it is in general far more solid and better regulated than the American one, is in its turn (in certain countries at least) confronting a major crisis of mistrust.

In such a situation, what might be the ECB's options if it is to retain its decision making autonomy?

Over the years, the ECB's mid-term strategy of price stability has allowed it to attain a reasonable margin of manoeuvre in relation to the Fed's monetary policy. There is a kind of independence within interdependence, seen mainly in the form of rate changes that are far less frequent than those of the American central bank and, above all, seen in a range of interest rate variations much less wide than in the USA over the last years (225 base points against 425), with higher minimum rates (2% against 1%), as the cost of giving priority to price stability, but also with lower maximum rates (4.25% against 5.25%), the result of this efficient vigilance.

For several months, autonomy had swung towards divergence. The ECB, far from following the Fed's lowering of rates, even with some lag as seen in the past, had raised its own. The bank had in fact let this be anticipated and at the time the decision surprised no-one. Now-a-days, the ECB's monetary policy is again arousing criticisms from the very people who praised its President three months ago, but who today resume their favourite curses.

A few weeks ago, the ECB's President, who had eventually anticipated the poor results of the second quarter, conducted a masterly exercise in communications before the figures were published. This did not proclaim, as some had expected, a reversal of his policy; nevertheless it sufficed to lower the euro's value and it helped reinforce the downward trend in oil prices. The continuance of those falls, or even their maintenance at present values, could supply a whiff of oxygen for European growth and inflation in this present very black context. Inflation already seems to be weakening, as far as we can judge from recent numbers, even though it remains well above the 2% objective. Therefore, expectations were that the ECB, with no loss of credibility and no rush but even so within a relatively short time frame, might soften policy though not reverse it.

The storm which hit the markets accelerated the tempo, but at the same time, because of this simultaneous lowering by several central banks, the ECB received the windfall opportunity to do policy softening without actually modifying it. "Too little, too late" comes the silly comment. It is obvious that the Fed's once more overly accommodating monetary policy is by no means a cure for the crisis. What is more, the markets have seen through this, plummeting back into the brightest red after a ten-minute initial rise, as though sending the message that the financial system, and the



economy too, have no need of money that costs almost nothing - such as the Bank of Japan has strived to offer to no avail for years; and as the Fed has done for far too long, leading to today's results.

Unless ... unless the American financial industry's capacity for mischief has not yet reached its peak.

Interest rate and inflation - Europe versus US

