Euro: A Story of Glory or Luck? – Comments to Hans-Joachim Klöckers "8 ½ years European monetary policy"

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1 Introduction

Dr. Klöckers has provided a brilliant exposition on how the European Monetary Union has facilitated price stability. The goal of my comment is to look at the change in the European monetary policy as only one of the major global developments that have happened in the past decade with consequences to price stability in Europe. From this broader perspective I hope to let the reader gauge qualitatively the importance of the Euro for lower and more stable inflation rates in the Euro Zone.

Among the major economic developments of the past decade we can list (i) a major spurt of world productivity growth; (ii) manufacturing and service outsourcing; (iii) the inclusion of millions of Asian laborers in the world production chain and; (iv) the creation of a savings glut. In my view, the first three developments are positive supply shocks that contribute to lower inflation rates for a

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given monetary policy. Since inflation expectations are somewhat backward looking, these positive supply shocks may have contributed to anchor expectations at a lower level, shifting down the forward looking Phillips Curve and thereby permitting lower unemployment rates at lower inflation levels.

The European Monetary Union was certainly another step in the same direction, since the ECB was created so that the reputation of pursuing low inflation rates developed along the post-WWII era by the Bundesbank could be exported to other countries. In this way the EMU, among other things, has worked as an anchor for inflation expectations, hence improving the unemployment - inflation trade-off. However, to attribute the success of price stability and of anchoring of expectations exclusively to the change in monetary policy could prove to be a naïve diagnostic that can divert focus of research and jeopardize the preparation for the challenges that European Monetary Policy will probably have to face in the future.

More recently some of the challenges that arose as a price for the past bonanza have started to surface. The inclusion of millions of Asians in the world production chain has cheapened the price of manufacturing goods and services dramatically in the past decade. However, this very same population is now starting to have access to some boons offered by the modern world such as abundant food, transportation and even toilet paper. This new demand for basic materials is already clearly reflected in the recent pattern of commodity prices. For instance, the price of oil has increased five fold in the past five years. A barrel of WTI oil was worth $20 in 2002 and now is negotiated for almost $100. The price pattern for other basic materials including metals, food stuffs and paper/pulp has been similar.

So far, this rise in commodity prices has had very little impact on inflation worldwide. De Gregorio and colleagues at the Central Bank of Chile (2007) have a paper that documents the decrease in pass-through from oil prices to inflation for 34 countries. One of the reasons they suggest to be a driver of this process is the fact that economies became much less intensive on commodities usage. After all, these days the so called industrial countries, have the service sector accounting for the lion share of their GDPs. Another reason that may be yielding an observed lower pass-through from commodity prices to inflation is that other positive supply shocks are hitting the global macro-economy concomitantly, which may jeopardize the identification of the true Pass-though in econometric exercises if these other variables are not controlled for.

More specifically in the case of Europe, the appreciation of the Euro has isolated the EMU somewhat from the spike in basic material prices. Furthermore, lower manufacturing prices, higher productivity, outsourcing and the savings glut are still playing a key role in the world macroeconomics. The size of the challenge that lies ahead for European Monetary Policy will be larger the more the shock to commodity prices outweighs the bonanza effects described previously on inflation.

In the monetary policy literature, a shock like the rise of commodity prices, such as the one we are currently experiencing, is denominated cost-push shock. This shock deteriorates the short run trade-off between inflation and unemployment. The current literature suggests that the best monetary policy response to this nature of shock is some kind of inflation forecast targeting approach (see Svensson 1996 and Woodford 2007). This policy recommendation implies that at least in the short run, price stability and low inflation volatility would have to give. Under this policy, the monetary authority accommodates some of the shock via prices in the short run and sets policy rates to conduct inflation rates back to target in the future. The more preoccupied the monetary authority is with output, the longer the time of inflation convergence back to target.

However if the negative cost push shock is persistent, as the one that we are experiencing could be, the amount of optimal shock accommodation via prices may be lower, otherwise prolonged deviations from the inflation target can jeopardize the credibility anchor. In other words, under a persistent cost push shock more economic hardship in the medium run may be necessary to sustain the long term credibility anchor. This is an issue that is due to be politicized and different inflation tastes across the EU nations will rapidly surface with politicians vowing in favor of a larger price accommodation, especially because cost push shocks will affect different nations in different manners.

One major take away from this comment is that the challenges that lie ahead were mitigated by the fact that the Euro was implemented in an era of bonanza, which allowed the ECB to build a large amount of credibility, at a relatively inexpensive cost, that may prove invaluable in the future.

The rest of the comment is structured as follows. In the next section I summarize the main points of Dr Klöckers' article putting them in perspective with other world macroeconomic developments. In the third section I describe some of the major economic developments of the past decade that may have contributed to price stability in the Euro Zone. Section 4 concludes speculating on challenges for the future of the European monetary policy.

2 Summarizing and commenting on Dr. Klöckers exposition

Dr. Klöckers starts his exposition by showing how the decline of the inflation rate in Europe took place only after the Maastricht treaty was signed. He also points out that by the end of the 1990s the rate of inflation has remained remarkably stable around 2%. In his words:

"Only after the Maastricht treaties, at the beginning 1990s, inflation rates returned lasting to what the ECB has defined as price stability. One also can observe that with the start of the Economic and Monetary Union an obvious regime change took place. After a one-off downwards in 1998/99, when oil prices temporarily went under 10 US-dollar a barrel, inflation rates showed a remarkable stability around a yearly change of 2 per cent."

Interestingly the 1990s were an era of declining inflation rates globally. Even Latin American countries, well known for absolute disorder in their price systems managed to bring inflation rates to single digits. In the U.S., inflation was also normalized after the tough years of Paul Volker acting as the Fed chairman. Hence looking at inflation developments around the world suggests a common trend.

It looks like an egregious task to quantitatively gauge the importance of the development of monetary institutions for price stability. Though it has probably played a crucial role, the recent increase in productivity due to the IT revolution, the drop in commodity prices and the inclusion of millions of Asian laborers in the world production chain have also played a key role in reducing the level of inflation during the early 1990s. These other major global developments have certainly facilitated the workings of the newly developed monetary institutions.

Next, Dr. Klockers proceeds to examine the rise in petroleum prices in the 2000s suggesting that inflation rates remained stable despite the shock, because of the machinery of the new European monetary policy.

"This stability is even more remarkable, as deeper/larger oil price shocks occurred after 1999. It seems that the regime change has contributed to a better absorption of these shocks, compared to earlier periods. The average inflation since 1999 was 2.0 per cent and lies therefore clearly below the average inflation rates in the past decades. The volatility of inflation rates went also noticeably down."

Despite the clear success in terms of price stability during the oil shock of the 2000s, it might be naïve to believe that monetary policy played all necessary role to prevent inflation from propping up. The oil shock of the 2000s looks like a demand driven price increase, rather than a supply driven shock as the one observed in the 1970s. In recent years commodity prices have been rising on the back of soaring consumption and investment in Asia. Commodity price increases are not the only major shock hitting the world economy during the 2000s. The IT revolution is still yielding dividends and outsourcing has been curbing manufacturing and service price increases. If we understand the current oil shock, simply as one of the forces hitting the world economy, the importance of monetary policy becomes less clear for price stability.

One manner of gauging the role of monetary policy in containing inflation is to look at inflation expectations. As Dr. Klöckers correctly points out, the introduction of the Euro has been extremely successful in anchoring the inflation expectation of private agents at the inflation target level. However it is also true that this success was facilitated by the bonanza shocks that hit the world macroeconomics during the 1990s. Price declines of manufactures and services have probably contributed for the expectation of future price declines. Despite the rational inflation expectation revolution in macroeconomics, it is still a consensus in the profession that, in reality, there is a non dismissible backward looking component to inflation expectations. In this case higher world productivity and outsourcing have probably contributed to the success of driving inflation expectations to where they are.

Let us now switch gears to address the change in fiscal policy that was undertaken in Europe and that has to some extent followed the letter of the Stability and Growth Pact. In the words of Dr. Klöckers:

"In area of fiscal policy some progress could be achieved too. Figure 9 clearly shows that in mid 1980s a regime change took place in fiscal policy. During the 1980s and beginning 1990s, average budgetary deficits in the euro area varied between 3% and 5% of the gross domestic product (GDP). At the same time the debt stock, measured in per cent of GDP, rose continuously and doubled approximately between 1980 and 1996. In contrast, deficits vary, since 1997, on average "only" between 1% and 3% of GDP and the debt ratio could be stabilized and/or even slightly reduced."

Due to fears of debt monetization, a key requirement for the sustainability of a common currency is some sort of fiscal discipline. The Stability and Growth Pact was engineered with this purpose, establishing limits to fiscal deficits and debt sustainability. Recently many of the core countries signatories of the Pact have been breaching it. Germany and France have both exceeded the 3% maximum nominal deficit at some point and concerns that other countries could follow have mounted.

The fiscal policy in most Euro Zone countries is dictated by social spending. In their 2004 book “Fighting Poverty in the U.S. and Europe: A World of Difference”, Alesina and Glaeser point out that the US government corresponds to 30% of GDP, whereas this number for Europe is of 45%. Two thirds of this disparity is due to different levels of welfare benefits. So to understand European fiscal policy, we need to understand redistribution.

As pointed out by Dr. Klöckers, during the Euro era, labor market reforms have started to yield some modest dividends. Belgium, France, Germany, Ireland, Italy, and the Netherlands have introduced new labor regulation that allows for temporary contracts. This has contributed somewhat for the mild reduction in unemployment across the continent and for a descent increase in employment growth. However, the rate of GDP growth has not gone up in tandem with the rate of employment growth, which suggests that productivity growth in Europe was low.

The recent pattern of employment and GDP in Europe can be understood in light of points made by Robert Gordon and Olivier Blanchard. Gordon argues that if labor regulation is introduced such that the minimum wage stipulated at a high level, this would lead to a smaller but more productive employed labor force, since it will not be profitable to pay unproductive workers for more than what they contribute to output. Blanchard argues that the introduction of temporary labor contracts lead to the creation of two classes of workers, the more productive one abiding by the old fierce labor regulation and the least productive one that is on temporary contracts. If there is some learning by doing component to productivity, these classes of workers can perpetuate themselves because the temporary workers will have to be fired to characterize the temporality of their contracts losing the opportunity to rise as fast in the productivity ladder.

The fact that labor market reforms lead to the absorption of low productivity workers by the labor force might have eased pressure on further social spending. Because less productive workers that had previously to be taken care by the state can now earn their own living. Hence, even though the Stability and Growth Pact was important to signal the need for change in fiscal policy, the real economic force that allowed this change to materialize might have to do with the labor market reforms that contributed to a smaller demand from the European populace for redistribution.

A sounder fiscal policy delivered by countries in the EMU may have contributed to reducing the level of risk premium paid in capital markets. This is especially true for the countries that had Central Banks reputed as inflators, since the EMU effectively prevents these countries from printing money to monetize debt. Benjamin Friedman argues that bonds issued by EMU countries shall be no longer called sovereign bonds, if one's definition of sovereign bonds is a bond issued by a sovereign government denominated in the currency it can print.

Another factor that might have provided a contribution of perhaps the same order of magnitude for lower risk premium was the formation of a savings glut. Asian countries have been running sizeable current account surpluses since the Asian crisis. They have therefore accumulated a sizeable amount of foreign exchange reserves. The People's Bank of China has currently over $ 1 trillion dollars in this account. The club of countries with sizeable current account surpluses has gained new members with the rise of commodity prices in the 2000s. This abundance of cash in the hands of sovereign wealth managers may contribute to the decrease in risk premium, because at a very high level of international reserves, governments can afford temporary capital losses without risking a liquidity crisis. We have been observing countries with massive international reserves vis-à-vis their eventual liquidity need putting together sovereign wealth funds that invest in all sort of asset classes. Singapore is an example of this and China is headed in the same direction, but with less transparency.

The level of interest rates has also benefited from the same developments, sounder fiscal policy and the savings glut. Lower interest rates were not only a phenomenon in the EMU, but also in the US and in many emerging market countries. As any economist first guess, an era of abundant money should also be an era of cheap money.

To conclude his work, Dr. Klöckers brings our attention to a potential challenge for European monetary policy. He shows that structural inflation differences within EMU countries are more durable than within U.S. states.

"However, a special characteristic in the euro area is that the inflation differences are more durable than within the USA: There are some countries in the euro area, which exhibits a structurally higher inflation rate than the average, while other countries regularly exhibit a rate, which is below the average."

This issue can be magnified in the face of a larger and persistent shock. Given a unified monetary policy, countries with higher inflation inertia, may impose more economic hardship on countries with a more palatable Phillips Curve. In an era of bonanza it is usually easier to solve differences. However once economic hardship is imposed to a country for the common good of a monetary area, a queue of politicians may be formed to raise the flag against the ECB monetary policy.

3 Major Economic Developments in the Past Decade

Among the major economic developments of the past decade we can list (i) a major spurt of world productivity growth; (ii) manufacturing and service outsourcing; (iii) the inclusion of millions of Asian laborers in the world production chain and; (iv) the creation of a savings glut. The goal of this section is to further explore these developments and understand the role they played in fostering lower inflation rates and higher price stability in the EMU.

In May 15th 2005, the Financial Times has published an article that started as follows: *"The world economy has moved into a higher gear over the past decade with productivity growth almost doubling compared with the previous five years. Rapid growth of output per employee in China and India, combined with improved productivity growth in north America, eastern Europe, the Middle East and Africa drove the world economy forward, according to a report published today by the Conference Board, a global business organization."*

From the Economics Glossary available at the website About.com, the definition of productivity is *"a measure relating a quantity of output to the inputs required to produce it".* Hence when productivity increases, the quantity of inputs necessary to produce the same level of output diminishes. As a consequence higher productivity implies either lower output prices, or higher margins. When competition is fierce, more of the former tends to happen. This deflationary force in manufacturing products, for given input prices, has allowed inflation to decrease with less effort on the part of monetary policy.

One of the driving forces of these astounding productivity gains were allowed by the revolution in telecommunications experienced in the 1990s. Today a manager sitting in Chicago can observe the production of his factory in Guangdong on real time. He can talk face to face with his workers sitting at thousands of miles of distance. The cost of telecommunications became so low that call centers for costumer services are being built in India. The reductions in prices of final goods allowed by these innovations are not to be disguised.

The IT revolution has permitted the world production chain to tap an untouched workforce. This cheap labor allowed production and assembling costs to plummet, lowering as a consequence final good prices. Even though in the past years some of this opportunities were explored, the wage gap between developed and emerging market countries are still remarkable even weighting by productivity. Furthermore, more than half of the Chinese population still live in rural areas and have not been presented to the new opportunities created by this revolution in telecommunications.

These massive productivity gains have permitted the expansion of the export led growth strategy adopted by Hong Kong, Taiwan, Singapore and South Korea in the 60s, 70s and 80s to all corners of Asia. The export led growth strategy coupled with the perception by Asian policy-makers that currencies shall remain cheap to avoid a replay of the 1997 Asian Crisis led to sustained balance of payment surpluses in the continent and thereby the accumulation of sizeable international reserves. This latter story is in the spirit of Dolley, Garber and Folkers-Landau (2004). Theories on why this accumulation of savings in Asia was so sizeable have mounted. Some academics have attributed it to Demographic aspects while others have pointed out the role of underdeveloped insurance markets and the precautionary motive for over saving.

In spite of the reason for the formation of this savings glut, our intent here is to call the attention of the reader to it and claim that in a world of abundant savings, it should be of little surprise that the price of money has gone down. Interest rates have collapsed worldwide.

Furthermore, the savings glut formation had some positive feedback effect on the abundance of savings. This has happened because the export led growth strategy in Asia has increased the demand for basic materials such as oil, metals, paper and food. This new demand ballooned commodity prices increasing the exportation of commodity rich countries. As a consequence, balance of payments in commodity countries has been showing persistent and massive surpluses, leading to a further accumulation of savings.

In my view, most of these developments contribute to a better trade off between inflation and unemployment permitting price stability with rather low interest rates.

4 Perspectives for EMP

In this section I attempt to speculate on the challenges that lie ahead for the European monetary policy makers, looking at which kind research effort shall be undertaken to allow for adequate policy decision making in the future.

The implementation of a unified European monetary policy and of a single currency in Europe was done in a period of world bonanza, with many good and service prices falling. In this context, achieving price stability and inflation convergence to a low level has proved to be not so costly in terms of output.

This is wonderful news for the future and the credibility of a unified European monetary policy and for the euro. The credibility that was built in the past 8 and ½ years is an asset that can prove to be invaluable for the challenges that European monetary policy makers may have to confront.

In fact, some of these challenges may be already surfacing now. The era of bonanza has fueled demand for commodities and some of these basic materials are now 5 times more expensive than they were five years ago. Cost push shocks, such as this rise in commodity prices, put a strain on monetary policy, worsening at least the short term trade off between inflation and unemployment.

However, if this commodity price shock is persistent and ever increasing, the strain can be such that the European Central Bank may be confronted with the choice of serious economic hardship for a few quarters or the loss of the credibility anchor built in the past years. This would be a real test for these newly developed European institutions, since it would be in the best interest of many politicians to raise the flag against the ECB in the spirit of what Mr. President Sarkozy has been doing even though growth has been faring relatively well in France.

In sum, in my view, in the context of a persistent cost push shock, different inflation tastes will become clear and countries within the EMU with less inflation inertia and lower dependence on basic materials might have incentives to defect from the Union since they will have to face much tighter monetary policy than if they had sovereignty over setting their own interest rates.

I believe that the size of the challenge that lies ahead of central bankers around the world depends on the relative quantitative importance for consumer prices of the rise in commodity prices and of the benefits of productivity gains. If one believes that most of the gains in productivity are behind us and that now the main development for prices is the rise of key input prices, then a lot of output might have to be given up for price stability. However, if both effects are to coexist in the future, than it shall not be clear that we have some bumpy road ahead.

Therefore, in my opinion research efforts should be concentrated on gauging the quantitative importance of these two forces to consumer prices, in addition to the time lags and time horizon that they may take to materialize. Gauging these forces quantitatively with more accuracy may prove invaluable for conducting monetary policy in Europe.

5 Summary

The goal of my comment is to look at the change in the European monetary policy as only one of the major global developments that have happened in the past decade with consequences to price stability in Europe. From this broader perspective I hope to let the reader gauge qualitatively the importance of the

Euro for lower and more stable inflation rates in the Euro Zone. Among the major economic developments of the past decade we can list (i) a major spurt of world productivity growth; (ii) manufacturing and service outsourcing; (iii) the inclusion of millions of Asian laborers in the world production chain and; (iv) the creation of a savings glut. In my view, these developments contribute to a better trade off between inflation and unemployment permitting price stability with rather low interest rates.

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