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Working Paper No. 323

Easy Money through the Back Door: The Markets vs. the ECB⁽¹⁾

by
Jörg Bibow

March 2001

At the start of 1999, a new policy regime was introduced in Europe that included the launch of the euro and the establishment of a centralized control over monetary policy common to the eleven European Union (EU) countries that decided to participate.⁽²⁾ The objective of this paper is to assess the experiences over the new regime's first two years, particularly the performance of the European Central Bank (ECB) in charge of conducting area-wide monetary policy.

The following recent developments in the euro area stand out. On the one hand, economic growth picked up markedly by mid-1999 and employment growth has been quite impressive, meanwhile lowering the rate of unemployment by some three per cent compared to extremely high levels reached over 1995-7. On the other hand, the new currency's external value had fallen by some 20 per cent up to November 2000 and inflation has increased from its very low level at the start to well above the ECB's declared tolerance level. Conventional wisdom views the former facts as being mainly driven by changing labor market institutions and wage trends (OECD 1994, 1999; ECB 2000b), and recent declines in unemployment were accompanied by downward revisions in NAIRU estimates (OECD 2000b). As regards the latter developments, the euro's plunge and the rise in inflation, there is a tendency to see them as not directly related to monetary policy itself; the tenor being that despite these failures the ECB has done a "good job".

The analysis of this paper challenges this view, proposing an alternative interpretation of European growth, price, and labor market performance over recent years. In contrast to the conventional focus on labor market institutions this paper attributes a key role to demand-side factors as the driving force behind employment growth. A full assessment would have to also consider the fiscal policy shift to a more neutral stance that occurred in 1998. This paper focuses on monetary policy and the evolution of monetary conditions only. It is argued that the euro's plunge essentially resumed the trend of D-mark weakness that had started in 1996, introducing "easy money through the back door" as a magnifying factor behind the export demand stimulus that lifted Euroland out of the doldrums in 1999. To some extent, the roots of euro weakness thus lie in past: the low-growth legacies of unsound macro policies inflicted upon Europe over the 1990s. But the ECB made matters worse, first, by failing to communicate effectively and coherently with financial market participants and, second, by playing against the markets and running into the following time-inconsistency problem: attempts to prop up the euro through narrowing the current interest rate spread vis-à-vis the US \$ fail if they are perceived by the markets as risking the euro zones growth prospects and hence the sustainability of tighter money in the future. Interest rate hikes may then weaken rather than strengthen the currency. A more balanced and pro-active attitude toward growth, and medium-term orientation as regards inflation, might have both reduced inflation in the short run and improved growth in the longer run.

After discussing some a priori difficulties in assessing the ECB's performance in section 2, the analysis revisits the convergence process of the 1990s: section 3 concentrates on monetary conditions in Germany, while section 4 then illustrates that monetary conditions evolved markedly different in some other EU countries. A detailed discussion of the ECB's performance then follows in section 5, at first focussing on the ECB's ongoing communication problems, and then turning to the above-mentioned time inconsistency problem. Section 6 concludes.

SOME ISSUES IN ASSESSING THE ECB'S PERFORMANCE

Monetary policy is generally held to affect the economy in complex and less than fully understood ways. It is widely agreed though that in open economies with flexible exchange rates these effects arise mainly through two channels of transmission: changes in the level of interest rates and the exchange rate. Performance measures for monetary policy too remain controversial. In principle, an assessment of central bank performance may either focus on how skillfully policies are executed and communicated with the view of achieving their stated goals. Or assessment may focus on the extent to which those stated goals were actually achieved. The ECB for its own part has from the beginning declared that it wishes its own performance to be judged in terms of the medium-term price developments in Euroland only (Duisenberg 1999, Issing 1998), that is, in terms of its primary objective of price stability, defined by the ECB as a year-on-year increase in the Harmonized Index of Consumer Prices (HICP) of "less than 2" over "the medium term".⁽³⁾ This standard of (ex post) evaluation raises a number of difficulties though.

One difficulty is that no such medium-term record is available so far. Given that the lag between monetary policy measures and prices is commonly held to be around one and a

half to two years long, an assessment of the ECB's performance on the price front would have to focus on current and most recent developments (and the prospects for prices over the next few years). Another difficulty is that it seems rather misguided to solely focus on (medium-term) price developments in assessing the performance of monetary policy in the first place.

For such a single-variable performance measure would seem to presume that monetary policy has no effects other than determining inflation in "the medium term". Yet, the consensus view among economists is that monetary policy has largely real effects in "the short run". Economic theory would thus seem to forbid us to abstract from those short-run real effects of monetary policy - unless these were of no significance to economic welfare. This, however, is barely the case, not even in the context of abstract theoretical models. In practice, monetary policy is clearly operating in the (politically sensitive) short run of real world affairs at all time; as, in truth, the real world "equivalent" to the analytical fiction of "the long run" is nothing but a sequence of successive short runs anyway. The mounting empirical evidence on the role of hysteresis (or at least persistence) to European unemployment (see e.g. Ball 1997, 1999) surely adds extra doubts about the practical relevance of the notion of money neutrality and, hence, the ECB's preferred standard of assessment. Fortunately, taking growth and employment into account not only broadens but also lengthens the basis for assessing the ECB's performance, as real developments since mid-1999 might be seen as having been affected by the ECB.

A third difficulty arises from the crucial role of communication of monetary policy, implying that outcomes cannot be assessed as if they were independent of policy implementation. In particular, effective communication of monetary policy to financial market participants is key to outcomes given the paramount role of the financial system in transmitting monetary policy; ex post policy success therefore crucially hinges on how well the central bank guides market expectations and perceptions. In practice, central banks have little difficulty in controlling very short-term interest rates and, generally speaking, these usually provide a good index of the level of interest rates in the economy. Central banks' control over financial asset prices other than short-term interest rates, however, is neither direct nor resting on any secure basis. In short, implementing any desired policy stance presupposes successful guidance of market expectations; while communication failures may provoke market opposition and result in establishing the markets', rather than the central bank's, (imposed) monetary stance.

Analyzing the central bank's degree of control over long-term interest rates, Keynes (1936) identified the following "time-inconsistency problem", featuring market participants' fears of financial losses that a future policy reversal would inflict on them (cf. Bibow 2000b). In his example, the central bank injects liquidity into the system through open market operations in bond markets, that is, the central bank even exerts a direct influence on the long-term rate of interest. However, Keynes argued, if the central bank fails to steer long-term interest rate expectations downwards sufficiently, market participants may increasingly prefer to reduce their bond market exposure and thereby counteract the central bank's measures. Essentially, market expectations of a future reversal of today's desired policy stance prevents the desired policy stance from being established in the first place. This problem arises if the central bank fails to convincingly communicate to the markets that its preferred stance implies a sustainable course of policy. As a result of the central bank's lack of credibility, it loses control over policy stance, and the markets impose their preferred stance instead.

Today, central banks generally abstain from directly operating in market segments other than very short-term interest rates. For if the markets decided to oppose the central bank, financial losses incurred by a central bank due to asset market intervention might be difficult to hide. Yet, relying on "open mouth operations" in exerting influence on financial asset prices in general (other than through arbitrage links to directly controlled short-term rates) hardly diminishes the importance of successful communication of monetary policy; it merely makes it easier to cover up policy failures and avoid losses in reputation and prestige caused thereby.

Crucially, the time-inconsistency problem identified by Keynes is not restricted to bond markets. It applies to asset prices in general, such as stock and currency markets. Monetary policy affects expectations about future growth and inflation and, hence, the expected future path of policy stance considered sustainable in the markets' perception. Effective communication of monetary policy to currency markets, and the prospects any policy heralds for future growth and inflation, seems especially important given that the exchange rate channel of monetary transmission features relatively short lags for both activity and prices. Accordingly, communication failures concentrated in currency markets may quite easily disrupt monetary policy and impose a monetary stance different from the one intended by central bankers.

These considerations move the euro exchange rate into the spotlight of the analysis. What effects did the euro's plunge have on the economy and how appropriate was the ECB's conduct in view of these developments? In what ways has the ECB's conduct affected the euro and the current situation in Euroland, and the likely developments over the next few years?

Before addressing these questions the run-up period to EMU needs to be scrutinized, beginning with an analysis of monetary conditions and economic performance in Germany over the 1990s. For one thing, it is widely hoped that the ECB will pursue monetary policy with the same kind of "stability orientation" that the Bundesbank claimed for its policies. For another, the state of the German economy was widely seen as a prime force behind the euro's plunge, as reflected by the Economist's (1999) headline on Germany as "the sick man of the euro".

MONETARY CONDITIONS IN GERMANY OVER THE 1990s: THE STORY OF THE "SICK MAN OF THE EURO"

As I have shown elsewhere (cf. Bibow 1998, 2000a), *western* ⁽⁴⁾ Germany's dimly poor economic performance over the 1990s, an average growth rate of real GDP of 1.5%, job losses of some 5% of the labor force and a near-doubling of the unemployment rate, cannot be properly understood without appreciating the extraordinary length and degree of monetary tightness imposed by the Bundesbank between 1990 through 1995. By the turn of 1989-90, real short-term interest rates had reached their peak level of 5-6% at which they were kept until the economy was smashed into Germany's worst post-WWII recession by mid-1992. Then, from September 1992 onwards, niggardly slow interest rate cuts were fully compensated by exchange appreciation until the turn of 1995-6. Effectively, as figure 1 shows, the ultra-tight monetary conditions ⁽⁵⁾ established in 1989-90 remained basically unchanged for six years.

In fact, the degree of monetary tightness became even more stringent when fiscal policy embarked on consolidation in 1992, while capacity utilization not only dropped sharply in the 1992-3 recession but remained stuck at severely depressed levels in subsequent years. As economic theory would predict, six years of ultra-tight money had glaring real consequences. Depressed domestic demand reflected the severeness of the deflationary policy-mix imposed well. In particular, investment in capacity expansion was notable for its absence in Germany after 1991. And private consumption stagnated throughout the 1990s as unemployment soared to unprecedented levels in *western* Germany. Mirroring these developments public finances deteriorated sharply since 1992, despite (or because of?) desperate attempts to keep them under control by continuing cuts in public investment and consumption accompanied by ever new tax hikes. In view of the fact that this exceptionally long span of ultra-tight money lasted until spring 1996, it is hardly surprising that employment kept on falling, and unemployment continued to soar and persist, until the end of 1997. Figure 2 illustrates the evolution of monetary conditions and capacity utilization ⁽⁶⁾ in western Germany between 1989 and 1998. In this section I wish to elaborate in more detail on the following two points of interest: first, the process of monetary easing that started in Germany in 1996 arose through the exchange-rate channel only and, second, the euro's plunge since its launch essentially resumed the trend of DM weakness. The first point serves to illustrate the causes for Germany's unbalanced recovery in the late 1990s: its free-riding on external growth and sole reliance on export demand. The second point offers some exoneration to the ECB, which had to put up with the Bundesbank's legacies inherited by 1998-9, focusing the analysis on the question how well the ECB handled this burden (to be addressed in section 5 below).

Figure 3 illustrates the evolution of the monetary conditions index and its two constituent parts from 1995 to the end of 2000. ⁽⁷⁾ A few comments are in order here on occurrences through 1998. First, the degree of monetary easing that arose through the interest rate channel, after having proved insufficient to stimulate domestic demand between September 1992 and 1995, was rather limited after 1995 too. This was despite the fact that nominal short-term rates reached their historical record low of 3% in the summer of 1996, as inflation too had meanwhile been squeezed to very low levels while grossly underutilized resources and still falling levels of employment acted like a drag on domestic demand. By contrast, second, monetary easing through the exchange rate channel until autumn of 1997 was quite considerable, as the effective exchange rate of the D-mark depreciated by some 10 per cent from its peak in 1995. At that point, however, third, the Bundesbank's surprise 30 basis points hike of 9 October 1997 occurred. ⁽⁸⁾ Fourth, by autumn 1998, price and interest rate changes together had fully reversed the niggling monetary easing through the interest rate channel that had occurred in 1995-6. In addition, fifth, note that monetary conditions tightened further at this time through exchange appreciation.

The final point is especially noteworthy for the fact that this tightening of monetary conditions coincided with the severe export demand shock that hit Germany in 1998 in the context of the Asian and Russian crises. (Indications for an imminent slowdown in growth had been apparent from spring 1998 onwards.) In the event, the Bundesbank not only took the purely discretionary decision not to cut interest rates; as other, more balanced and rule-oriented central banks like the US Fed and the Bank of England did in a timely fashion for reasons of risks to economic stability. Bundesbank President Tietmeyer publically proclaimed that the external demand shock would not affect stability in Euroland (thanks to the "serious preparation" undertaken "on German insistence" in the years before; cf. Hutter 1998a,b); thus, if anything, even encouraging the unwarranted DM appreciation of autumn 1998.

It does not seem too far-fetched, then, to view the Bundesbank's final acts as preparing the ground for the euro's subsequent slide ever since its launch at an inappropriately high rate. And a few more preliminary comments are thus in order here on developments on the right-hand side of the vertical bar in figure 3 marking the euro's launch.⁽⁹⁾ First, some degree of monetary easing through the interest rate channel occurred during 1999, which has been fully reversed meanwhile though. Second, another marked easing arose through the exchange rate channel, picking up the previous trend of DM weakness that had started in 1996. Third, while the overall degree of monetary easing that has arisen since 1996 is very considerable indeed, its composition remained severely unbalanced, with any direct stimulus being solely concentrated in the external sector. This stark imbalance in demand stimuli is further illustrated by figures 4 and 5, the former showing the disparity between domestic and foreign orders to manufacturing over the 1990s, the latter showing the importance of net exports as a contribution to GDP growth.⁽¹⁰⁾

Importantly, this is not to deny the possibility that even a stark imbalance in growth might not - eventually - cure itself "automatically", particularly if the export boom continues for long enough to ignite self-sustaining growth in domestic demand. One obvious risk of this free-riding strategy is though that the export boom may not come to last for long enough. Another risk is that economic policies may even fail to at least accommodate this "self-correcting" process and prematurely restrain knock-on effects on domestic demand.

The preliminary conclusion of this story of "the sick man of the euro" is that the evolution of monetary conditions provides considerable explanatory power as regards (western) Germany's unbalanced real performance both during the run-up to EMU and during the new currency's first two years. Both in 1996-7 and 1999-2000 strong pick ups in external growth came to Germany's rescue where depressed domestic demand due to a persistently deflationary macro policy-mix was the order of the day throughout the 1990s. The external crises of 1997-9 provided a succinct warning of the risks involved with this strategy though. The next section will complement this picture by looking at developments in some other EU (ERM satellite) countries.

ECONOMIC CONVERGENCE ACHIEVED BY 1997-8: APPARENT OR REAL?

To understand the degree (or lack) of real economic convergence in the euro area on the eve of the new currency's launch, and specifically the role of monetary conditions in this context, the analysis now turns to comparing the situation in other EU countries with Germany's. For developments in Germany over the 1990s were certainly peculiar, starting with a strong expansion in domestic demand at the start of the decade, to be followed by persistent stagnation of domestic demand until its end. As before, the assessment of monetary conditions involves two factors, exchange rate developments and their effects on competitiveness and foreign demand on the one hand, and interest rate developments and their effects on domestic demand on the other. Two events stand out: first, the ERM upheavals between 1992 and 1995 and, second, the process of interest rate convergence that occurred over 1996-8.

The ERM crisis of 1992-3 marked the first key factor of divergent monetary conditions. Up to that point the Bundesbank's ultra-tight policy stance presented an even heavier burden to Germany's EU neighbors than to the anchor country itself. As most EU countries were already experiencing weak growth, or were on the brink of (or even in) recession, by 1990-1. Moreover, in some countries inflation in the early 1990s was below, while nominal interest rates stayed above Germany's and spreads increased even further as risk premia widened significantly during recurrent bouts of financial market instability. Unification offered some relief through rising German imports (disparately benefitting the smaller countries like Austria and the Netherlands), but the depressive effects on domestic demand due to severely inappropriate monetary conditions go a long way in explaining the drawn-out period of recessionary conditions in large parts of Europe between 1990 and 1993.

A significant and early monetary easing then occurred in some countries after September 1992. The marked appreciation of the D-mark during the first half of the 1990s was not just due to pronounced US dollar weakness, but also to a significant appreciation *within* the ERM zone. Germany's loss of competitiveness was partly mirrored by other EU countries gains.

The group of euro zone countries that benefitted from gains in competitiveness early in the decade consists of Finland, Ireland, and the three Latin countries Italy, Spain and Portugal.⁽¹¹⁾ Their currencies depreciated by around 20 per cent or more against the D-mark, and this shift in competitiveness had the effect that economic theory would predict: in all countries growth in export volumes picked up markedly relative to Germany around 1993 and remained above growth in world trade over the decade; while Germany's export volumes grew at first below and later in line with world trade. The OECD's export performance measure⁽¹²⁾ of fig. 6 illustrates these developments. Starting in 1996, pronounced D-mark weakness then presented a further *common* export demand stimulus and Germany's *relative* trade performance improved again towards the end of the decade. While Finland was also strongly affected by country-specific factors, Italy's case is of much interest. As fig. 6 shows, Italy's improvement in trade performance was more temporary in nature, as the lira appreciated sharply in 1996, rather untimely in view of Italy's particularly severe fiscal tightening at that time.

The process of interest rate convergence over 1996-8 provided the second driving factor behind diverging monetary conditions among euro zone countries during the run-up to EMU. I have noted above that ERM countries generally faced an even tighter monetary stance in the early nineties as growth and capacity utilization was generally below but interest rates (in some cases significantly) above Germany's levels. However, once financial market confidence about the prospects of an EMU start by 1999 began to improve after 1995, the fall in interest rates to the floor set by German levels bestowed an additional stimulus to domestic demand in these countries. The spreads in nominal interest rates between the three Latin countries and Germany were still some six per cent in 1995. They then fell to zero at the turn of 1998-9. Taking national inflation trends into account, fig. 7 shows that real short-term interest rates were still very high in 1995, but then fell towards or even below the German level by 1999.⁽¹³⁾ This represented a marked easing in monetary conditions *relative* to Germany where interest rates stayed near neutral levels throughout. In contrast to persistently depressed domestic demand conditions in Germany, the stimulus from interest rate convergence coincided with growing employment arising from the earlier exchange depreciation, and by 1997-8 domestic demand was growing rather strongly in these countries (except for Italy where fiscal tightening and lira appreciation seem to have compensated the interest rate easing).

To illustrate the degree of divergence in monetary conditions between Germany and some of its EU neighbors over the course of the 1990s, both in terms of exchange rate as well as interest rate developments, a comparison between Germany and Spain is especially instructive. Both Spain (cf. Ferreira and Serrano 2001) and (western) Germany experienced protracted falls in employment and large rises in unemployment before 1995 and 1998 respectively. And in both countries these developments are largely attributed to "structural" problems and "inflexible" labor markets. I argued

above that this assessment ignores the exceptional length and degree of monetary tightness imposed on Germany until 1996.

The monetary conditions indices⁽¹⁴⁾ for Germany and Spain in fig. 8 illustrate the marked degree of monetary easing that took place in Spain over the 1990s not only in absolute terms, but also *relative* to Germany. Importantly, in Spain's case the process of monetary easing started three years earlier than in Germany. For one thing, starting from much higher levels, Spanish real short-term interest rates fell to German levels by 1994. Probably more important, the real effective exchange rate of the peseta fell quickly and sharply while the D-mark's rose. The temporary tightening of monetary conditions in 1995 was followed by a growth slowdown in 1996. But the early export stimulus had turned the labor market by 1994-5 and was already underpinning domestic demand as interest rate convergence accelerated domestic demand by 1997-8.

Note that employment growth in Spain since 1995 has meanwhile reduced the rate of unemployment by some 10 per cent from its peak in 1994; while the latest OECD (2000b) estimates for Spain's NAIRU show that structural unemployment fell by less than 2 per cent over this period. Spain thereby exemplifies well a point of general - although at varying degrees! - validity in Europe over the 1990s: ultra-tight money in the early years of the decade and very easy money towards its end go a very long way in explaining trends in employment and unemployment.

Two further observations are in order here before the analysis turns to the ECB's conduct over 1999-2000. First, financial markets and benevolent external developments, particularly the acceleration in US growth in 1996, rather than "stability-oriented" macro policies in Europe were key to successful convergence by 1997-8. Trends in European growth, employment, and public finances until 1996 stand witness to the fact that these policies had largely counterproductive effects as long as one country's benefit came at another's expense and overall policy stance in the union was deflationary. Only the common export stimulus arising since 1996 from accelerating US growth and magnified by D-mark weakness together with interest rate convergence, that is, factors external to European policies and largely orchestrated by the markets, made it possible for most countries to meet the fiscal convergence criteria virtually in the last minute.

Yet, second, the attested successful convergence by 1997-8 (cf. EMI 1998, EC 1998, ECB 1999e) was apparent rather than real. In truth, strong forces of real economic divergence were at work which had their roots to a large extent in divergent monetary conditions over previous years. While some countries had by then achieved a state of balanced and sustainable growth, others, and especially Germany, were solely relying on export demand to compensate for their depressed demand conditions at home.

And this brings me back to the story of the sick man of the euro, the last-minute external demand shock and the policy blunders that spoiled the strong euro dream. In principle, the international crises of 1997-9 were in the nature of a symmetric shock, as all countries were affected in the same direction, requiring a common policy response. Yet, as the situation within the euro area differed starkly in terms of strength of domestic demand and countries' exposure to the shock, the consequences were rather asymmetrically distributed. Most remarkably, while the average level of euro area interest rates did fall in late 1998 due to convergence, the very country where relief was probably most urgent, Germany, faced both a *tightening* of monetary conditions *and* an especially sharp fall in export demand. It is hard to escape the conclusion that the German authorities' "stability-oriented" policies that had led Germany up to the EMU starting line managed to put it in a remarkably poor starting position. Divergence was bound to get worse.

THE ECB VS. THE MARKETS: EASY MONEY THROUGH THE BACK DOOR

One reason for revisiting in some detail the convergence process of the 1990s is that the problems that were going to arise over 1999 and 2000, and hence the issue of the ECB's appropriate response to them, cannot be properly assessed without understanding these problems' roots in earlier developments. The key problems were real economic divergence on the one hand, and the risk of stagnation, particularly in the euro area's core, on the other. The roots of these problems lie to a large extent in divergent monetary conditions over the 1990s, and the extraordinary length and degree of monetary tightness that strangled domestic demand, particularly in Germany, over the whole period. The stark growth differential between the US and Euroland that emerged by the mid-1990s had been behind the trend of D-mark weakness since 1996, and it provided the basis for the time inconsistency problem that the ECB was going to run into. Ultimately, the sustainable level of interest rates in an economy depends on its rate of growth. And by offering higher prospective financial returns the faster growing economy's currency will tend to appreciate; providing welcome disinflationary relief. While benefitting from the export demand stimuli, the low-growth economy may find the price level effects arising through currency weakness less desirable. Ironically, interest rate hikes intended to fight inflation may expedite further currency weakness and hence inflation, rather than the opposite.

Another reason for revisiting the 1990s stems from the apparently wide-spread hope that the ECB will conduct monetary policy very much the way the Bundesbank did. The analysis so far has hopefully left the reader with some doubt as to the sanity of this longing. This section will further substantiate this concern, arguing that the ECB's conduct may well be too much inspired by its grand model.

To begin with, it is probably uncontroversial that the two key issues in monetary policy over 1999-2000 were pronounced euro weakness on the one hand, and the ECB's on-going difficulties in communicating effectively and coherently with the outside world on the other. In what follows I shall first rationalize and then explore the hypothesis that these two issues might have been more closely and more deeply related than many observers seem to appreciate. To be fair, as already noted above, the Bundesbank's blunder on the eve of EMU set the scene for things to come: the euro was launched from an "extremely high starting point" (Cottrell 2000, p. 77). At just that time, however, it became generally apparent that Bundesbank President Tietmeyer's stability proclamations had been far off the mark, particularly in Germany's own case. The euro thus started on a negative note and immediately zoomed in on the D-mark's (only briefly interrupted) downward trend.

Another root of the difficulties that arose from early on must be seen in the Treaty provisions as regards responsibility for exchange rate policy (particularly Art. 111⁽¹⁵⁾; cf. Kenen 1995), giving rise to numerous irritations among and between finance ministers and central bankers. Occasionally, these irritations were conflated with, and further magnified by, certain political decisions that were perceived as "market-unfriendly" or less than enthusiastic about "structural reform" by financial market participants (perceptions generally encouraged by ECB proclamations⁽¹⁶⁾). Overall, these factors may have added some "noise" to the currency's pronounced downward trend. At some point the ECB's president adopted the "Mr euro" title, and finance ministers learned to coordinate and restrain their public utterances on the euro (OECD 2000, p. 61-2). As it turned out, adopting that name involved attracting quite some blame.

It seems rather compelling, then, to scrutinize carefully to what extent the ECB's own conduct might have contributed to the euro's plunge, what the consequences for economic developments in Euroland were, and how these developments have fed back into the ECB's policy-making process. As a first step, the analysis of the ECB's conduct will be carried out within its own policy making framework, the two-pillar stability-oriented strategy featuring, first, a quantitative "reference value" for M3 and, second, the ECB's "broadly based assessment of the outlook for future price developments and risks to price stability in the euro area as a whole" on the other. As a second step the analysis then turns to the question whether the ECB's interest rate decisions (derived from and explained within its own strategy) might have given rise to a time-inconsistency problem that effectively imposed the market's rather than the ECB's stance.

The first pillar, the reference value for M3, may be dealt with rather briefly here, the key fact being that the actual growth in M3 was significantly and consistently above the reference value throughout the last three years.⁽¹⁷⁾ This was not really surprising as the reference value of 4.5 per cent was set conspicuously low; the most plausible explanation for which is that the chosen reference value was mainly meant as a hedge against criticisms of monetary restriction in the first place: a reference-value overshoot would either provide an excuse for a rate hike, or be "explained" as accommodating certain "special factors" that the ECB - at its own discretion - decided would, for the time being, not pose any risk to price stability. Strategic use of an apparent "rule" to fend off outside criticism on the one hand, but enlarge (rather than constrain!) the central bank's own discretion on the other, is in line with Bundesbank traditions.

However, when the reference value was announced on 1 December 1998 it had probably not been foreseen that an above-reference-value growth in M3 would complicate matters when the ECB's 50 basis point interest rate cut of 8 April 1999 occurred, an issue that surrounded the ECB's first move with great confusion and controversy (not least in Germany where adherents to monetary targeting are less rare a species than elsewhere).⁽¹⁸⁾ As M3 growth has remained above its reference value ever since, this factor allowed the ECB on later occasions to argue that monetary policy was not restricting growth. The situation became more complicated during the second half of 2000 when the ECB continued to raise interest rates while M3 growth was already slowing markedly. To those who trust the reliability of M3 as an indicator this would seem to herald a marked slowdown in GDP growth and raise doubts about why the ECB *continued* tightening nevertheless. Be this as it may, given that not too many ECB observers seem to have been convinced of either the usefulness of the M3 reference value or its *systematic* role in the ECB's strategy anyway, the analysis may now focus on the second pillar.

In fact, the second pillar, the ECB's broadly based assessment of the outlook for price stability in the medium term, above and apart from any irritations arising from contradictions with the first pillar, has been the primary source of communication problems throughout, particularly regarding the role of the exchange rate. And the ECB's communication policy has seen some remarkable shifts on this issue indeed, evolving together with the degree and length of euro weakness. At the start, the ECB emphasized that the task of focusing on the maintenance of price stability in the euro area is "facilitated" by the fact that the ECB's strategy did not embody any kind of exchange rate "target" for the euro (ECB 1999a). And during the first period of the euro's decline, lasting until mid-1999, the ECB seemed likewise keen to downplay the relevance of this factor and its own concern about it. Certainly the ECB's (1999c) deliberations on the "role of short-term economic indicators" in the April Bulletin did not shed any light on this important issue, nor did Mr Duisenberg's famous slip on the lack of an exchange rate policy ("For the time being there is neglect") help to meet any by then emerging charges of "benign neglect".⁽¹⁹⁾

But in truth it became ever more apparent that the ECB was highly concerned about the euro's pronounced decline, given that the new currency's image began to take serious damage in the general public's view too. The fact that an experienced central banker like Mr Issing caused a stir in the markets in late 1999 by 'appearing to gloat that speculators had "burnt their fingers" in the attempt to push the euro below parity' (Financial Times 1999) illustrates well how very unnerving these developments must have been for the people at the top of the ECB. The euro then fell decisively below US dollar parity in early 2000. Up to that point, the ECB had largely confined itself to the use of open mouth operations, emphasizing the "potential upside" of the euro. But when the Fed raised its Fed Funds target on 2 February 2000, the ECB quickly followed suit the day after; a panicky move that did little to build up its already blemished market reputation. A whole series of interest rate hikes followed between March and October 2000, with euro weakness being increasingly explicitly cited as a key factor underlying them. Finally, on September 22, the ECB organized concerted foreign exchange market interventions in which it was joined by the US Fed and the Bank of Japan. Their success proved rather temporary though as Mr. Duisenberg committed another blunder only shortly afterwards that led to the so far most serious crisis in his presidency (with hopes for his sooner rather than later resignation being expressed more explicitly and more widely than ever before, cf. Barber 2000, Economist 2000).

All in all, it seems hard to escape the impression that the ECB's ongoing failure to communicate effectively and coherently has probably contributed more than some minor noise to the currency's plunge. Of course, the verdict that the ECB's communication with the outside world features some scope for improvement is not really controversial. Even Mr Issing has admitted as much in his reply to outside criticism, suggesting that "the verdict among most, if not all, our 'watchers' seems to be that - broadly speaking - the ECB has done a good job but has not been very effective in presenting and explaining itself" (Issing 1999).

It seems to me that this statement may be far less to the point than it might at first appear. In fact, the statement is quite nonsensical - unless it is argued that communication failures are of no real consequence whatever, either in establishing monetary stance or concerning its effects on the economy. If that were the case though, it would be barely understandable why so much attention is being paid to the issues of transparency, communication, credibility, and reputation etc. in the first place. Either these issues are of importance and thus need to be taken into account in assessing monetary policy. Or they are irrelevant and one might just as well solely focus on interest rate decisions and take financial market perceptions, the euro exchange rate etc as exogenous factors that were neither affected by, nor themselves affecting, monetary stance. The former interpretation seems more compelling to me.

Over and above those on-going irritations caused in currency markets by the ECB's incoherent behavior, another, deeper layer to the relationship between the pronounced euro weakness and the ECB's communication problems has been involved. The basis for this deeper layer of the problem lies in the pronounced growth differential between the euro zone and the US (cf. Corsetti & Pesenti 1999, Spahn 2000). And, importantly, growth has clearly represented the "primary theme" in financial markets over recent years. Acting in this "pro growth" environment, the ECB has failed to grasp the following time-inconsistency problem: attempts to support the euro by narrowing the interest rate differential vis-à-vis the US dollar may be counterproductive if the narrowing of the *current* interest rate differential is perceived as risking a widening (rather than narrowing) of the growth differential ultimately underlying any *sustainable* path of *future* interest rate differential. In fact, the ECB's aggressive interest rate hikes over the course of 2000 appear to have been increasingly perceived as lacking credibility, namely for risking the euro zone's growth prospect. This hypothesis offers an explanation for the paradoxical feature that interest rate hikes by the US Fed tended to be good news, while those by the ECB bad news for the euro. A brief review of the course of developments will help to illustrate the issue.

After its initial slide of some 7 per cent since the start of 1999 the euro's external value stabilized between June and October. During the summer the euro zone's growth prospects brightened up and by July ECB statements started to feature a tightening bias. Yet, during this phase of euro stability the short-term interest rate differential vis-à-vis the US dollar even widened (as the US Fed, after its quick easing in 1998 in response to growth risks, started to tighten again), while euro bond yields rose (and the long-term interest rate differential shrank). A reversal then occurred in November 1999 with the ECB's 50 basis point hike. The short-term spread vis-à-vis the US dollar fell, but euro bond yields stabilized (and the long-term interest rate spread widened again). And the euro resumed its decline, reaching near parity with both the US dollar and the yen by the end of 1999.

In 2000, the same pattern became even clearer with the ECB's three 25 basis point hikes of February, March and April each. The ECB succeeded in keeping the short-term interest rate spread in check, as the Fed too continued its tightening. But, if anything, the euro's downward drag seemed to have gained new force from these hikes, with euro bond yields being set on a declining trend (although falling more slowly than in the US where a marked yield curve inversion developed that was however not perceived as heralding a recession but attributed to public debt redemptions instead).

In terms of the time-inconsistency problem hypothesized here the ECB faced a choice between: either containing the short term interest rate differential vis-à-vis the US dollar in the short run while risking that this would be perceived as unsustainable (by causing growth risks); or falling behind the curve and deriving support from improving growth prospects, in turn promising a more sustainable basis for a tighter monetary policy course in the longer run. Note that the latter strategy features a medium-term orientation of waiting until the US Fed achieves its intended slowdown in US growth while stimulating the domestic demand growth that would be needed once that slowdown materializes. A central bank single-mindedly preoccupied with inflation risks at all time though will be naturally inclined to opt for the former strategy.

The crucial point is that - given the primary theme of the market - a market perception of an "anti-growth attitude" may well prove counterproductive in both the short run and the longer run. In the short run, it might even raise inflation through facilitating currency weakness rather than the opposite, running against the central bankers' primary obsession. Even worse, by risking growth and an unbalancing of the economy, i.e. society's primary concerns, central bankers' myopic behavior may also have detrimental longer run effects.

A clear opportunity for the euro arose in the early summer of 2000, when the Fed's 50 basis point hike of 16 May 2000 was followed by weak data on US growth, dampening market perceptions of underlying US (dollar) strength and implying that US interest rates had peaked. The ECB missed this opportunity too by continuing to play against the markets' primary theme, following suit with a 50 basis point hike on 8 June 2000. And the euro resumed its decline. Most remarkable, the ECB even continued tightening (two 25 basis point hikes followed on 31 August and 5 October) as evidence was mounting that indicated that euro zone growth had already peaked too, while M3 growth also began to slow down markedly. [\(20\)](#)

In line with the time-inconsistency problem hypothesized here, it thus took confirmation of US weakness to reverse the euro's fortune in November 2000. And by the turn of the year the euro had strengthened significantly. Showing behavior largely reminiscent of occurrences in 1998, Europe's central bankers chose to continue playing tough in January 2001. While the US Fed, after its quick cut of 3 January 2001, signaled that further cuts would follow in view of rising growth risks, the ECB continued to stress inflation risks, seemingly ruling out interest rate cuts for quite some time. With both the growth theme still intact and the US Fed's credibility - for better or worse - unquestioned, even moving the interest rate spread in the euro's favor *in the short run* backfired again: the euro weakened once more. In a market dominated by a pro-growth attitude, inflation obsession may fail to pay off (cf. Spahn 2000). More US weakness will be needed to prop up the euro - with uncertain consequences all around.

In conclusion, I must strongly disagree with the view that the ECB has done a "good job" despite the fact that it "has not been very effective in presenting and explaining itself". Rather, it seems to me, the latter factor goes quite some way in explaining why the ECB lost effective control over determining monetary stance in Euroland. Perhaps this was not even all that bad though, as the markets did quite a good job indeed: imposing "easy money through the back door". Overall, the markets' imposed stance was well in line with requirements: employment has started to grow at an impressive pace and unemployment fallen markedly. This outcome would have been quite impossible with a central bank steadfastly holding on to the belief that all European unemployment is necessarily structural and hence of no concern to monetary policy. Those who recommend that the ECB should aspire the Bundesbank's kind of stability orientation should expect to see Germany's kind of performance as seen over the 1990s. Easy money policies to stimulate growth were never among the Bundesbank's repertoire. External growth, one-off occurrences like interest rate convergence, or other benign measures bestowed by the markets cannot be relied upon as a general policy.

Certainly the euro's plunge was a mixed blessing only. As some countries were no longer in need of easy money in the first place, others, like Germany, were more in need of domestic rather than foreign demand stimuli. Furthermore, without the euro's pronounced depreciation, inflation (rather: price-level increases) would have been lower. The right answer to this, however, is not more monetary restriction, but less. To begin with, if monetary policies had been more conducive to domestic demand-led growth in the past, the ultimate source of euro weakness would not have arisen in the first place, which, unfortunately, is still not water under the bridge. But by playing (and losing) against the markets, the ECB made matters worse: raising inflation in the short run, and diminishing the euro zone's growth prospects for the longer run.

SOME CONCLUDING REMARKS ON A MIXED BLESSING UNLIKELY TO LAST FOR LONG ENOUGH

Assessing the ECB's performance is not an easy task, particularly in view of the euro's plunge. The analysis in this paper offers some exoneration to the ECB. To an important extent the problems that arose over the past two years, including pronounced euro weakness, had earlier roots: the unsound macro policies, especially inappropriate monetary policies, imposed on Euroland over the 1990s. By desperately trying to imitate the Bundesbank matters were made no easier by the ECB: except for monetary stance. For, luckily, the ECB was lacking its grand model's credibility, and the markets imposed their preferred monetary stance on Euroland instead: easy money through the back door. The ECB has not only failed to impress the markets by its own primary theme of price stability. By playing against the markets the ECB gave rise to a time-inconsistency problem that had consequences which were both undesirable from the ECB's own point of view as well as for the economic prospects of the euro zone.

By the turn of 2000-1, Euroland appears to have reached a rather critical point. As Fig. 9 shows, pronounced monetary ease [\(21\)](#) had arisen through the back door, magnifying the benefits of export growth largely sponsored by the US over 1999-2000. Internally though, monetary policy is already restraining domestic demand in important regions of the euro area (though not in others, and real divergence is part of the problem). Particularly if it is taken into account that underlying inflation is around 1.5%, while a negative terms-of-trade effect brings no relief to borrowers or anyone else (as deflating interest rates by headline inflation erroneously suggests), real short-term interest rates are already close to levels associated with slow growth and worsening public finances over recent decades.

No doubt, neither the euro's image nor the ECB's reputation gained much from developments since 1999. But more worryingly, and largely due to its own making, the ECB seems to have maneuvered itself into a trap from which it might find it hard to escape quickly enough. With average inflation in the euro zone running well above the ECB's definition of its primary objective of price stability, combined with significant divergence in both real and inflation terms within the union, the ECB might find it difficult to convince itself that there are also pending risks around other than merely nominal ones. The shape of the euro yield curve does not seem to confirm the ECB's convictions in years of strong growth ahead. And stopping to play against the markets might involve less of a loss in face than continuing to do so.

This is neither to suggest that the markets are always right nor that central banks must abide with whatever theme the markets might come up with. [\(22\)](#) The point is that if a central bank fails to impose itself as conductor of its own preferred theme, playing against the markets' theme may lead to disharmonious outcomes. Entering the arena against a strong player approved by the markets for holding a pro-growth attitude (rather than single-mindedly fighting the previous war), the ECB had nothing to win except by joining in the growth game (even if growth is something of an embarrassment to the structural myth). Of course market themes can change just as market perceptions (and realities) do, and sometimes swiftly. But it remains to be seen whether the new environment now unfolding (with a marked US slowdown or worse) will be more conducive to impressing anyone with a "price stability above all else" theme that has so far backfired severely.

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NOTES

1. Preliminary draft, prepared for presentation at the Annual Conference of the Eastern Economic Association, New York City, February 23-25, 2001.
2. In January 2001, Greece became the twelfth member; while Denmark has decided to stay out in a referendum on 28 September 2000. Sweden and the UK are the other two non-participating EU countries.
3. Article 105 of the (Amsterdam) Treaty on European Union (TEU) lays down the E(S)CB's "primary" goal as that of securing "price stability". Unfortunately, the Treaty neither defines what price stability is supposed to mean, nor does it specify the conditions under which the ECB could not refuse to pursue her "secondary" goals, that is, the EU's real objectives as laid down in Article 2 TEU. So it was all left to the central bankers to decide what suits them best. Interestingly, the ECB has meanwhile even resolved the tension that arises from Article 2 TEU, through slightly re-wording Article 105 TEU. In the October 2000 Bulletin the ECB declares that its task is to fulfil the "clearly defined mandate to maintain price stability in the euro area *and, in this way* [sic!] to contribute to the achievement of the objectives of the Community" (ECB 2000d, p. 52; emphasis added). Any possible trade-offs were elegantly declared non-existent in this way. No objective other than price stability deserves explicit consideration when deciding monetary stance. Note the legal difference involved in the ECB's and US Fed's respective mandates, with the Fed's featuring price stability *and* full employment *on an equal footing*. In addition, there are marked differences in practices and attitudes toward output stabilization, employment and growth.
4. Given the special situation in former East Germany, it is important to realize that the chosen macro policies had rather disastrous consequences in the West too. Moreover, and particularly with regard to price and wage trends, today's common focus on All-German data gives a greatly distorted picture of the true situation in the early 1990s. Where data availability allows, the analysis will therefore concentrate on western Germany.
5. A "monetary conditions index" (MCI) captures exchange rate developments and their effects on monetary stance. Effectively, a MCI combines two indicators of monetary stance, a short-term interest rate and the effective exchange rate, the two factors being weighted according to their relative role in the transmission mechanism in their effects on aggregate demand and economic activity. The absolute value of the MCI does not represent a measure of monetary stance. The MCI merely indicates whether stance has become more or less restrictive relative to some base. The base here is the

1st quarter of 1990. Other inputs are, first, the Frankfurt overnight interest rate deflated at the (western) German CPI and, second, the effective exchange rate vis a vis 18 industrial countries and based on the deflator for total expenditure, with a 3:1 weighting (equivalent to the Bundesbank's (1999) estimates). This means that a one percentage point increase in real interest rates or a three percent appreciation of the real effective exchange rate (REER) are being treated as having equivalent effects on aggregate demand. The explicit use of an MCI in monetary policy was first introduced by the Bank of Canada (cf. Freedman 1995).

6. The output gap measure used here is due to the German Council of Economic Experts (the "wise men") which has the advantage of concentrating on western Germany's production potential as derived from the rate of utilization of the economy's capital stock (see Annual Report 1998-99, p. 285, table A1).

7. The MCI of Fig. 3 is very similar to the one shown in Figures 1 and 2 above. Its base is the 1st quarter of 1999. Its inputs are, first, the Frankfurt overnight interest rate (EONIA since 1999) deflated at the All-German CPI and, second, the (Bundesbank's) Indicator of competitiveness vis a vis 18 industrial countries based on the deflator for total expenditure, with a 3:1 weighting.

8. The Bundesbank's (1997) excuse for this hike in terms of inflationary risks seemed less than perfectly honest. More likely, the hike represented an (ill-guided) attempt to buck the currency trend. For price level effects due to depreciation must not be confused with underlying inflation trends, particularly when wage inflation was running at less than 2 per cent and a huge negative output gap existed. Be this as it may, "inflation" stayed "below 2 per cent" in 1997 and fell back to (and temporarily below) zero subsequently. The currency trend, largely driven by fundamental weakness vis-à-vis the US, was only briefly interrupted and soon to resume.

9. Just before the start, in December 1998, the Bundesbank orchestrated its final interest-rate move, a cut of 30 basis points, that allowed European short-term interest rates to converge to the new floor of 3 per cent. From a German perspective, this minor and much belated cut just about compensated for falling inflation. The Bundesbank (1998, p. 13) declared at the time that this move "will clarify the interest-rate horizon for the foreseeable future and will facilitate the start for the European Central Bank".

10. It may at first appear paradoxical that Germany's growth featured a strong recovery in exports that already started after the 1992-3 recession, given the marked appreciation of the D-mark since 1992. Yet, this paradox is more apparent than real. The strong D-mark bestowed a severe profit squeeze on Germany's (export-oriented) manufacturing industries where job losses were concentrated, the latter factor in turn depressing domestic demand, while export demand was at least growing not too much out of line with world trade. Alas, when world growth faltered in 1995, Germany's brief recovery of 1993-4 abruptly ended.

11. The Danish krona, the French franc, and the Belgian/Luxembourgian franc depreciated only temporarily and on a minor scale in 1993; but had to put up with significant risk premia at times. The Austrian schilling and the Dutch guilder had been "on the D-mark" for at least a decade, and monetary conditions (though not necessarily monetary policy requirements!) in Austria and the Netherlands were basically identical to those in Germany. Accordingly, the causes for any disparate performance have to be sought elsewhere; with these countries thus being of no particular interest to us here. I also excluded the opt-outs, Sweden and the UK, although particularly the UK is of great interest for the fact that it conducted its own monetary (and fiscal!) policies ever since (not quite so) Black Wednesday in September 1992. Pronounced monetary easing arose both early and simultaneously through both currency depreciation and quick interest rate reductions, and growth in the UK recovered strongly and early (being well balanced until the late 1990s when the UK paid for its successful macro management in terms of a strong pound). Sweden emerged from its deep 1991-3 recession through strong export growth combined with weak domestic demand as interest rates remained allied to the Bundesbank's stance. Only with the interest rate convergence of 1996-8 has growth become more balanced and since 1998 rather strong overall. I have dealt with the Netherlands' case elsewhere (cf. Bibow 2000a). Essentially, the "Dutch miracle" was built on a strategy - introduced in 1982 - of systematically underbidding Germany's (and hence Europe's) wage inflation trend. This beggar-thy-neighbor policy is not a viable longer run strategy for any larger country or group of countries. But it worked well in the case of a small and open economy like the Netherlands (OECD 1999, p. 160-4).

12. Export performance is the ratio between export volumes and export markets for total goods. To illustrate relative performance I deducted Germany's export performance from each of the other countries' series.

13. Long-term interest rates featured a similar convergence process (benefitting even a larger group of countries relative to Germany before 1995), but there are well-known problems with estimating real long-term rates. The ECB (1999f) attributes the convergence and falls of real long-term rates to stability-oriented policies, particularly reduced public sector demand for "capital" due to fiscal consolidation. Arguably, a more reasonable interpretation is this: starting from an extremely and unsustainably high level of interest rates in the early 1990s, monetary easing brought down the general level of interest rates, which made consolidation possible in the first place, both directly through shrinking debt service costs and indirectly through stimulating growth.

14. The German MCI is identical to the one in Figures 1 and 2 except that the common base was set here at 1st quarter of 1992. Inputs to the Spanish MCI are, first, the call money rate and, second, the real effective exchange rate of the Peseta vis-à-vis developed countries, both CPI deflated and with a 3:1 weighting.

15. Article 111 of the Treaty foresees that the Council of Ministers (Ecofin) "acting by a qualified majority either on a recommendation from the Commission and after consulting the ECB or on a recommendation from the ECB, may formulate general orientations for exchange-rate policy in relation to [non-Community] currencies".

16. A prime example here is the German Chancellor's, Gerhard Schröder, bail out of the bankrupt construction firm Philip Holzmann AG in December 1999 that attracted rather explicit public criticism from Mr. Duisenberg, who blamed the measure as causing euro weakness. Mr. Schröder briskly reminded Mr. Duisenberg that the ECB was not in charge of German politics. One issue is what caused more damage: the supposed market-unfriendliness of the bail out or the open conflict about it provoked by the ECB. Another issue is that Europe's central bank politicians are at amazing ease talking well beyond their own monetary portfolio, but would quickly regard equivalent behavior by any democratically-elected politician as impinging on the ECB's independence.

17. The reference value of 4.5 per cent was first announced by the Governing Council on 1 December 1998 and then reviewed and confirmed in December 1999 and December 2000. Its derivation assumes a trend growth rate of real GDP of 2 to 2.5 per cent, a declining trend for the velocity of circulation of 0.5 to 1 per cent per annum, and inflation between 1 and 2 per cent (implicitly assuming that the GDP deflator and the HICP would move in line with one another). M3 is monitored on a three-month moving average basis. The ECB (1999b, p. 40) argued that "money growth substantially in excess of this value would tend to signal inflationary risks if the relationship between M3, prices and real GDP underlying the velocity trend decline of 0.5 to 1% remains stable". But at the same time the ECB is keen to emphasize that "the concept of the reference value does not entail a commitment on the part of the Eurosystem to correct deviations of monetary growth from the reference value over the short term" (providing numerous further caveats so as to maximize its own scope for discretion). Note that the ECB's approach is seriously flawed for the fact, among others, that it ignores the significant negative output gap existing over recent years (Tober 2000). Correct quantity-theoretic reasoning implies that both the money stock and the economy could grow above trend until the economy runs at its potential without such "excessive" money growth representing any risk to price stability. No doubt though operating in an environment of persistent negative output gaps makes life easier for a central bank single-mindedly preoccupied with inflation risks only (in line with Bundesbank traditions).

18. Commenting on the rate cut in its April Bulletin, the ECB (1999c) "explained" that monetary growth should not be seen as signaling upcoming inflationary pressures "at this juncture", referring to unspecified "special factors" at

19. The remark was made during a hearing at the European Parliament's Sub-Committee on Monetary Affairs on 19 April 1999. It was not the only occasion that forced Mr Duisenberg to "clarify" his remarks later on in order to limit the damage done. In a speech on 4 May 1999 he explained "we do not have a target for the exchange rate of the euro, for example, against the US dollar. This does not mean, and it is good to underline this once more, that the ECB is indifferent to the external value of the euro or even neglects it." (Cf. OECD 2000, fn. 36.)

20. The Financial Times of 6 October 2000 featured a column on the "ECB's surprise" that partly identified the problem outlined above, ending with the prophetic-sounding observation that the ECB "risks giving itself the reputation of an inflation-obsessed central bank, which is willing to put

growth at risk even when price pressures are marginal. If this happens, it will lose political credibility and investor confidence".

21. Inputs to the euro zone MCI are, first, EONIA deflated at the HICP and, second, the real effective exchange rate of the euro vis-à-vis a broad group of countries and CPI deflated; with a 6:1 weighting. The base here is January 1999.

22. And it should also not be overlooked that serious imbalances have built up in the US over recent years, both nationally and internationally (cf. Godley and Wray 1999).

Figure 1. A not-quite-so-short-run of ultra-tight money: monetary conditions in Germany, 1990-95

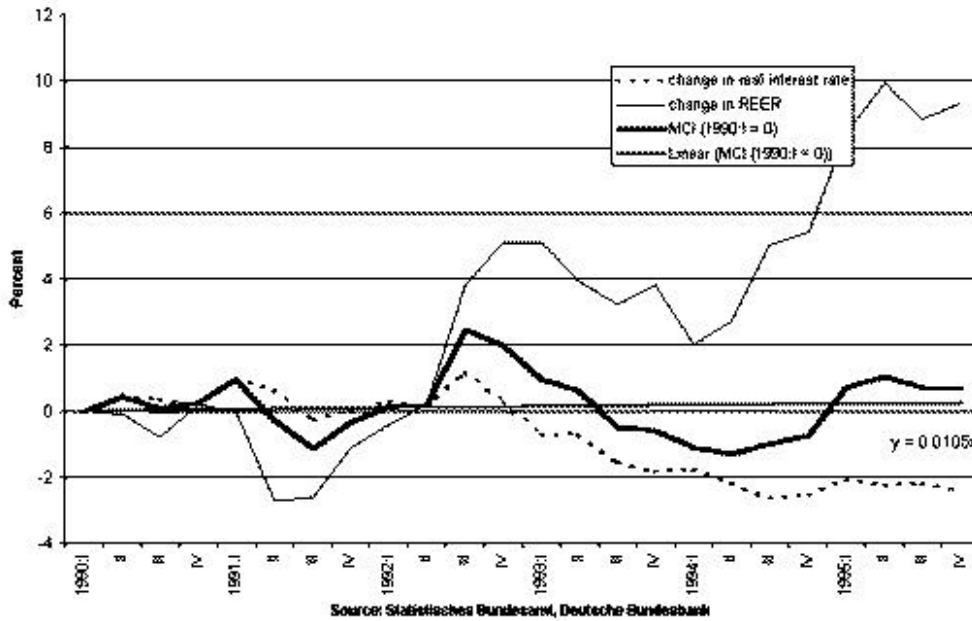
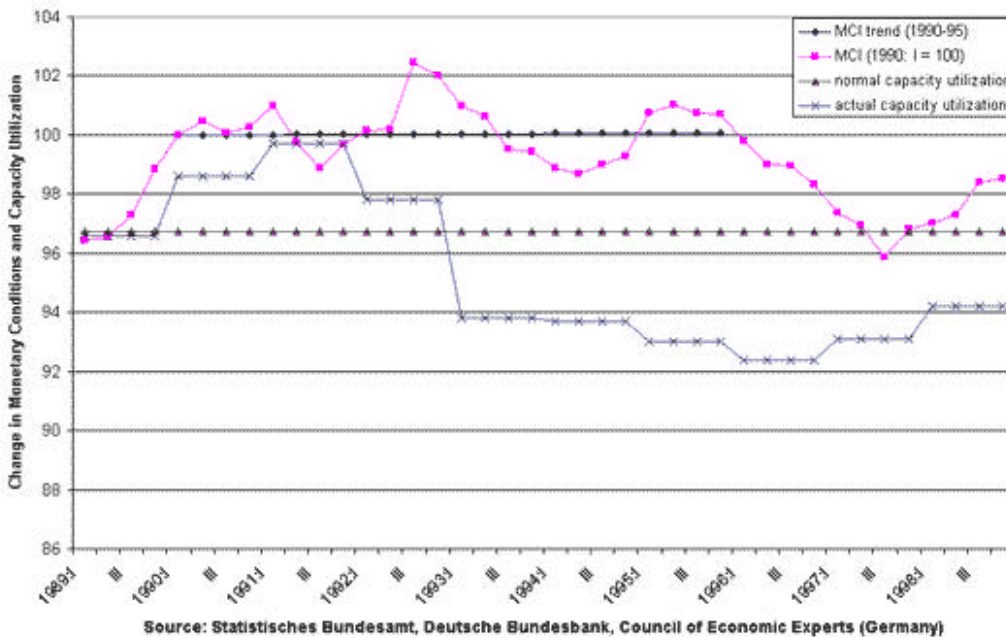
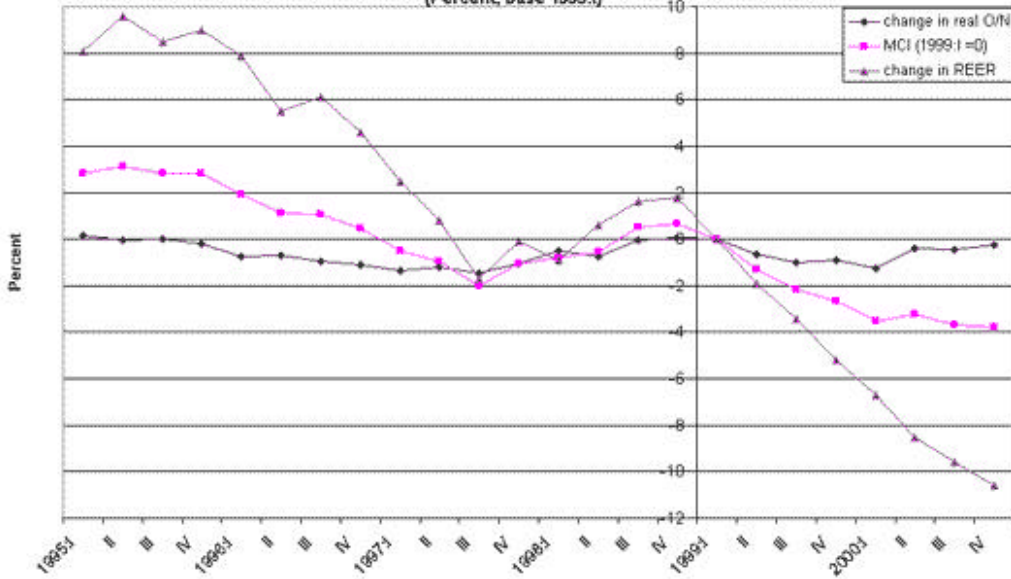


Figure 2. The story of the "sick man of the euro"
Monetary conditions and real performance in (western) Germany, 1989-1998

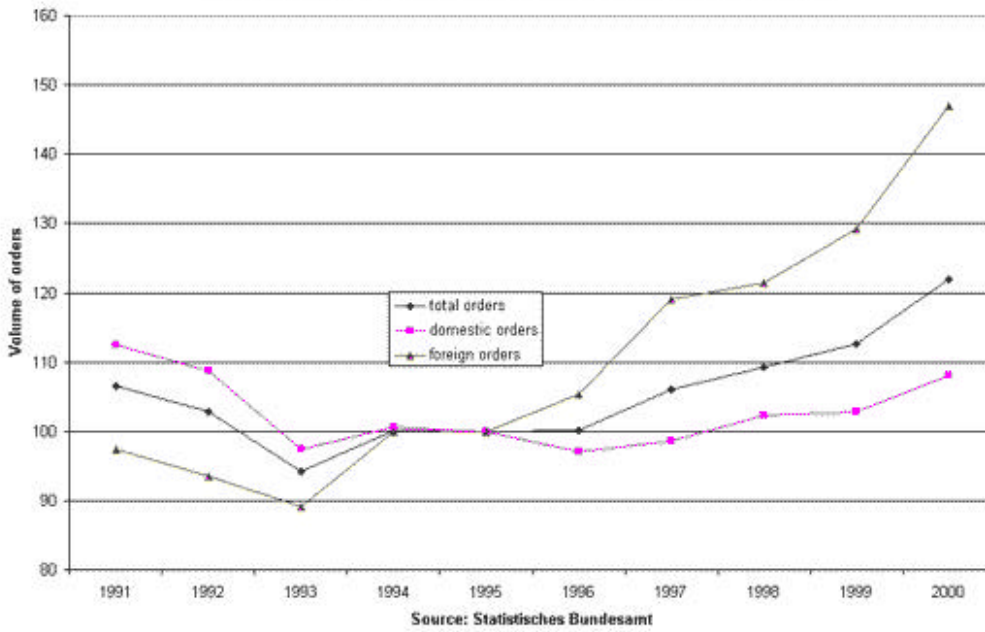


**Figure 3. Easy money through the back door:
Currency weakness and monetary conditions in Germany since 1996**
(Percent; base 1999:I)



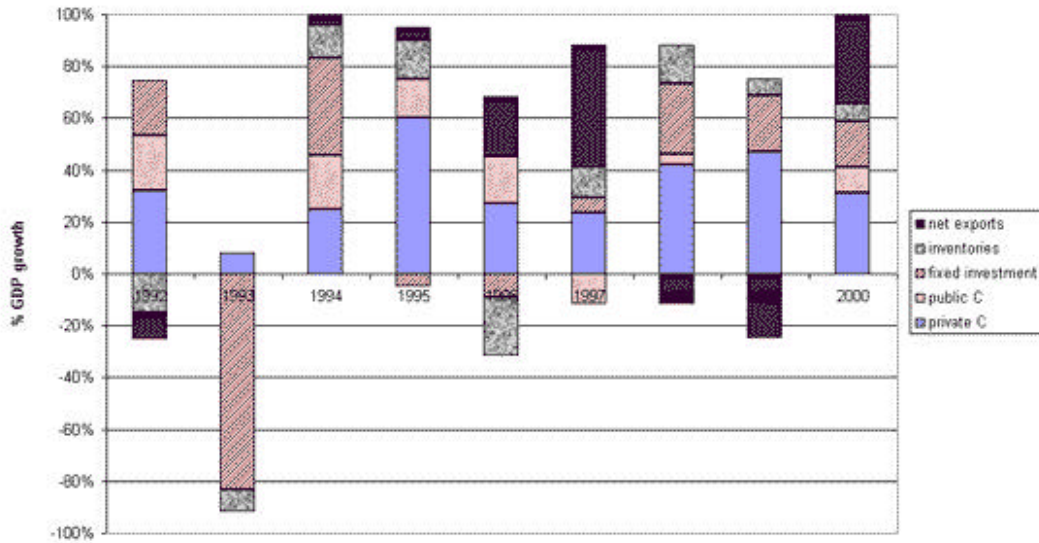
Source: Statistisches Bundesamt, Deutsche Bundesbank

Figure 4. Germany's growth imbalance
Volume index (1995 = 100) of orders to manufacturing industries in (western) Germany



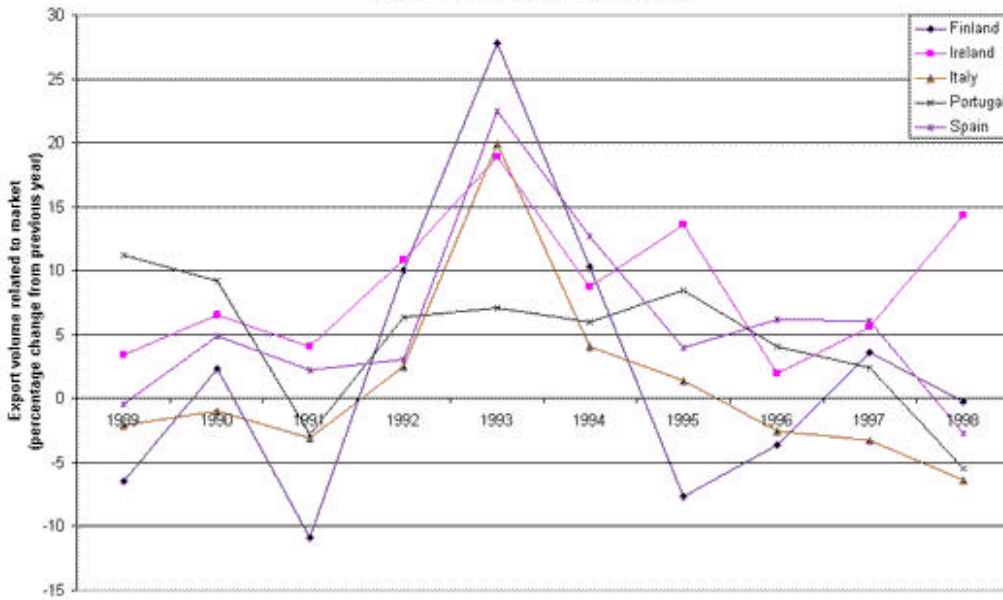
Source: Statistisches Bundesamt

Figure 5. Contributions to real GDP growth
(as a percentage of total GDP growth)



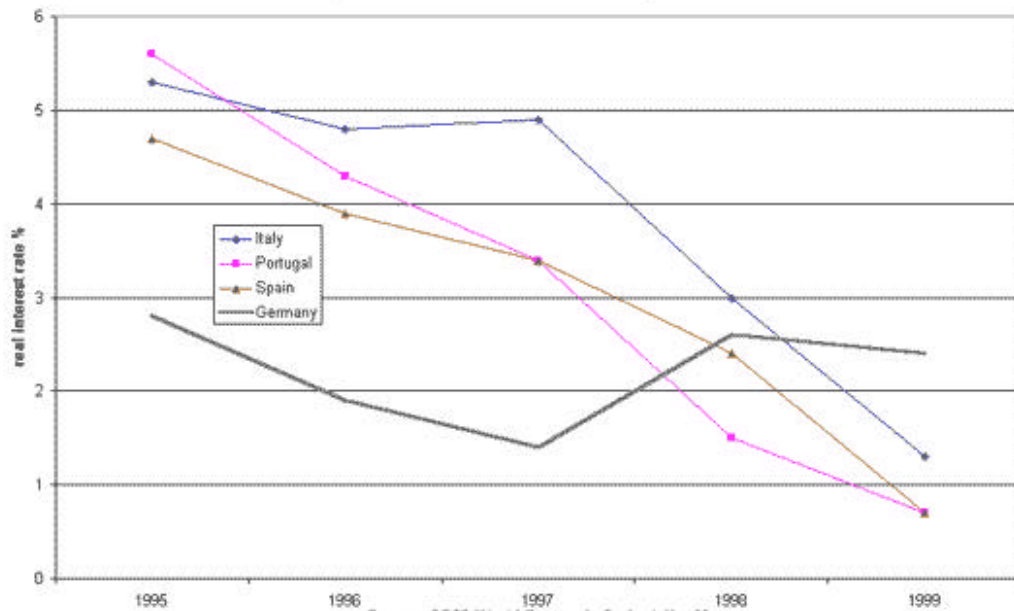
Sources: Statistisches Bundesamt
German real GDP grew at: 2.2 (1992); -1.1 (1993); 2.3 (1994); 1.7 (1995); 0.8 (1996); 1.4 (1997); 2.1 (1998); 1.6 (1999); 3.0 (2000)

Figure 6. Trade performance relative to Germany, 1989-98
Export performance for total goods (OECD)



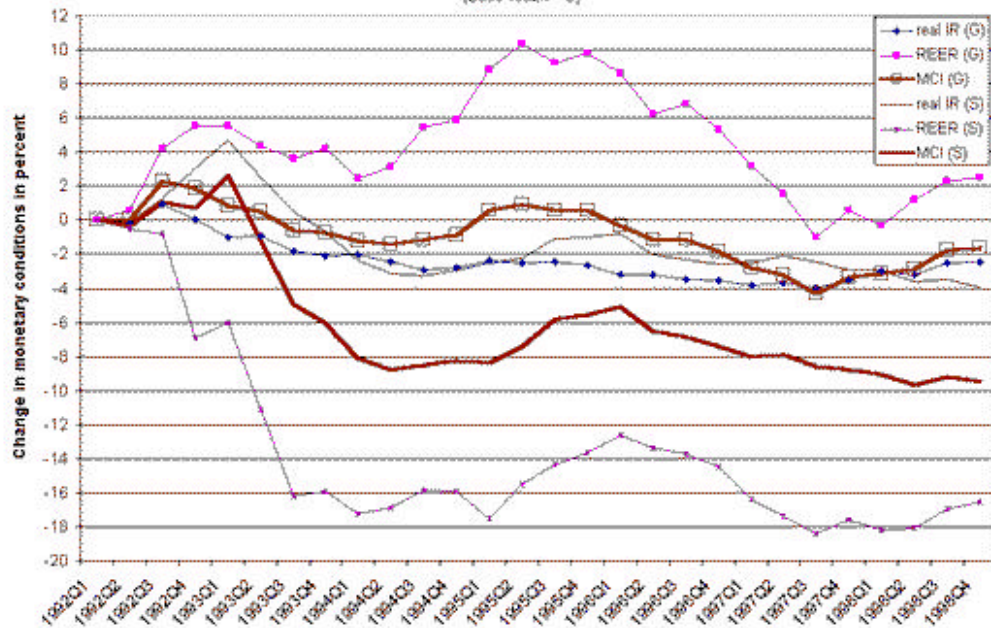
Source: OECD World Economic Outlook No. 68 (Annex Table 46)

Figure 7. Interest-rate convergence since 1995
Divergence in domestic demand stimuli bestowed by the markets



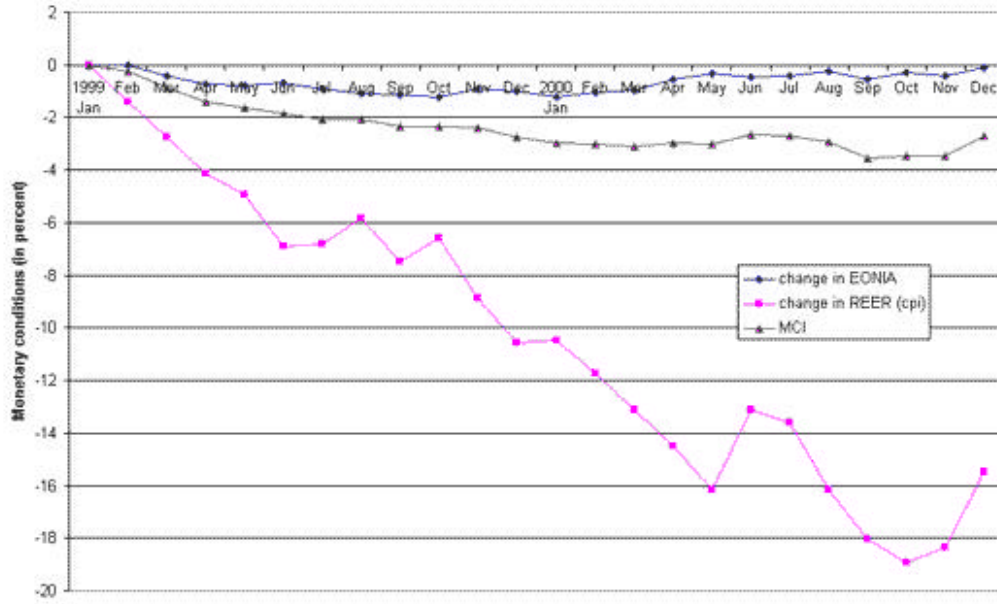
Source: OECD World Economic Outlook No. 68
(Three-month money market rates deflated at national CPI)

Figure 8. Monetary conditions in Germany and Spain, 1992-98
(Base 1992:1=0)



Source: IMF, Bank of Spain, Deutsche Bundesbank, Statistisches Bundesamt

Figure 9. Monetary conditions in Euroland, 1999-2000
 (Base January 1999=0)



Source: European Central Bank