European Central Bank rate decision opens up a financial rift

Nick Beams
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The decision by the European Central Bank (ECB) not to cut interest rates has opened up a potentially dangerous division between the world's three major financial authorities over the setting of monetary policy.

The US Federal Reserve Board has made three cuts of 0.5 percentage points so far this year, and may make another either before or at the next scheduled meeting of its monetary policy committee on May 15. The Bank of Japan has instituted a virtual zero interest rate policy. But the ECB is sticking to the rate it set last October.

The decision, announced by ECB president Wim Duisenberg last Wednesday came in the face of pressure from eurozone ministers, businesses, and international bodies, including the International Monetary Fund and the Organisation for Economic Cooperation and Development (OECD), which had all indicated they favoured a rate cut.

Their calls for a rate reduction came amid indications that economic growth is slowing in Europe in the wake of the slowdown in the United States. The OECD has revised its growth forecast for the eurozone from 3.1 percent to 2.7 percent, while a joint report issued by six major economic institutes in Germany has cut the growth forecast for that country from 2.7 percent to 2.1 percent for this year.

In the lead-up to the decision there were indications from some members of the ECB board that they were in favour of a rate cut. But when he announced the decision, Duisenberg said it had been unanimous and there was not even the need for a vote.

In his statement to the media, Duisenberg said while growth forecasts had been revised downwards since the increase in European rates last autumn and the external environment was “less favourable” and marked by “high uncertainty”, there were “no indications of a risk of a global recession.”

Not only was the decision to maintain rates surprising but also the rather defiant way in which Duisenberg defended it. Asked whether it mattered to him that there were so many people calling for a cut, Duisenberg replied: “Of course I am polite so ... It does matter. You might say I hear but I do not listen.”

In answer to another question on the ECB's stated “wait and see” policy, Duisenberg pointedly refused to give any indication that the bank might move to cut rates in the future. He did not want, he said, to introduce a “bias” into public statements “so you keep on waiting and we keep on seeing.”

The decision to keep rates on hold, after they were lifted by a cumulative 2.25 percentage points from November 1999 to 4.75 percent in October last year, brought criticism from sections of the financial press.

The *Financial Times* said that the principle behind the ECB decision was “if it aint broke, don't fix it” but “logically” the decision did not stand up. “Monetary policy is all about balancing the risk of inflation against the risk of unnecessarily depressing growth. Since last October ... the balance of risks has changed radically. If the interest rate was appropriate then, it cannot be appropriate now.”

It pointed out that while the forecasts for growth of around 2.5 percent were “encouraging”, Duisenberg had “failed to emphasise that the risks to these forecasts are substantial.”

“The weakness in Germany is dragging down the region, and even the better performers such as France are starting to suffer. Both the International Monetary Fund and the Organisation for Economic Co-operation and Development have warned of the risks of a sharper than expected slowdown. The main reason for optimism is continued consumer confidence and spending, but these could worsen abruptly if unemployment rises.”

Under the headline “Steadfast or stubborn,” the *Economist* magazine said the decision was grist to the mill for the bank's critics, of which there are many, who believe that the ECB decision-making procedures are too opaque and that it is too preoccupied with inflation “when the more worrying problem now is the risk of recession.”

The article referred to contradictory statements emanating from members of the ECB board, which had seemed to indicate that it was moving to a softening of interest rate policy.

As the *New York Times* noted in its report, three weeks ago Jean-Claude Trichet, the president of the Bank of France and a member of the ECB board, had stated that the bank was more worried about an economic slowdown than inflation.

But last week's decision “suggested that hard-liners, led by Mr Duisenberg and the Bundesbank in Germany, had consolidated their position on the central bank's board.”

No concession

The refusal by the ECB board to make even a minor concession to the demands for a cut—such as a 0.25 percentage point reduction—left financial analysts and media pundits scratching their heads for the reason. Some suggested it was a desire by the recently created central bank to show that it had genuine independence and to build its reputation for being “tough cookies.” Others warned that the ECB was taking a gamble with respect to growth expectations.

In his public statement Duisenberg made it clear that as far as he was concerned the mandate of the ECB was to ensure price stability and that while inflation in the 12-country eurozone was expected to fall below the ECB's target level of 2 percent in the second half of the year there were still dangers of price increases. “Wage developments remain an upward risk to price stability,” he added, “which needs to be closely monitored.”

Apart from the desire to keep a clamp on wages and inflation in the short-term, there may also be longer-term considerations at work in the decision.

When the euro was launched at the beginning of 1999, it was hailed as a potential global rival to the US dollar. That prospect, however, seemed to fade somewhat with the fall of the euro from its launch value of around $1.17 to less than 90 cents as capital continued to flow out of Europe to the US to take advantage of the more profitable opportunities offered by the US stock market and investment boom.

But with signs of a major slowdown in the US, the ECB may now consider that maintaining interest rates will enable the euro to play a more powerful role in the world economy.

In the longer term, the bank considers that considerable “restructuring” of the European economy is needed in order to improve profit opportunities. Dismissing pressure for a cut in rates to boost growth, Duisenberg said monetary policy could not lift growth potential which was determined largely by “structural factors.”

“To increase potential output growth, comprehensive structural reform policies aimed at an increased labour market participation rate and improved investment incentives are required. While acknowledging that significant progress has been made, a more ambitious implementation of market-oriented reforms is needed in many areas,” he said.

In line with this view, the decision not to ease monetary policy may well have been taken with the aim of keeping up the pressure for “reforms”, thereby increasing the attractiveness of Europe for global capital.

Whatever the exact motivations for the ECB decision, it has the undoubted potential to create difficulties for the US Federal Reserve Board.

With daily announcements on falling profits and job cuts, indicating that the US economy is moving into a period of very low growth, if not outright recession, the Fed is under pressure to continue cutting interest rates.

But there are dangers. While they are not spoken of publicly, the US financial authorities fear that if cuts are too rapid, or if interest rates move in the opposite direction to the rest of the world, then this could trigger a collapse in the dollar on top of a recession. Such a situation has been dubbed a “nightmare scenario” because of the contradictory policies it indicates. On the one hand, a rapid fall in the dollar indicates the need for interest rate increases, while the growth of recession points to the need for interest rate cuts on the other.

So far, financial flows to the US have continued, even in the face of falling stock markets. But Greenspan in particular is well aware of the dangers that can arise from a divergence between US and European interest rates.

It was just such a divergence when German interest rates rose in the middle of 1987, shortly after he took office as Fed chairman, which helped trigger the stock market crash in October of that year.

In the intervening period the US financial system has potentially become much more susceptible to destabilising international capital flows. In 1987, the US was still an international creditor nation. Today, however, external debt is around $1.6 trillion, equivalent to about 16 percent of gross domestic product and its growth has been so rapid that it would hit 60 percent of GDP by the year 2010 if it were to continue at the present rate.

In these conditions, harmonious interest rate policies are more necessary than ever. While financial authorities will remain publicly silent on the ECB decision, there will undoubtedly be some heated criticism behind closed doors.