Global Counsel

The ECB can't match the Fed

Blog post by Chief Economist Gregor Irwin, 25 June 2019

The European Central Bank (ECB) and the Fed are both worried about stubbornly low inflation and a weakening outlook. They are both signalling that they will turn the policy dial back towards a looser monetary stance. But the differences in the political circumstances and the institutional constraints facing each are stark. They suggest the Fed is much better positioned to manage a downturn. And the fact that it is, may complicate the ECB's predicament.

Figure 1 shows that both the Fed and the ECB have a low inflation problem. Despite about a decade of exceptionally loose monetary policy, tighter labour markets and the progressive closing of their estimated output gaps, neither has seen the higher inflation they expected.

Now there are concerns that their economies are slowing once more, as the external environment and confidence indicators deteriorate. This has led to a rapid change in market expectations in the US from tightening to a loosening of policy and statements by the Fed chair, Jerome Powell, saying the Fed is ready to respond if necessary. In the euro area, the ECB has extended its forward guidance for low interests rates through to the middle of next year, while its outgoing president, Mario Draghi, has gone further, emphasising that the ECB has "considerable headroom" to loosen policy and, just last week, that it will act absent any improvement in the data.

But this is where the similarities end. And when you look at the differences – in policy space, institutional constraints and political pressures – the comparisons are largely unfavourable for the ECB.

On interest rates, the Fed has room for eight quarter point cuts, well beyond what the market currently anticipates, before it hits the effective lower bound at, or just below, zero. Even so, Jerome Powell describes the proximity of interest rates to the effective lower bound as one of the "preeminent monetary policy challenge of our time". The ECB already has negative rates and the existing 0.4% charge on bank reserves is hitting bank profitability. The speculation now is that a ten basis point cut might be in the offing, but not much more than that. It is not close to, but at the effective lower bound.

If the ECB can't cut interest rates much further, then it may need to restart its quantitative easing programme. But it would need to increase its issue and/or issuer limits if it is to signal that a new programme can be sustained at scale for an extended period. It has the legal space for this, following a court ruling last year, but several euro area member states would still regard this as dangerously close to monetary financing. The Fed, by contrast, has no such constraints on bond purchases.

Mario Draghi has already suggested that fiscal policy may need to do more in the euro area to prevent a deeper downturn. But the European Commission's own analysis suggests that few euro area countries have any fiscal space at all. And the big one that does – Germany – has its own national constraints (the "black zero" balanced budget policy and the constitutional debt brake) which mean there is little room there. The Fed has a more willing partner in the US government, with the Trump administration's tax cuts at the end of 2017 already providing a boost to growth.

Central bankers as a rule don't like getting advice from politicians. Both the Fed and the ECB get plenty, nevertheless. The ECB gets advice from all sides (including the US president) even though most European political leaders respect its operational independence and instead focus on narrower questions

about whether it is acting within its mandate. That scrutiny – and sensitivity – is inherently higher when the ECB is contemplating less orthodox policies, as may be required in another downturn. The Fed has the opposite problem, with President Trump calling repeatedly for looser policy. While Fed policymakers may claim they are not swayed by this, it certainly gives them cover for a more rapid loosening, which the ECB does not have.

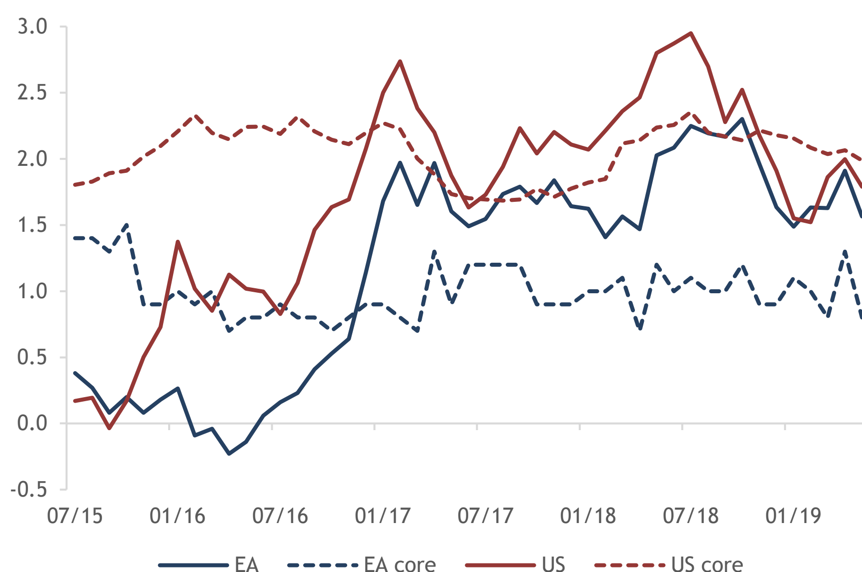
The first step by any central banker who wants to influence financial conditions is not to do anything at all, but to explain what you might do in the hope that the impact on expectations is enough to achieve the same purpose. This is why they spend so much effort crafting forward guidance and why it is a big deal when this changes.

The Fed has recently gone further, by launching a review of monetary policy strategy, tools, and communications. It has dropped some heavy hints that it might end up moving from a central inflation target to an average inflation target instead. This would allow the Fed to commit to looser policy for longer in an upswing, which should help it get out of a downswing more quickly, providing its policy has credibility and inflation expectations remain anchored. This raises the bar for forward guidance in ways that the ECB simply cannot match, as it has virtually no scope to change its own mandate unilaterally as the Fed appears likely to do.

Each of the differences between the Fed and the ECB described above point in the direction of a simple conclusion, which is that the Fed has more space and more flexibility to act than the ECB.

The concern for the ECB must be that should the Fed loosen policy sharply in response to a deteriorating outlook, then not only will it be unable to follow the Fed's lead, but it may also have to contend with a strengthening euro. At a time when external demand is coming under pressure in the euro area, that's the last thing that ECB policymakers would want.

Fig. 1: euro area and US inflation rates



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