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An evaluation of ECB policy in the Euro's big four

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ABSTRACT

The Taylor curve can be viewed as an efficiency frontier displaying the trade-off between the volatility of output and volatility of inflation. We build on the existing literature in this area and view Taylor curves as a lens through which to gauge the deviations of actual ECB policy from the optimum. We employ data over the period 1999-2013 period to measure the orthogonal distance of the observed volatilities from the Taylor curve in Germany, France, Italy, Spain, and the Euro area using a recursive VARs. We find that the distance has substantially increased in all four countries suggesting that monetary policy has become less efficacious for Germany, France, Italy, and Spain since the financial crisis in 2007-2008. We also estimate counterfactual Taylor rules and find that a simple Taylor rule would have only substantially improved monetary policy efficacy in Germany.

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1. Introduction

On January 22, 2015 the ECB ushered in a new era by launching an aggressive quantitative easing program in an attempt to stimulate the Eurozone economy. However, there has been substantial disagreement between ECB council members regarding monetary policy's role since the financial crisis of 2007-2008. In particular, Jens Weidmann, the governor of the Bundesbank has been particularly outspoken against the unconventional measures undertaken by the ECB.[1] The Bundesbank's insistence on low inflation has come under fire by many prominent economists and policy makers. For example, the Head of the International Monetary Fund, Christine Lagarde, recently warned that "low-flation" risked undermining global growth.[2] Moreover, several notable economists have called for a doubling or tripling of the ECB's target 2% inflation rate.[3]

While the ECB council members state that only euro-wide economic conditions are considered in policy settings, the economic differences across euro countries mean that monetary policy (conventional or unconventional) may not be appropriate for each member state. As such, an important question is how efficacious is ECB policy for each member state? Previously, Dorbusch et al (1998), Berger and De Haan (2002), Meade and Sheets (2005) argue that diverging national economic conditions would likely influence the voting patterns of individual members on the ECB council. As divergences in economic conditions become more apparent, it is not surprising that disagreements between members have arisen. For

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[1] http://www.ft.com/intl/cms/s/0/08f93276-8521-11e4-bb63-00144feabdc0.html#axzz3Qd5RDQse.
[2] http://www.reuters.com/article/2014/04/02/imf-economy-idUSL1N0MU15O20140402.
[3] For example see Ken Rogoff's http://www.project-syndicate.org/commentary/the-benefits-of-higher-inflation-by-kenneth-rogoff and.

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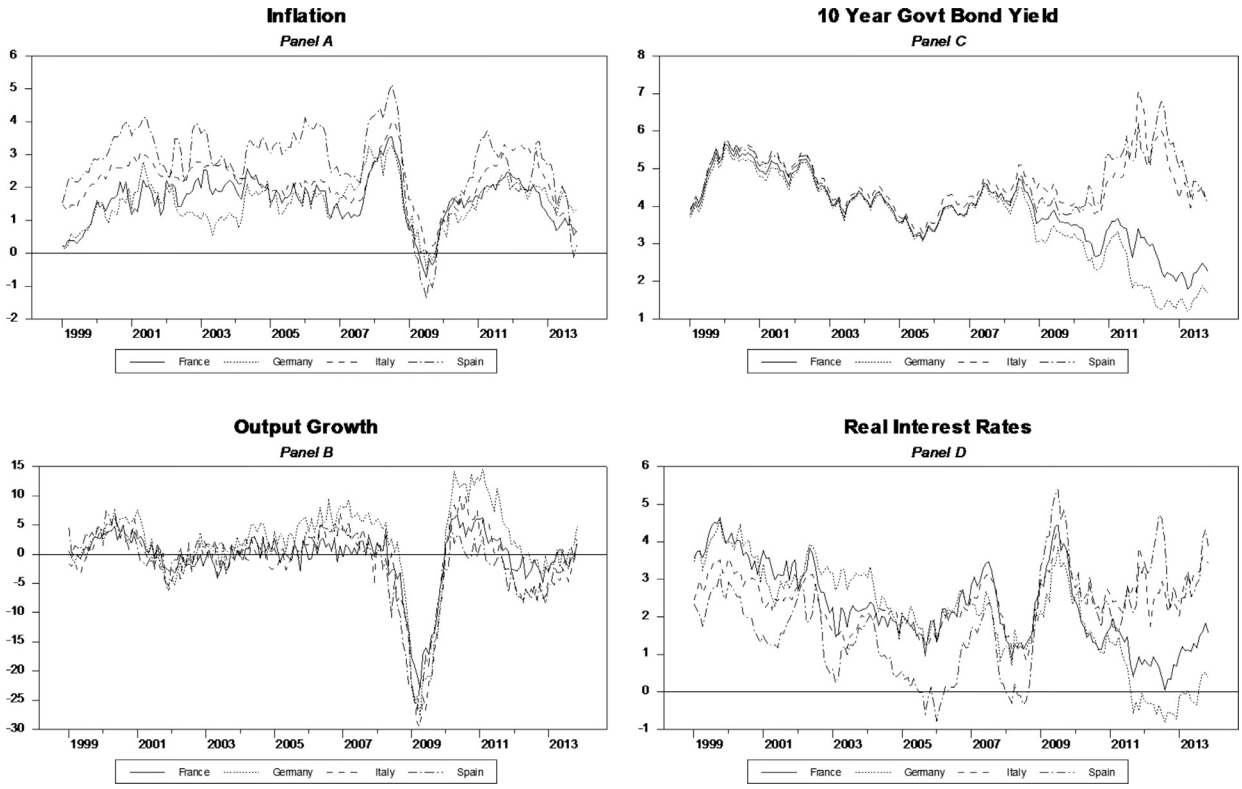

Fig. 1. Macroeconomic Data for France, Germany, Italy and Spain.

Table 1
Summary Statistics of Macroeconomic Data for France, Germany, Italy, and Spain

	France 2010 - 2013	Germany 2010 - 2013	Italy 2010 - 2013	Spain 2010 – 2013
Inflation	1.62	1.66	2.14	2.22
	(0.52)	(0.44)	(0.83)	(0.89)
Output Growth	0.97	4.97	-0.39	-2.32
	(3.28)	(5.81)	(5.55)	(3.50)
10 Year bond yield	2.80	2.11	4.83	5.04
	(0.55)	(0.69)	(0.83)	(0.77)
Real interest rate	1.18	0.44	2.68	2.81
	(0.51)	(0.93)	(0.47)	(0.77)

Note: The standard deviations are listed in parenthesis () below the level of the variable.

example, Fig. 1 displays the year over year inflation rate, output gap, yield on the ten year government bond, and the real interest rate (ten year government bond – inflation rate) for France, Germany, Italy, Spain over the 1999 – 2013 time period. While the trends in the output gap and inflation rate appear somewhat synchronized, the borrowing rates and real interest rates are not, especially after the financial crisis of 2008. Table 1 displays the summary statistic of the four variables in Fig. 1 over the 2010 – 2013 sample period. As can be seen in Table 1, the real interest rate in Italy and Spain has been five time higher than in Germany and twice as high as the real interest rate in France. Thus, given the divergence in economic performance, it is not surprising that dissention has arisen on the ECB's governing council. In fact, September 6, 2012 was the first time that the ECB openly acknowledged that a monetary policy decision was not reached by a consensus vote.

Previous studies, such as Gerlach (2007), Gorter et al. (2010), Van Poeck (2010), Hayo and Méon (2013), and Bouvet and King (2013) examine the appropriateness of ECB policy by comparing the ECB policy rate to national estimated Taylor rules. Heinemann and Huefner (2004) tackle whether ECB policy makers consider national data rather than euro-wide economic data when setting interest rates. Heinemann and Huefner (2004) report some evidence for national bias. Fendel and Frenkel (2009) find that the ECB is less likely to tighten policy when high inflation differentials rise between euro members to deflationary in the low inflation countries. Hayo and Meon (2013) use national Taylor rules to generate a counterfactual

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