American Enterprise Institute for Public Policy Research

August 2012

Economic Outlook

What Can Central Banks Do?

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This summer, the US Federal Reserve Bank (Fed) and the European Central Bank (ECB)claimed they would strive to address fundamental structural problems in the US and European economies. Yet neither central bank has rolled out concrete measures to achieve these goals. Even if the Fed were to undertake additional quantitative easing in September, there is no guarantee that this would effectively reduce US unemployment or increase economic growth. If enacted, ECB lending programs would provide only temporary relief to peripheral sovereign borrowers such as Spain and Italy. Furthermore, the Fed seems to lack confidence in its own ability to spur economic growth, and the progress of the ECB's loan program greatly hinges on upcoming decisions by German courts. The most recent round of Fed and ECB meetings thus serve as reminders that in the aftermath of the 2008 and 2010 economic crises, central banks are being asked to promise more than they can deliver.

At their midsummer meetings, both the US Federal Reserve Bank (Fed) and the European Central Bank (ECB) offered verbal assurances to markets about their ability to address fundamental structural problems. But neither took any action. The Fed acknowledged that the US economy was continuing to slow down midyear, without acknowledging that this was the third year in a row that a midyear slowdown had occurred, after the Fed had stipulated that it would take further steps as necessary to boost growth. The ECB faced perhaps the more difficult task of offering assurance that it had at hand a remedy to manage the increasing tensions threatening the viability of the European Monetary System.

The Fed's specific aim is to reduce the US unemployment rate and to boost economic growth, while the ECB is aiming to reduce borrowing costs for peripheral sovereign borrowers such as Spain and Italy. Absent the announcement of concrete measures to achieve these goals—which are arguably outside the usual scope of central bank policies—markets were at first disappointed. US stock prices fell, while in Europe, the interest rates facing peripheral sovereign borrowers such as Spain and Italy rose.

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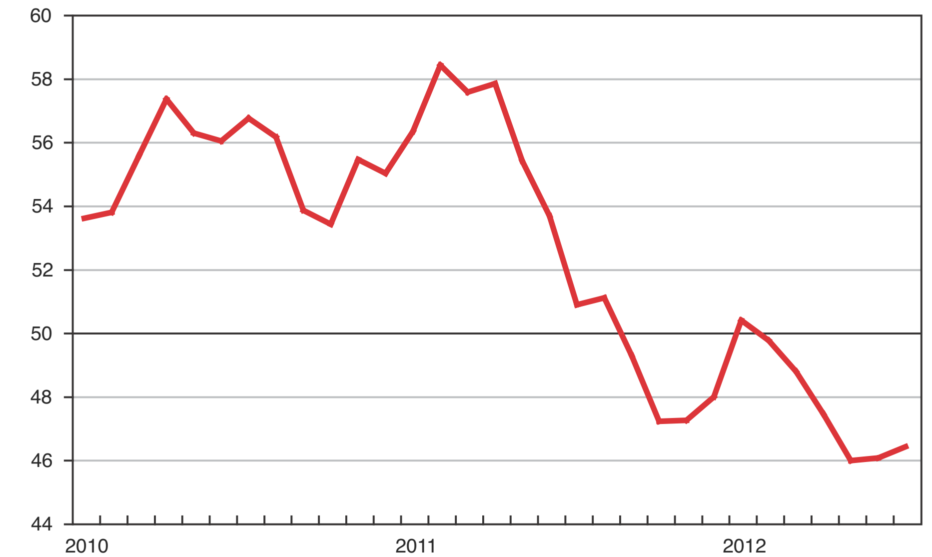
Key points in this *Outlook*:

- Although the Fed has announced its aim to reduce America's unemployment rate and boost economic growth, there is no guarantee that more quantitative easing will effectively stimulate more hiring or investment.
- With the eurozone falling back into recession, the European Central Bank (ECB) has promised to do whatever it takes to preserve the euro, but at best, ECB lending programs will provide only temporary relief to peripheral sovereign borrowers.
- To successfully affect fundamental economic variables, central banks such as the Fed and the ECB need to look toward restructuring US fiscal policy and Europe's flawed monetary system.

However, twenty-four hours after both central banks had spoken, stock markets rallied and investors returned as purchasers of Spanish and Italian bonds. After some initial hesitation, markets chose to hope that the next round of Fed and ECB actions—when it came—would boost growth, reduce unemployment, or reduce tensions in the European Monetary System. Were stock markets right to anticipate that the Fed—after three consecutive years of midyear disappointment—would finally be able to succeed in inducing faster US growth, and that the ECB would be able to stabilize the European currency system after two years of failed efforts? Probably not.

FIGURE 1

EURO-AREA COMPOSITE PURCHASING MANAGERS' INDICES (2010–PRESENT)



SOURCE: Markit Economics

NOTE: Above 50 indicates expansion; below 50 indicates contraction.

Challenges Facing the Fed

The Fed faces serious challenges to its credibility. America's election year began on what seemed like a positive note for the US economy, as payroll tax cuts and long-term unemployment benefits were extended for another year and the Fed undertook additional monetary easing. But US growth—which had been expected to hold at around 2.5 percent—drifted down to a 2 percent pace in the first quarter. A still lower 1.5 percent US growth rate emerged in the second quarter as consumption, exports, and government spending slowed along with investment.

European growth slowed as well; most of the euro-area countries were in recession during the first half of 2012, having been weakened by the stringent policies imposed on nations seeking more loans to cope with the persistent and rising problems associated with the euro crisis. Figure 1 shows the rapid deterioration of Europe's manufacturing sector as these policies have been imposed. German growth slowed rapidly as its exports to Europe and China slowed. China's growth also weakened, falling to an annual pace of below 8 percent during the second quarter.

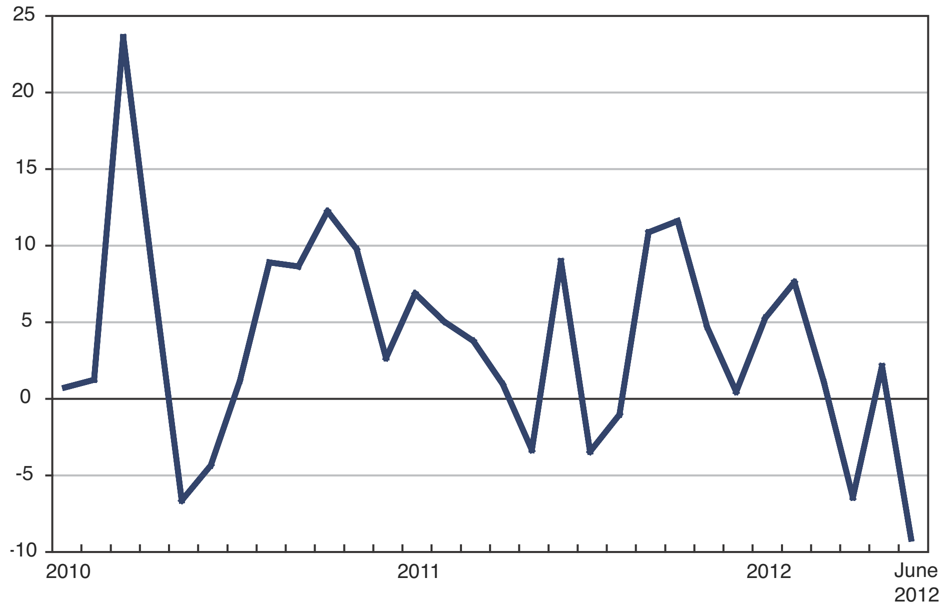
The fade in US growth this spring was tied to a number of factors, some of which were linked to the waning effectiveness of macro policy tools that had been applied repeatedly to keep growth going. While the extension of payroll tax cuts and unemployment benefits provided short-term support for demand growth, a slower pace of overall government spending was underway because past "stimulus" measures were running down.

There was also the prospect of a sharp cutback in overall fiscal spending on the horizon. Current US law mandates an end to a broad collection of tax cuts while enacting sharp spending cuts, simultaneously occurring at the end of 2012. Without action by the US Congress (which is unlikely before the November election and uncertain after the election and before year's end), a combination of tax increases and spending cuts equivalent to 4 percent of gross domestic product (GDP) will be triggered.

The current transition toward slower US growth tied to slower demand growth is evident in the latest report on GDP. During the first quarter of 2012, final sales rose at a 2.4 percent annual rate, faster than output growth (measured by a 2 percent growth rate of GDP). Inventories were drawn down to meet sales growth and excessive output growth. But during the second quarter, final sales growth dropped sharply to a 1.2 percent rate, contrary to the Fed's forecast of sustained growth of around 2.5 percent for the year. As sales fell, output growth was cut to 1.5 percent in the second quarter. With the reduced output growth still above the weak sales growth pace of 1.2 percent, inventories rose at the end of the second quarter. Weak retail sales at the end of the second quarter also suggest that inventories of unsold goods may be building further in the third quarter, meaning output growth will have to be reduced to avoid an excessive buildup of unsold goods. (See figure 2, which shows monthly US retail sales.)

The combination of weaker sales growth and resultant inventory growth with policy uncertainty tied to the year-end fiscal cliff will likely keep households cautious about spending, and businesses cautious about hiring labor and investing to enable capacity for more goods production. Employment growth did rise during July, partly as a result of what will probably be one-time statistical adjustments to the employment data. Without these adjustments, weaker employment growth is likely to resume in coming months. Investment growth continued to be weak in June, suggesting that firms remain cautious about adding to capacity.

FIGURE 2
US REAL RETAIL AND FOOD SERVICE SALES
(2010–PRESENT, PERCENTAGE CHANGE AT AN ANNUAL RATE)



SOURCE: Federal Reserve

The Fed has watched the US slowdown unfold, and, as a result, has lowered its US growth forecast while emphasizing its willingness to ease monetary policy further if necessary. There are two problems with this tentative approach. First, growth has already slowed to a pace well below the Fed's forecasts, so its hesitation to act raises questions about its confidence in its own ability to stem the growth slowdown. Second, it is not clear whether the Fed has much firepower left with which to induce faster growth. Interest rates have been cut virtually to zero, and longer-term rates have dropped to historic lows as the economy has slowed and risk-averse investors have sought out the safety of government bonds. Losing the advantage of preemptive easing when monetary policy has become less effective portends another disappointment with the efficacy of US monetary policy.

The persistent inability of the Fed to stimulate aggregate demand makes it difficult to escape the reality that the US economy is stuck in a liquidity trap. Fed actions to push down longer-term interest rates—such as additional quantitative easing or additional Operation Twist—have had little if any effect on aggregate demand. As investors add more to their holdings of cash and government bonds, interest rates fall even more. The yields on ten-year US Treasury bonds—now about 1.75 percent—are actually negative once adjusted for inflation. The yield on two-year notes—around .30 percent—suggests that investors with a two-year time horizon are willing to earn virtually no return on investments that are perceived as safer than other investments, such as stocks or commodities. The combination of negative real interest rates and weak real investment growth suggests little confidence in the Fed's ability to push for resumed higher growth through quantitative easing or another Operation Twist.

The ECB's Problem

Before its August 2 meeting, ECB president Mario Draghi had signaled to markets that the ECB was prepared to do "whatever was necessary" to preserve the euro currency system. Suggestion of doubts about the survivability of the system had driven up borrowing costs for countries such as Italy and Spain beyond sustainable levels. Draghi had proposed to radically expand the ECB's mandate to include keeping sovereign interest rates at manageable levels to remove doubts about the survivability of the euro currency system. Most analysts expected some concrete movement toward the new mandate after the ECB's August 2 meeting. However, no measures were undertaken.

Part of the reason for the ECB's hesitancy with new measures is tied to the circular reasoning behind them. If Spain and Italy have not been able to fund their deficits at levels the ECB considers sustainable, then the implication is that markets have doubts about the viability of the European Monetary System as it stands. Spanish interest rates moved above 7 percent because of the additional risk of lending to Spain, where growth is falling rapidly and the country's viability as a member of the European currency system at current interest rates was in question. Now, the ECB has insisted that any loans to weaker peripheral countries such as Spain or Italy be made conditional on plans by those countries to deflate further to make them more competitive.

> A still lower 1.5 percent US growth rate emerged in the second quarter as consumption, exports, and government spending slowed along with investment.

In the short to medium run, such adjustment requires sharply lower wages and prices that are probably not politically viable. The combination of more loans to weak euro-system members in exchange for more stringent measures to reduce fiscal deficits proved a losing formula for Greece, and would likely be the same for Spain. Italy has made some progress in adjusting its fiscal deficit. Nonetheless, the pain of such adjustments has increased the risk that a technocratic Monti government may not survive a challenge from former prime minister Silvio Berlusconi, who has already expressed his opposition to stringent adjustment policies being imposed on Italy in exchange for financial aid.

Furthermore, the ECB has said that it would purchase peripheral government bonds only if it received a formal request for such bond market support from the European Financial Stability Fund (EFSF) or the European Stability Mechanism (ESM). This procedure would mean the ECB would not lend directly to sovereigns, which, along with the conditionality placed on the loans, is an effort to shield the ECB from the criticism that it is monetizing debt issued by sovereigns. Despite the EFSF's buffer role, the new ECB initiative Draghi described simply repeats a familiar formula. This formula includes more lending to peripheral sovereigns in exchange for tighter policies aimed at making peripheral economies competitive without the devaluation of their currencies that is impossible if they remain within the eurozone.

The Deutsche Bundesbank has signaled its opposition to additional intervention in peripheral sovereign bond markets, but it does not have the power to block implementation. The Bundesbank is uncomfortable with the new lending initiative because it believes, with good reason, that more accommodation of peripheral borrowing needs at below-market interest rates will be inflationary. This is of course true because the only way to keep the euro system together is through more inflation in Germany or more deflation in the periphery, and the new ECB lending accommodates the former.

The day after ECB President Draghi outlined the new procedures without acting on them, Spanish officials softened their resistance to making a further request for EFSF assistance. The Spanish government was concerned that the conditionality tied to further support for their bond market might require more fiscal tightening and structural reforms beyond those already agreed to in previous negotiations. Of course, more stringency is exactly what would be required if the new bond-buying measures were to allow time for more adjustment rather than accommodate more inflationary policies. That said, given the rapid weakening of the Spanish economy, it is unlikely that proposals for more stringent conditionality to be attached to any new loans under the new ECB plan will be enacted. The uncertainty attached to Spain's ability to remain in the euro system will persist. And that uncertainty will cause continued contagion concerns about Italian policies that in turn will keep borrowing costs elevated.

The new ECB lending programs will, if enacted, probably provide temporary relief in the form of lower borrowing costs for peripheral sovereign borrowers. But the fundamental requirement for the survival of the eurozone (without more deflation in the periphery) is more inflation in Germany and the resulting further weakening of the euro. The better path for the ECB would be to acknowledge that its bond-buying program actually amounts to quantitative easing aimed at implementing a monetary policy that is suitable for all eurozone members. The implicit message to markets would be that the euro is a truly European currency instead of a deutschmark surrogate. The euro would then weaken against most other currencies and the eurozone crisis would begin to ease. Yet, this outcome is unlikely, and so we can expect the eurozone pattern of intermittent crises to continue.

There is one more specific risk facing the euro system. It will be difficult for the ECB and the EFSF to move forward with the new loan program until September 12, when the German courts will rule on the constitutionality of German participation in programs that involve expanded lending to other sovereign nations. Perhaps this is why Draghi announced an intention to pursue the new lending program without actually implementing it after the ECB's August 2 meeting. There is no way to tell how the independent German courts will rule. If they rule against additional support from Germany for the periphery, the euro crisis will quickly return, and interest costs for peripheral borrowers will rise back up above manageable levels. If they rule in favor of German participation, the new ECB program will go forward, and peripherals will continue to experience relief from a temporary period of lower borrowing costs.

Hope Springs Eternal

Markets have already reflected hope for more accommodative policies from the Fed and the ECB. The Fed will probably undertake another round of easing in some form at its September meeting, perhaps after chairman Ben Bernanke's August 31 speech at the Fed's annual Jackson Hole symposium provides a strong hint that such action is forthcoming. However, as we move toward year's end with a high degree of uncertainty attached to the fiscal cliff, it is not clear that a promise by the Fed to buy more long-term Treasury securities or to purchase more mortgage-backed securities would cause additional hiring or investment. Given that uncertainty, the Fed's extra accommodation is unlikely to reduce the unemployment rate or produce a sustained increase in economic growth. A modest additional easing by the Fed is not going to make the fiscal cliff disappear, nor is it going to solve the crisis facing the European Monetary System. As already noted, doubts about the efficacy of further easing measures may be one of the reasons the Fed has been reluctant to undertake concrete new steps even as it acknowledges a slowing trend in the US economy.

The ECB will probably engineer further bond purchases that will support additional borrowing by peripheral economies in Southern Europe that are struggling with the rapid slowdown in activity. Germany's growth is also slowing, threatening to create a negative feedback loop that further weakens peripheral country growth and further increases their need for additional support for their bond markets. Further bond-buying by the ECB, as already noted, represents a concession to the reality that the deflation required for Southern Europe to remain within the European Monetary System is not politically viable. Instead, higher inflation and a weaker euro will be the ultimate result, not a very surprising outcome given that the vast structural differences between Germany and, say, Spain cannot be bridged with ECB policies aimed at maintaining a stable German price level.

The latest round of Fed and ECB meetings are another reminder that in the aftermath of the 2008 financial crisis and the 2010 euro-system crisis, central banks are being asked to promise more than they can deliver. The Fed cannot do much more to boost growth and employment with additional quantitative easing, and the ECB cannot do much more to make Spanish and Italian producers more competitive by in effect buying more of their bonds.

> The yields on ten-year US Treasury bonds—now about 1.75 percent—are actually negative once adjusted for inflation.

The United States, notwithstanding additional easing by the Fed, still needs to manage the fiscal cliff while moving toward a medium-term sustainable fiscal policy that includes lower marginal tax rates, a broader tax base, and a lower projected path of government spending. With the ECB offering another round of additional lending to weaker peripheral countries in exchange for additional conditionality, European governments still face the reality of a monetary policy that is appropriate for Germany but highly contractionary for much of the rest of Europe. Higher inflation and a weaker euro provide a relief valve against the extraordinary deflationary pressures inflicting Southern Europe.

No More Puts

The ability of the Fed and the ECB to protect and prolong economic expansion through further monetary easing is limited, while the dependency on their efforts is rising. The "Greenspan put"—a monetary policy approach that aims to further ease when sharp market sell-offs threaten financial markets and growth—has been followed by the "Bernanke put," and, most recently, by the "Draghi put."

The puts evaporate, however, as the efficacy of monetary stimulus wanes, as it is doing now. Consequently, it is better for central banks to promise less and to instead force governments to move toward a restructuring of US fiscal policy and a restructuring of Europe's flawed monetary system.