Department of Economics University of Maryland

Economics 325
Intermediate Macroeconomic Analysis
Supplement 16
Professor Sanjay Chugh
Fall 2011

The following article appeared in the November 4, 2011 edition of *The Wall Street Journal*. It describes the surprise (or "shock") cut on November 3 in the short-term nominal interest rate (from 1.25% to 1.00%) by the European Central Bank (ECB), which is the European counterpart of the U.S. Federal Reserve.

The move was especially-closely scrutinized because Euro-area inflation (which is the ECB's sole official mandate, a legacy of the German experience(s) with hyperinflation between World War I and World War II) is at 3%, which is considered well above the 2% inflation target of the ECB. But prospects regarding growth (i.e., quantity, rather than price) have weakened dramatically recently, not least of all because of the on-again/off-again Greek government debt crisis, which seems to have figured prominently in the decision.

The ECB meeting was also prominent because it came days after Mario Draghi (as a side note: Draghi earned a PhD in 1976 at MIT, and his supervisor was Nobel-Prize Winner Robert Solow), an Italian, took over as the new ECB president, the first Italian to hold the position. There were concerns that Draghi would **not** be a "strong inflation-fighter," and the thinking had been that that itself would cause him to try to hold interest rates up generally. But the ECB decision at his first meeting went the other direction.

NOVEMBER 4, 2011

Central Bank Weighs in With Surprise Cut

New ECB President Warns Euro Zone Is Heading for a 'Mild Recession'

By BRIAN BLACKSTONE

FRANKFURT—The European Central Bank cut interest rates despite elevated inflation in the euro zone, underscoring concerns that the Continent's worsening debt crisis is pushing the region back into recession.

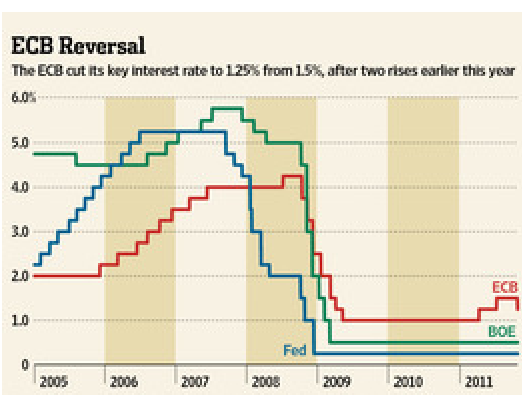
The rate cut, which corresponded with a change in the central bank's leadership, caught financial markets off guard; the ECB's new president, Mario Draghi, an Italian, has been widely expected to maintain the bank's rigid anti-inflation stance.

The ECB's sole responsibility is to keep inflation low. By contrast, the U.S. U.S. Federal Reserve has a dual mandate—to keep inflation stable and maximize employment—giving it more latitude to respond to signs of economic stress.

Even as the ECB eased monetary policy, however, Mr. Draghi aligned himself with his predecessor Jean-Claude Trichet, known for his aversion to large-scale government-bond purchases as a means of alleviating the debt crisis.

Against an operatically turbulent Greek backdrop, Mario Draghi gave a polished performance as new ECB president at a press conference following the central bank's surprise decision to cut interest rates.

Mr. Draghi rejected pleas from some euro-zone governments that the ECB commit itself to backstopping the euro zone by buying massive quantities of public debt. It is up to politicians to get their finances in order and keep borrowing costs in check, Mr. Draghi said.



The ECB "delivered on rate cuts and tried to get ahead of the curve on the economy, but drew the line on creating a Big Bazooka" for government bonds, said Carsten Brzeski, economist at ING Bank.

The ECB lowered its key interest rate 0.25 percentage point to 1.25%. Although some ECB officials had pressed for lower rates last month, most economists had expected officials to wait until December, when the ECB will publish its next round of economic and inflation forecasts.

The European Central Bank's new president, Mario Draghi, delivered a huge surprise to financial markets Thursday by unexpectedly slashing interest rates by 0.25 percentage points, as the Greek government teeters on the brink of collapse.

Thursday's decision was unanimous, another surprise to ECB watchers who had thought Germany's anti-inflation hard-liners, Bundesbank President Jens Weidmann and ECB executive board member Jürgen Stark, would oppose such a move.

"I would have expected Weidmann or Stark to opt for a rate cut if it was an emergency, but this isn't an [economic] emergency," Mr. Brzeski said.

Still, Mr. Draghi said next month's forecasts will show a "significant" downward revision to growth estimates for 2012. Many economists now expect the ECB to deliver another rate reduction when those projections are released next month.

If the ECB cuts rates again in December, it would fully reverse a pair of increases in April and July that had aimed at stemming a rise in consumer prices—though inflation is even higher now.

The 17-member euro bloc is headed for a "mild recession," Mr. Draghi told a packed news conference, his first since he became ECB president on Nov. 1, succeeding Mr. Trichet. The economic downturn should ease pressure on wages and prices, bringing inflation—currently at a three-year high of 3%—back below the ECB's 2% target next year, Mr. Draghi said.

Bloomberg News

ECB chief Mario Draghi at a news conference in Frankfurt Thursday.

With a reception usually reserved for Hollywood stars and heads of state, Mr. Draghi was surrounded by dozens of photographers and television crews as he entered the ECB's conference room.

Officials were particularly spooked by surveys of purchasing executives at euro-zone firms that signaled a steep slide in the region's manufacturing sector last month, which Mr. Draghi singled out as a factor in the rate-cut decision. Even powerhouses such as Germany, France and the Netherlands saw shrinking manufacturing output last month, according to the surveys.

"The fact that the ECB has lowered its interest rate already shows how worried it is about the economic risks posed by the sovereign-debt crisis," said Jörg Krämer, chief economist at Commerzbank.

Still, the interest-rate move is a gamble. At 3%, euro-zone inflation is well above the ECB's 2% target. Mr. Draghi conceded that it will stay above target in coming months, before declining below 2% next year. With economic uncertainty rooted in the debt crisis, mMany economists doubt that lower interest rates at the ECB will help the economy much.

If inflation stays elevated well into next year, Mr. Draghi may lose some of his credibility as an inflation fighter, especially in Germany, where the new ECB chief had to overcome early doubts about whether an Italian would adhere to Germany's strict anti-inflation philosophy. Mr. Draghi previously headed Italy's central bank.

"The ECB is a bit more dovish than we had thought before," said Mr. Krämer. "People have to understand that there are limits to the politics of easy money."

Mr. Draghi has earned global praise for his handling of the Italian banking sector while he headed that country's central bank and for his stewardship of the Financial Stability Board, a global regulatory body.

His predecessor, Mr. Trichet, pushed the ECB far beyond its mandate by propping up the region's weakest banks with low-interest loans and purchasing government bonds of vulnerable countries such as Greece and Italy. The latter decision has been vigorously opposed by German ECB officials, who believe it puts the central bank in the realm of fiscal policy, threatening its independence.

But the measures have been largely ineffective at stemming the crisis. Despite an estimated €70 billion ($96 billion) in Italian government-bond purchases by the ECB since August, Italy's 10-year bond yield is above 6%, a level many analysts say Rome can't afford, given its high debt levels.

Some euro-zone governments, led by France, think the ECB needs to be more forceful by buying more bonds or by financing Europe's rescue fund. U.S. officials also want the ECB to take a stronger role, as the Fed did in fighting the housing crisis.

Under Mr. Trichet the ECB rejected those calls, saying it was up to governments to keep their interest rates down by enacting fiscal austerity measures.

Mr. Draghi continued with that line Thursday, saying the ECB bond purchases are "temporary, limited" and solely to ensure that the ECB's interest-rate decisions transmit smoothly into the economy. Unlike Mr. Trichet, Mr. Draghi didn't rule out buying bonds even after Europe's rescue fund has the ability to do so.

"It's pointless to think sovereign-bond rates can be stably brought down over time by outside interventions," Mr. Draghi said.

"There's still a strong aversion to using the ECB as the ultimate savior of the euro area," said Nick Matthews, economist at RBS, who was in the minority of economists that forecast Thursday's rate cut.

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