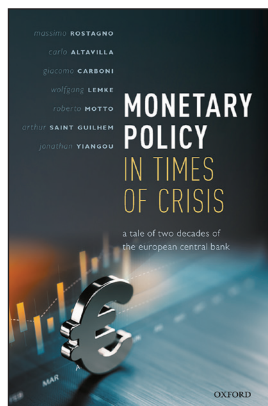


Massimo Rostagno, Carlo Altavilla, Giacomo Carboni, Wolfgang Lemke, Roberto Motto, Arthur Saint-Guilhem and Jonathan Yiangou, **Monetary policy in times of crisis: a tale of two decades of the European Central Bank**, Oxford University Press, 2021, 448 pages

Let me first state loud and clear: I like this book! Why?

First, it is an admirable blend of historical narrative, empirical facts, and economic and econometric analysis – the last-mentioned rendered through an imaginative yet rigorous use of figures. I counted nearly 140 figures, reassuring the reader that the conclusions in the text are supported by strong quantitative evidence.

Second, the book does not fall in the trap of saying that, over the past two decades, the European Central Bank has done everything right – or that it did not need to learn by doing, and knew it all from the start. For instance, the interest rate increases of 2011, just when the European phase of the crisis was worsening, are recognised as not justified. “The case for action in 2011 appears weaker,” the authors state. They are explained by the ECB’s fear of losing its reputation as an inflation-fighter, pushing it to act as a price- rather than an inflation-targeter, keen to offset repeated upside misses on inflation.

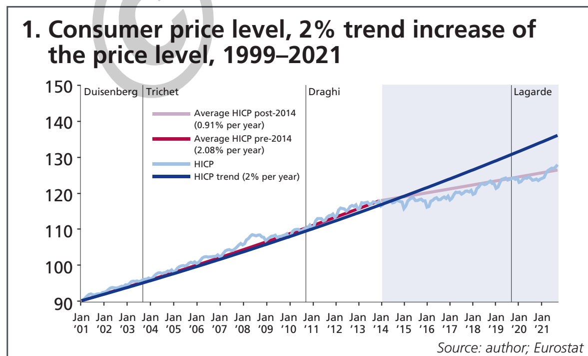
The one issue where I found the treatment a little too defensive is on the role of monetary aggregates in the first years of the ECB. I agree with the authors that “if one allows for a wide spectrum of possible scenarios – including extremes featuring high inflation or deflation – money demonstrates a more robust association with prices and the economic state than the conventional interest rate instrument of monetary policy”.

However, it is my sense that the ECB took way too long to recognise that it was not confronted with “extreme scenarios”, and it should have moved away from any form of monetary targeting much earlier.[1] I also doubt that looking at monetary aggregates was so useful in assessing financial stability: credit developments and asset prices are much more important in this respect.

Third, the book makes many (214) references to the staff of the ECB, giving a rare insight into its inner workings, and correcting the impression from press conferences and official communication that the ECB starts and ends with its Governing Council. Along that same line, maybe a little more prominence could have been given to the staff of national central banks.

There are also some limitations of the book. For example, while it is targeted as a volume for experts, rather than one for the general public, a more agile prose and less jargon would have improved readability.

To further review this book with its 400 intense pages, let’s assume a Martian visits Earth, and is given only two pieces of information about monetary policy in the eurozone: first, that the objective of the ECB is to keep consumer price inflation around 2%; second, a graphic like figure 1.



1. Consumer price level, 2% trend increase of the price level, 1999–2021

Source: author; Eurostat

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Inevitably, the Martian would say that the ECB has been much more successful in the first, non-shaded period in the figure, ending around the beginning of 2014, than in the following period, in which average inflation was about a half of the objective.

However, if the Martian was given a copy of this book, her assessment would have to change significantly. Indeed, she would probably agree with the book that the life of the ECB can be partitioned in 'two regimes': "One – stretching slightly beyond the ECB's mid-point – marked by decent growth in real incomes and a distribution of shocks to inflation almost universally to the upside; and the second – starting well into the post-Lehman period – characterised by endemic instability and crisis, with the distribution of shocks eventually switching from inflationary to continuously disinflationary.

I also believe that if the Martian was given, as further documentation, the 2018 book by Tuomas Välimäki and me (*Central banking in turbulent times*), she would agree that during and after the great financial crisis, the ECB's interest rate instrument became markedly less effective. Indeed, three implicit but critical assumptions underpinning monetary policy failed during one phase or another after the start of the crisis:

- The ability to tightly control the short interest rate was negatively affected;
- The relationship between the short-term interest rate and longer rates, more relevant for the real economy, became much more uncertain, as shown by variable spreads, and;
- The space for lowering rates as needed to bring the economy to a good equilibrium was substantially reduced as policy rates got closer to the effective, lower bound.

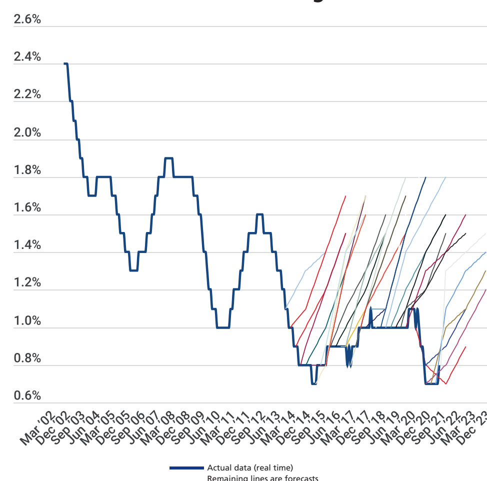
So, the Martian would understand that the first period cannot be compared with the second, in which deflationary shocks prevailed and the effectiveness of the interest rate instrument was affected.

When the traditional monetary policy instrument lost effectiveness and deflationary shocks became prevalent: "The GC [Governing Council] unveiled, from mid-2014 onwards, a radical first-of-its-kind policy package comprising three main elements: the introduction of a negative interest rate policy (NIRP), a step that no major central bank had taken in central banking history; a new series of targeted long-term refinancing operations (TLTROs) establishing tight incentives for banks to pass on lower funding costs through lending rates; and a large-scale asset purchase programme (APP) encompassing public and private sector securities." Later, the book says, the ECB added a fourth measure: forward guidance (FG).

At this point, the Martian would have a look back at figure 1, and notice the surprising fact that the launch of this forceful panoply of measures coincides with the beginning of the lasting failure to keep inflation around 2%.

And now, we could give the Martian another piece of evidence: figure 2, developed by one of my colleagues at Bruegel, Zsolt Darvas.

2. ECB staff macroeconomic projections for eurozone core inflation, average annual values



Source: Zsolt Darvas: updated version of chart originally published in: Darvas, Z, Forecast errors and monetary policy normalisation in the euro area, Bruegel Policy Contribution, Issue 24, December, 2018: www.bruegel.org/2018/12/forecast-errors-and-monetary-policy-normalisation-in-the-euro-area/

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Massimo Rostagno et al, **Monetary policy in times of crisis**, Oxford University Press, 2021, 448 pages

The figure shows actual inflation (the thick line) and ECB inflation projections (the lines that depart from the thick line). The inevitable conclusion from the figure is that the ECB systematically overestimated inflation, projecting that it would move towards its objective.

In sum, the ECB systematically overestimated the "potency" of its policy to reach its inflation objective. And the overestimation is also present in the book under review. "We find that, in the absence of the package (NIRP, APP, LTRO and FG), GDP would have been roughly 2.7% lower by end-2018, and annual inflation one-third of a percentage point weaker on average over 2015–2018." Thirty basis points of average annual additional inflation have been precious, given the behaviour of the economy, but I find it difficult to see it as a sign of "the potency of monetary policy instruments, when a central bank is determined to deploy them with the necessary conviction and vigour". I rather see the estimate as showing a dispiriting lack of bang for the buck.

Two basic views about the potency of monetary policy are presented in the book. According to the first one, there is a "belief that inflation was indeed 'always and everywhere a monetary phenomenon'". According to this view, invoking "inexorable disinflationary forces" borders on defeatism. In the second view, monetary stability and a prosperous economy require "a broader set of institutions and policies than monetary policy alone". Indeed, in the last pages of the book, the negative role of fiscal policy during and after the financial crisis is lamented, and the reader understands, even if it is not written in so many words, that the negative role of fiscal policy affected the ability to reach the inflationary objective.

If one pursues the second view to its logical consequences, a dangerous doubt arises: can central banks really control inflation? In their latest book, Charles Goodhart and Manoj Pradhan advance the proposition that it is demography, rather than monetary policy, that basically determines nominal variables, including inflation.[2] This raises the question: does the main inflation story take place outside the central bank?

I must admit I don't know the answer to this question – but I am no closer to having solved the doubt after having read this book. This is a disappointment, given the mass of intellectual effort put into it. But perhaps a central banking publication cannot even raise the prospect that inflation is not under the control of the central bank. ❑

Francesco Papadia

Notes

1. This is the advice already given by, among others, Paul De Grauwe and Magdalena Polan, in 2005. See: 'Is inflation always and everywhere a monetary phenomenon?' in *Scandinavian Journal of Economics*, 107 (2), August 12, 2005, pages 239–259. Leonardo Cadamuro and I recently provided evidence confirming his result that money is correlated with inflation only when monetary/inflationary conditions are unsettled. See: *Is money growth telling us anything about inflation?*, Working Paper 11/2021, November 4, 2021 (available on the Bruegel website: *https://tinyurl.com/ysuxcs75*).
2. Goodhart, CA, and M Pradhan, The great demographic reversal: ageing societies, waning inequality, and an inflation revival (London: Palgrave Macmillan, 2020).

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