CHAPTER 13

Experiencing Deflation or Disinflation around the World

Masaaki Shirakawa spent 39 years at the Bank of Japan, becoming its governor in April 2008. Exactly six years earlier, as adviser to the governor, he evaluated the experience of the first year of QE in a prophetic paper. He drew a skeptical tentative conclusion about the efficacy of the initiative, emphasizing the difficulty for a central bank to provide stimulus once the economy had begun to experience the zero bound on short rates. At the time he understandably focused on the buildup of excess reserves at banks:

> [T]he author would like to again emphasize the importance of the fact that Japan's economy is confronting zero interest rates . . . Based on this, in a situation where there is little room for a further decline in short-term interest rates, the effects of monetary easing will necessarily be limited. The fact that economic activity has not been stimulated despite an aggressive increase in reserves since March 2001 seems to be consistent with what such standard theory predicts. This kind of conclusion may frustrate readers who seek to find a monetary policy solution. Some may argue that, without other options, the Bank of Japan should try unconventional monetary policy even if the effects are not certain. However, given the difficulty of the problems facing Japan's economy, before jumping to such conclusion, economists are expected to present sober analysis of the situation fully utilizing all the information and knowledge available.[1]

Despite such skepticism, Governor Shirakawa responded to overwhelming public and political pressure by overseeing the renewed establishment of quantitative easing in November 2010. Yet Japan's extended deflation continued. In late 2012 Shinzo Abe was appointed Prime Minister. He deemed Shirakawa's monetary policy to have been insufficiently forceful. Abe successfully pressured the BOJ early in 2013 to double its existing 1 percent inflation target. He also appointed Haruhiko Kuroda to take over the BOJ and pursue much more substantial QE.

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On March 19, 2013, the last day of his five-year term, Shirakawa delivered his swan song at a press conference; this chapter, though, shows that a crucial part of his analysis was in error:

> A lack of cash isn't what's keeping companies from increasing capital expenditure . . . If there was a single thing that would have cleared the fog and solved all problems, Japan wouldn't have been in this situation for 15 years . . . What may be desirable for market participants may not necessarily be the same as what is desirable for the economy in the long run . . . I feel it is dangerous to believe that central banks can freely control market moves with words.[2]
>
> Powerful monetary easing by the central bank is necessary to overcome deflation. Meanwhile, a wide range of efforts from the government to enhance competitiveness and growth are required.[3]
>
> With the easing of the yen and the rising of stock prices, I believe a chance is here.[4]

Shirakawa Failing to Relieve Deflation in Japan and Kuroda Taking Over

The two "lost decades" in Japan occurred despite the initiation of quantitative easing in March 2001 for a half decade that resumed in the fall of 2010 before being expanded later.[5] But had its effectiveness really been impaired, as Bernanke has contended, by the BOJ's self-imposed restrictions on its scale and scope, limiting it mainly to shorter-term government securities? Kazuo Ueda has examined the deflationary situation in Japan. He wrote an instructive description:

> The rate of change in the ex-energy-food component of Japan's Consumer Price Index (henceforth, CPI) fell below zero in early 1999 and has been negative since then with only minor exceptions. During this period the BOJ has used many so-called nontraditional monetary policy measures in an attempt to stop the deflation. The attempt however, has so far not succeeded clearly. This episode is interesting in itself, but also in light of the current disinflationary tendencies of the developed economies and central banks' attempts, especially those of the Fed, to stop them. Many of the measures central banks are currently using are those that were used by the BOJ earlier.[6]

Chapter 9 interpreted the theory of inflation in Chapter 5 as core consumer inflation is:

(unity)(shorter-term expected inflation) – (beta) (unemployment rate – natural rate)

or:

(alpha) (targeted inflation) + (1 – alpha) (lagged inflation) – (beta) (unempl. rate – natural rate)

A steady level of the real short rate and hence the unemployment and inflation gaps allows us to derive this formula. Core consumer inflation is:

(1/alpha) [(alpha) (targeted inflation) – (beta) (unemployment rate – natural rate)]

During the five years of QE from March 2001 to March 2006, the Bank of Japan was aiming at zero inflation. (Ueda: "[T]he BOJ committed itself to maintaining the provision of ample liquidity until the rate of change of the CPI became zero percent or higher on a sustained basis.")[7] During that time, the unemployment rate also averaged around 4.5 percent. Suppose that the natural rate was 3.0 percent, a little above its average until shortly before the bursting of the bubble in the early 1990s, for a gap of 1.5 percentage points. Posit too that the values that I tentatively assumed in Chapter 9 for the United States after the mid-1990s of 0.5 for alpha and 0.25 for beta applied to Japan as well early in the last decade. (Of course, established Bayesian methods imply that when econometricians confront these theoretical priors with Japanese data to arrive at posterior values, changes no doubt will occur.) But using the assumed figures for now gives this result. Core consumer inflation is:

(1/0.5) [(0.5) (targeted inflation) – (0.25) (unemployment rate – natural rate)]

or:

(1.0) (0.0) – 0.5 (1.5) = – 0.75 percent

Not seasonally adjusted 12-month inflation of the CPI excluding food and energy in Japan over the five years from March 2002 through March 2006 averaged –0.4 percent at an annual rate.

The emergence of renewed deflationary pressures induced the BOJ in November 2010 to adopt another program of QE with asset purchases of one-fifth the size of the economy. For two years after the program started, the unemployment rate continued to average about 4.5 percent while the natural rate arguably rose to 3.5 percent. But this time the BOJ raised the targeted inflation rate to 1 percent. (Ueda wrote, "In the December [19, 2009] meeting, the BOJ announced that the mid-point of the [0–2] range, 1 percent was the most preferred inflation rate.")[8] Thus, on the assumption of no change in the coefficient values, now we have for the second episode: Core consumer inflation is:

(1.0) (1.0) – 0.5 (1.0) = 0.5 percent

For two years after the second round of QE started, the change in core prices did move higher, though staying well below the prediction. Not seasonally adjusted core CPI 12-month inflation rose from its November 2010 reading of –1.3 percent to a figure of –0.5 by December 2012.

Newly appointed Shinzo Abe became Prime Minister in late 2012. He appointed Haruhiko Kuroda to succeed Shirakawa. Kuroda vowed to expand quantitative easing enough to double the monetary base, extend the maturity of government debt purchases, and enlarge the buying of private debt, even including Real Estate Investment Trusts. And he followed through. As in the United States, speculative forces depressed long-term yields, at least for the time being:

> "Investors in Japan assume that the BOJ will continue to buy JGBs vigilantly next year and the year after," said Makoto Yamashita, the chief Japan rates strategist at Deutsche

> Securities, a primary dealer. "They take it for granted they can sell those bonds bought expensively to the BOJ as more and more notes disappear from the secondary market. It's too frightening to think what might happen when the BOJ tapers."[9]

Under pressure from Abe, the BOJ was forced in January 2013 once again to raise its target for consumer inflation—this time from 1 to 2 percent. Kuroda vowed to attain success in two years.

The theory of inflation just advanced together with no change in labor-market slack or in the assumed coefficient values implies that core consumer inflation indeed should rise over time to 1.5 percent. By December 2013 the 12-month trend of core consumer inflation *had* climbed already to 0.7 percent, but *also* auspiciously the unemployment rate had slipped off to 3.7 percent from 4 percent in November. Conceivably, the BOJ's goal of hitting 2 percent consumer inflation in two years' time is approachable after all. But that result would not demonstrate the effectiveness of QE; rather, it would show the power of the specification of the inflation target itself.

An alternative interpretation of the facts in Japan has been offered by Kenzo Yamamoto:

> Since Prime Minister Abe took office, the Japanese government implemented an expansionary fiscal policy including an increase in public investment. The size of the fiscal deficit has amounted to 8 percent of GDP. Aggressive fiscal policy, combined with the aggressive purchase of Japanese Government Bonds by the BOJ, has contributed to filling the gap between the actual unemployment rate and the natural rate and to changing the inflationary expectation of the public.
>
> No one denies that an extraordinary fiscal expansion with underwriting or aggressive purchasing of government bonds by a central bank will boost the economy, at least temporarily. From this point of view, it can be concluded that the effectiveness of fiscal expansion has been demonstrated in Japan. The power of the specification of the inflation target as well as the effectiveness of QE, however, has not been demonstrated yet.[10]

Obviously, Yamamoto has advanced a very plausible theory of the recent inflation experience in Japan, one consistent with the successful Japanese experience with the combination of fiscal and monetary stimulus in the 1930s.[11] Although much more research remains to be done, I still initially would reply that my own theory seems to be more general because, even ignoring fiscal policy, it better accounts for US inflation, as already seen in Chapter 9, as well as UK and Euro-zone inflation, as will be addressed next. Indeed, another crude initial observation is that taking all four areas around the globe together, fiscal stimulus even may be negatively related to inflation.

Living Long with the King of Threadneedle Street

Mervyn King, despite humble origins, had so much innate ability that he quickly ascended England's social hierarchy. He started out as an academic, sharing an office with Ben Bernanke when both taught at MIT in the early 1980s. He was appointed chief economist of the Bank of England (BOE) in 1991, becoming deputy governor in 1998 and governor five years later.[12] He served in that capacity until June 2013. By then he had been knighted by the Queen, which took place in 2011.

Governor King in 1994 characterized his policy as inflation targeting, "The use of an inflation target does not mean that there is no intermediate target. Rather the intermediate target is the expected level of inflation at some future date chosen to allow for the lag between changes in interest rates and the resulting changes in inflation. In practice, we use a forecasting horizon of two years."[13] Charles Goodhart conducted research that estimated that the Bank of England, after it started inflation targeting in 1992 but before it switched in 1998 to assuming that its policy setting would follow the path implied by forward interest rates, acted as if it had done so to the letter.[14]

Under Governor King's tutelage, a scenario involving quantitative easing similar to the United States played out in the United Kingdom from March 5, 2009, to May 31, 2010. Charles Bean, deputy governor for monetary policy and member of the Monetary Policy Committee (MPC), wrote in August:

> The initial responses in the United Kingdom to these measures have been moderately encouraging. Government bond yields fell significantly on the commencement of the programme of asset purchases, and yields appear to be some 50–75 basis points lower than they would otherwise be. And there are also signs of beneficial effects on conditions in the relevant corporate credit markets. Meier (2009) provides a full assessment. But it is very early to draw conclusions on the efficiency of these measures, as the transmission lags to nominal spending are likely to be long. Moreover, even in some years' time, it will still be difficult to draw conclusions, as the counterfactual is bound to be uncertain. But it will certainly provide fertile grounds for future PhD theses.[15]

Despite Bean's caveats, on September 19, 2011, the news broke that a central bank staff study of quantitative easing in the United Kingdom had indeed found appreciable effects:

> The Bank of England's purchase of £200 billion ($316 billion) of assets in 2009 and early 2010 may have increased the U.K.'s gross domestic product by 1.5% to 2% and boosted inflation by as much as 1.5 percentage points, new analysis by the central bank shows.
>
> An analysis of the BOE's program of quantitative easing in the bank's quarterly bulletin concluded it had an effect equivalent to a cut in the bank's benchmark rate of between 1.5 and three percentage points.[16]

The BOE study did leave that impression, attributing a decline in the long-term gilt rate of from 100 to 125 basis points to the announcements related to the Bank of England's program of government security purchases. Only a careful reader of Table B would have discerned that the *yield* on 10-year gilts (misleadingly called the "asset price" in that table's title) actually *rose* on balance by 30 basis points from March 4, 2009 to May 31, 2010, no doubt partly reflecting the wearing off of announcement effects.[17] The paper, though, merely asserted the following:

> But comparing their levels at the end of May 2010 to where they were before the start of QE suggests little net change at most maturities. However, net changes over the period are unlikely to provide a good measure of the overall impact of QE on gilt yields, given the amount of other news there has been over the period, including on the likely scale of future gilt issuance by the UK Government.[18]

In September 2011 Adam Posen, an independent member of the Monetary Policy Committee of the Bank of England before being appointed president of the Peterson Institute for International Economics beginning January 1, 2013, cast his twelfth consecutive dissent for more QE. Finally, on October 6, 2011, the BOE took his advice to implement more QE of its own, enlarging the size of its Asset Purchase Facility Fund.[19] The Bank of International Settlements released that December a supportive study of the experience with asset purchases in England and the United States. "[W]e estimate that the lasting reduction in bond supply via central bank asset purchases lowered government bond yields significantly. The effect is largely similar."[20]

Still, its additional rounds of quantitative easing evidently couldn't offset fiscal austerity. British statisticians announced in late April 2012 that the country in the first quarter had entered a double-dip recession, which was to last two more quarters. In a perverse but predictable public reaction, debate erupted over whether such central bank action should be extended rather than suspended as had previously seemed imminent. Undeterred by evident ineffectiveness, the BOE augmented its asset purchases in July 2012 to reach a total of £375 billion or a quarter of nominal GDP. Still, the economy, after a brief recovery, again took a nosedive in the fourth quarter.

In March 2013, UK Chancellor of the Exchequer George Osborne softened the government's instruction to the BOE to conduct inflation targeting in light of the current weakness in production as well as a five-year string of frequent upside inflation misses.

> The new remit permits the BOE to allow inflation to stray from its 2% target if the economy is in trouble, provided the MPC clearly sets out the arguments for doing so and how quickly it intends to get inflation back to target.
>
> More significantly, the new mandate gives the MPC the power to deploy whatever tools and policies it sees fit to meet its inflation objective, including policies aimed at easing the flow of credit to the private sector, and making use of Fed-style guidance on the future path of interest rates and the size and pace of its efforts to stimulate growth through bond purchases.[21]

Governor King and two other members of the MPC voted to resume quantitative easing for the fifth consecutive time at his final meeting in June 2013, but six others voted nay. In that light, his remark was surprising in a previous interview with a former student published on the same day in April that new statistics indicated that meager UK expansion in the first quarter had narrowly avoided a triple-dip recession. "In a remarkable admission for a central banker, he said events have shown that 'purely monetary stimulus will not be enough … Monetary policy is pushing on a string. It has some effect but less than we might have thought.'"[22]

Mark Carney replaced the retiring Mervin King on July 1, the first foreigner to head the Bank of England. As the former Governor of the Bank of Canada, in 2009 he had introduced forward guidance in the form of an explicit mid-2010 date for anticipated continued ease. (In the event, the Bank of Canada was surprised by economic strengthening and began an earlier firming in June of that year.) Chancellor of the Exchequer George Osborne in March 2013 had directed the BOE to assess the introduction of forward guidance in the United Kingdom. The MPC planned to

announce its conclusions on August 7. But as early as the July 4 meeting, the MPC stated that the recent "rise in the expected future path of Bank Rate was not warranted." That judgment came in the context of the MPC's unanimous vote to maintain the Bank Rate at 0.5 percent while again refraining from conducting additional quantitative easing by keeping the level of its asset purchases the same.[23]

According to *Bloomberg*, "The MPC's statement was a response to a jump in bond yields sparked by Federal Reserve Chairman Ben S. Bernanke's June 19 comments on the timing for unwinding QE in the United States. The increase represented an 'unwelcome tightening in monetary conditions' that could scupper the recovery, the BOE said."[24] At its August 7 meeting, the Monetary Policy Committee fully adopted prevailing American-style forward guidance. It did so by giving a threshold for firming of 7 percent for the unemployment rate compared with the prevailing 7.8 percent, so long as financial stability continued and inflation expectations and projected inflation stayed low enough even if remaining above the 2 percent objective. The relevance of that latter condition soon evaporated, as core consumer inflation from a year earlier receded more in December 2013 to only 1.7 percent relative to the 2 percent goal for the overall CPI, even though the unemployment rate dropped to 7.1 percent in the three months to November.

That specific 12-month rate of core consumer inflation at the end of 2013 in the United Kingdom can hardly be considered a surprise in light of the surrounding economic conditions and the theory of inflation presented in Chapter 5 of this book. Let's assume that my own crude estimate of the late-2013 unemployment gap (the natural rate minus the reported rate) were to persist at 0.625 percent. (That figure is one half of the midpoint of the BOE's February 2014 estimate of a 1.0 percent to 1.5 percent output gap having a 1.25 percent midpoint.) With that assumption, that country's core inflation rate forecasted by the model presented in this book in continued quasi-equilibrium can readily be shown to be 2 – 0.5 (0.625) or 1.7 percent, matching the reported value just mentioned.

"Super Mario" Reliving Shuddering Over There

Core European countries were less than fully successful in making further national bailouts conditional on fiscal discipline and repeal of unsustainable welfare laws. A currency crisis erupted in Europe in 2010 despite the incomplete fulfillment of those austerity measures. But other forces were at work. American money market funds retreated from their funding of European banks. Even with softening activity, financial regulators decided that raising mandates for bank capital backing assets with differential risk weights favoring sovereign debt would be a peachy idea. Many banks in response stiffened lending standards, which further repressed spending. Then Greece partially defaulted on its supposedly riskless debt.

Still, by the autumn of 2011 the economic situation in the Euro-zone was viewed as salvageable without having the central bank venture further into the uncharted territory of sovereign lending, at least in the mind of one influential person:

> At his inaugural press conference as ECB President on November 3, [2011,] Mario Draghi was asked a pointed question by a journalist. "Are you prepared now to make a commitment that you will do whatever is necessary to keep the euro area in one piece,

> including—if necessary—becoming the lender of last resort to governments?" Draghi's response was instructive. "I have a question for you: what makes you think that the ECB becoming the lender of last resort for governments is what is needed to keep the euro area together? No, I do not think that this is really within the remit of the ECB. The remit of the ECB is maintaining price stability over the medium term."[25]

When Walter Bagehot analyzed the idea of the lender of last resort, he obviously was contemplating only central bank lending to private commercial banks, not to sovereign governments! But London's *The Economist*, whose views have evolved in the era since Bagehot edited the publication in order to bring the eternal truths up to date, took a contrary position:

> Can anything be done to avert disaster? The answer is still yes, but the scale of action needed is growing even as the time to act is running out. The only institution that can provide immediate relief is the ECB. As the lender of last resort, it must do more to save the banks by offering unlimited liquidity for longer duration against the broader range of collateral. Even if the ECB rejects this logic for governments—wrongly, in our view—large-scale bond-buying is surely now justified by the ECB's own narrow interpretation of prudent central banking. That is because much looser monetary policy is necessary to stave off recession and deflation in the euro zone. If the ECB is to fulfill its mandate for price stability, it must prevent prices falling. That means cutting short-term rates and embarking on "quantitative easing" (buying government bonds) on a large scale. And since conditions are tightest in the peripheral economies, the ECB will have to buy their bonds disproportionally.[26]

The magazine in effect was recommending a massive expansion of an earlier ECB bond-buying program that has been initiated in May 2010 by then ECB President Jean-Claude Trichet. Neil Irwin's excellent book covered the episode.[27] That spring, although Axel A. Weber, the head of Germany's Bundesbank, opposed the idea, the majority of the ECB's Governing Council approved buying sovereign debt of peripheral countries under the new "Securities Markets Programme." The ECB did undertake offsetting open market sales to sterilize the purchases and keep the monetary base unaffected. In February of the next year Weber resigned, choosing not to succeed Trichet. And after a majority of the ECB's Governing Council voted to buy Italian and Spanish debt in August 2011, Jurgen Stark, chief economist of the ECB, also resigned.

Yet despite *The Economist*'s advice, the ECB under its new President Mario Draghi actually reversed course. At his first press conference in early November 2011 he amplified the comments earlier in this chapter by insisting that ECB bond purchases would be "limited" and "temporary." The ECB stood its ground for some time on its new policy of no longer buying large amounts of sovereign debt through literal quantitative easing.[28] Finally, on December 8 the central bank instead announced a number of qualitatively (though not quantitatively) traditional easing steps to add liquidity to the Euro-zone that would amount to replacing credit in the faltering European interbank market with its own liquidity. In particular, the ECB indicated that it would conduct "Long-Term Refinancing Operations" that month and in March 2012 to make three-year loans to commercial banks in the form of repurchase agreements with liberalized collateral requirements. In the end it injected fully

€1 trillion, or $1.3 trillion. "[S]aid Carsten Brzeski, an economist at ING Bank in Brussels . . . '[T]he ECB does everything to be the lender of last resort for the economy and the financial sector but not for governments.' "[29]

But financial markets remained skeptical. To provide reassurance, on July 26 Draghi made a significant concession: "To the extent that the size of these sovereign premia hamper [sic] the functioning of the monetary policy transmission channel, they come within our mandate." But then he uttered a more portentous thought: "Within our mandate, the ECB is ready to do whatever it takes to preserve the euro. And believe me, it will be enough."[30] That assertion sparked "a market rally amid hopes the bank would intervene to buy sovereign bonds."[31]

Exactly a week later, Draghi made good on his promise only in the sense that he made another promise, but his new expostulation turned out to be effective beyond his wildest dreams. Perhaps contributing to the promise's success, this time it had the concurrence of the ECB's Governing Council. That group averred that that under the right conditions large-scale central-bank purchases of sovereign securities would be possible. Under a new program called "Outright Monetary Transactions," it would buy government bonds with maturities of one to three years. But to qualify a Eurozone government would have to fully comply with an assistance program granted by an official European body. The ECB's new initiative, though not exercised until March 2015, much relieved the previous tensions in financial markets.

The relative calm persisted into 2013. Then in mid-March a group of European finance ministers demanded that Cyprus itself finance a third of another European Union bailout. The Eurogroup hit upon a dubious scheme that was supported by the IMF during the preliminary private negotiations, though it later tried to evade any culpability. The proposal was to finance that part of the required bank restructuring via new fees not only on large uninsured deposits but even on the insured deposits of unsuspecting little people. After the initial agreement, the IMF's Christine Legarde issued a shocking public statement that the plan "appropriately allocates the burden sharing."[32] Milton Friedman had blamed our country's Great Depression on the Fed, a government agency, which stood idly by in the early 1930s while the private sector caused a severe shrinkage of US deposits. That the honchos of European governments and international organizations intentionally had done as much must have made him turn over in his grave. President Draghi later seconded his opinion by calling the plan "not smart."[33]

After the entirely predictable outcry by Cyprus citizens, the nation's parliament unanimously rejected a slightly abridged proposal. But intransigent European officials still insisted that Cyprus cough up the same sum. So while insured depositors were spared in the end, large ones had to take a much more substantial hit. To forestall bank runs and transfers abroad, the government imposed withdrawal limits and capital controls with IMF support. Such restrictions, of course, were completely antithetical to the logic of the common currency union in which a Euro is equal everywhere and capital can flow unimpeded between member countries.

Now the reader gets a chance to "walk a mile" in a couple of different pairs of shoes. First try on those of a typical Cypriot. Don't you suddenly feel that the transfer of the capital of the two largest Cyprus banks to the tune of 25 percent of the island's national income to a Greek bank under the European Union's new policy in October 2011 of "private-sector involvement" in restructuring Greek government

debt, which was supported by the then-reigning Cypriot Communist Party ideologically desirous of punishing local banks, had been completely unjust?[34] Don't you also think that the big country bullies more recently had shown unforgivable disrespect to your elected president in private negotiations? Don't you believe that they then were unfair to uninsured depositors, which local as well as zone-wide politicos previously had insisted were inviolable? But even at the cost of undercutting their own self-interest by putting the future of the original Euro-zone in further jeopardy, the bullies for spite ruined your country's profitable status as an attractive tax haven, in which deposit inflows from abroad had enlarged your banking system to almost seven times the size of national income. How can the expropriation of large deposits in Cyprus by European finance ministers really represent the actions of bureaucrats seriously interested in establishing a uniform banking union? And now, despite a heralded so-called "bail-in," you have just lost your job in a financial sector that will never be the same again! Don't you suddenly feel that "all hope is gone?"

At this point slip on another pair of shoes, this set made in Berlin. Aren't you suddenly suffering from "bailout fatigue?" Don't you think your taxes have gone to undergird corrupt economic systems in the countries of the periphery—and to no lasting economic purpose? And hasn't your generosity in Cyprus amounting to a €9 billion infusion of your tax funds, with another €1 billion grant from the IMF, been greeted only with resentment? Haven't you had it up to here with Cyprus taking advantage of capital mobility in the Euro-zone to attract the ill-gotten gains of foreign tax evasion on the part of shady, even criminal, foreigners, importantly including Russian oligarchs? Is it your fault that Cyprus banks lost their shirts by investing the proceeds of those capital inflows in completely unsafe Greek government securities, following the misguided risk incentives put in place by the European banking regulators themselves? Didn't that keen observer from across the English Channel long ago advise that in a panic a central bank should lend freely at a high rate only to solvent, but temporally illiquid, banks? Didn't he recommend letting clearly insolvent banks simply go belly up, implying that their uninsured depositors and creditors would lose much of their invested funds? Wouldn't all those uninsured Cypriot depositors be a lot worse off if that sound advice had been heeded? So why shouldn't the uninsured Cypriot depositors join senior debt holders in financing the liquidation of one and recapitalization of another of their own domestic banks?

Once the dust had settled, President Draghi introduced forward guidance on the same day that the BOE did so under Governor Carney. At his press conference on July 4, 2013, he pledged to maintain existing or lower key ECB interest rates for "an extended period."[35] That was the same qualitative phrase that the FOMC had used in its statements for more than two years starting in March 2009. It is ironic that, as with the BOE, the step was prompted by the rise in domestic interest rates induced by Bernanke's remarks on tapering. Notice that in President Draghi's judgment, the ECB was better advised to offer only vague, qualitative guidance, as opposed to adopting the quantitative guideposts of the Fed and later the BOE under newly installed Governor Carney.[36]

Even during the previous relative calm in financial markets, the average Euro-zone citizen (Call him Pierre Wine Bottle) continued to experience worsening economic conditions. Euro-zone income slipped 1/2 percent over 2012, including a decline of

about 1 percent in the fourth quarter on average, with the periphery countries much worse off. The recession continued through the first quarter, extending the drop in output to six quarters. And while the average unemployment rate in the Euro-zone had risen to 12 percent, some southern countries had more than one-quarter of the labor force out of work, with youth unemployment twice as bad.

A mild upturn began in the second quarter of 2013. But the first week of October witnessed another worrisome downward revision to the European Commission's output forecast for 2014. Also, 12-month core consumer inflation in October fell from 1.5 percent a year earlier to only 0.8 percent—equal its record low of early 2010 and way below the goal just short of 2 percent. In early November, the ECB reacted by moving sooner than predicted by halving its benchmark refinancing rate to 0.25 percent. But even with the easing, the record unemployment in the Euro-zone implied that core consumer inflation only around 1 percent seemed probable.

To see why, consider the illustrative figure of a 1.95 percent inflation target. At Jackson Hole in August 2014, President Draghi cited an average estimate of the European Commission, the OECD, and the IMF for structural unemployment in the Euro-area in 2013 of 10.3 percent.[37] Further posit that the actual Euro-zone unemployment rate would persist indefinitely at its 12.2 percent preliminary reading for September 2013 as perceived at the time of the ECB's November easing. The European Commission projected it to stay there on average during the next year.[38] The above formula for quasi-equilibrium then yields 1.95 – 0.5 (12.2 –10.3) or 1.95 – 0.95 or core consumer inflation of 1.0 percent. Through December 2013, actual 12-month core inflation in Euro-zone registered a rate of 0.8 percent, while the unemployment rate slipped to 12 percent.

These outcomes were not merely cyclical but signaled that the underlying challenges to the currency union still remained insufficiently addressed. (Indeed, it remains to be seen whether the ECB's actions, though so far effectively addressing the sovereign debt crisis in the near term, can forestall indefinitely the breakup of the original Euro-zone.) The economic torpor in the single-currency area, which was created in 1999 for the political purpose of pacifying the continent, owed to the inevitable operation of the following innate structural economic flaws:

1. Absent a fiscal union, budgetary profligacy on the part of some governments, which was dishonest in the case of Greece, often had led to extravagant spending;
2. Mitigating official fiscal benchmarks in peripheral countries often were missed and delayed, partly due to unexpectedly deep recessions;
3. The dependent citizenry long before had become accustomed to "bread and circuses;"
4. Regulatory overkill, especially in the periphery, had created a sclerotic economy with inadequate individual freedom of action;[39]
5. No peripheral member could stimulate its economy by having its national central bank set a relatively low overnight interest rate but had to accept the common monetary policy established by the ECB;
6. No such country could become more competitive through a depreciation of its national exchange rate relative to the Euro but instead had to undertake the wrenching task of internal deflation;

7. A single currency is only appropriate for an "optimum currency area" in which internal immigration to relieve labor-market imbalances can occur readily without engendering a social backlash; and
8. Political incentives in crisis management have remained national rather than European.[40]

After the sovereign debt crisis erupted in 2010, European authorities attempted to address budgetary profligacy, but the resultant fiscal conditionality often was violated and postponed. Also, the initiative for a fiscal union encountered roadblocks.[41] But, as shown in Table 13.1, the European Commission still could report in February 2014 that the zone's 2009 primary government deficit, which excludes interest expenditure and one-time payments, of 3.5 percent of GDP was completely closed by 2013. Even so, the gross debt-to-GDP ratio in the Euro-zone continued to mount through the end of that year, though an appreciable slowing in the gain was in train for 2014.[42] The commission foresaw an imminent decline in the following year. Time will tell whether that anticipated reduction in the debt to GDP ratio in 2015 actually will come true.

President Draghi accurately diagnosed the first four sources of these eight problems:

> He said Europe's vaunted social model—which places a premium on job security and generous safety nets—is "already gone," citing high youth unemployment; in Spain, it tops 50%.
>
> He urged overhauls to boost job creation for young people.
>
> There are no quick fixes to Europe's problems, he said . . . He argued instead that continuing economic shocks would force countries into structural changes in labor markets and other aspects of the economy, to return to long-term prosperity.
>
> "You know there was a time when [economist] Rudi Dornbusch used to say that Europeans are so rich they can afford to pay everybody for not working. That's gone."
>
> Mr. Draghi argued that austerity, coupled with structural change, is the only option for economic renewal. While government spending cuts hurt activity in the short run, he said, the negative effects can be offset through structural overhauls.[43]

But for political reasons he hardly could question the basic shared currency area, the enforced common monetary policy, or the most important, underlying source of its problem:

> The real cause, as long argued by Sir Mervyn King, Governor of the Bank of England, and now accepted by most leading economists, is a simple, old-fashioned balance of payments crisis. Europe has long been divided into surplus and deficit nations: those that manage to pay their way in the world and those that have to borrow and import from abroad to sustain their standard of living. But since the advent of the euro, these

Table 13.1 Euro-area Debt and Primary Deficit (Percent of GDP)

	Average/2004–2008	*2009*	*2010*	*2011*	*2012*	*2013*	*2014*	*2015*
Gross Debt	69.0	79.9	85.6	87.9	92.6	95.5	95.9	95.4
Primary Balance	–1.1	3.5	3.4	1.1	0.6	0.1	–0.5	–0.6

Source: Allan Meltzer, *A History of the Federal Reserve, Volume 2, Book 1: 1951–1969* and *Book 2: 1970–1986,* The University of Chicago Press, 2003, pp. x, 1243, 1251, and 1252.

> imbalances have got very much worse. Normally, they would be corrected through the natural market mechanism of free-floating exchange rates. Deficit nations would devalue against surplus ones, bringing trade and capital flows back into balance. But in a monetary union, this cannot happen. In fact, the exact opposite has occurred. A low interest rate designed to help Germany deal with the costly aftermath of reunification encouraged a consumer and construction boom in the underdeveloped periphery. This in turn caused differences in prices, wages and industrial competitiveness to widen.[44]

Robert Samuelson's column in the *Washington Post* clearly identified the dilemma:

> Can anyone doubt that the euro's creation in 1999 was a huge blunder? The great lesson here is that bad ideas, once embraced, become entrenched. The euro was a monstrously bad idea from which there is no easy escape.[45]

The Euro-zone crisis had entered into public consciousness once the basic imbalances had become too acute to fester quietly. On top of everything else, labor costs in the periphery, especially Greece, began to grind lower because depreciation of individual national currencies wasn't possible. Wage and price deflation was drawn out and painful. The same debilitating adjustment had been enforced by the rules of the gold standard in the 1930s. The damaging process really got going in May 1931 after the failure of Credit-Anstalt, a Viennese commercial bank, whose demise induced a worldwide financial panic. That panic in turn transmogrified into a further disastrous drop of output and incomes in industrial countries. This outcome was artfully analyzed by John Maynard Keynes in 1936 in the *General Theory*, as well as by Milton Friedman and Anna Schwartz, Barry Eichengreen, and Ben Bernanke in later decades. The point is that pacifistic political motivations shouldn't simply ignore economic realities. Even so, Friedrich Hegel unfortunately got it right: "What experience and history teach is this—that nations and governments have never learned anything from history, or acted upon any lessons they might have drawn from it."[46]

After examining the main issues raised by Fed history, the concluding chapter then will examine how ivory-tower economists have done taking hold of the policy reins. Finally, we'll try to discern what it all means. But before doing so, the cheaper will sum up my own take on the last round of quantitative easing. To anticipate, the Fed's adopting QE3 in September 2012 reminded me of Oscar Wilde's quip, the second sentence of which originated with Samuel Johnson: "Marriage is the triumph of imagination over intelligence. Second marriage is the triumph of hope over experience."