The European Central Bank: Building a Shelter in a Storm

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Abstract

As the financial crisis gathered momentum in 2007, the United States Federal Reserve brought its policy interest rate aggressively down from 5¼ percent in September 2007 to virtually zero by December 2008. In contrast, although facing the same economic and financial stress, the European Central Bank’s first action was to raise its policy rate in July 2008. The ECB began lowering rates only in October 2008 once near global financial meltdown left it with no choice. Thereafter, the ECB lowered rates slowly, interrupted by more hikes in April and July 2011. We use the “abnormal” increase in stock prices—the rise in the stock price index that was not predicted by the trend in the previous 20 days—to measure the market’s reaction to the announcement of the interest rate cuts. Stock markets responded favorably to the Fed interest rate cuts but, on average, they reacted negatively when the ECB cut its policy rate. The Fed’s early and aggressive rate cuts established its intention to provide significant monetary stimulus. That helped renew market optimism, consistent with the earlier economic recovery. In contrast, the ECB started building its shelter only after the storm had started. Markets interpreted even the simulative ECB actions either as “too little, too late” or as signs of bad news. We conclude that by recognizing the extraordinary nature of the circumstances, the Fed’s response not only achieved better economic outcomes but also enhanced its credibility. The ECB could have acted similarly and stayed true to its mandate. The poorer economic outcomes will damage the ECB’s long-term credibility.

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Introduction

Although the financial crisis originated in the United States in early 2007, it spread quickly to the eurozone. The shock to banks moved rapidly from the U.S. to the euro area, because banks were perceived as facing a common risk. And probabilities of default and volatilities in credit markets rose together. The economies on both sides of the Atlantic experienced parallel and equally-sized declines in stock prices and GDP through 2008 and the first half of 2009 (Figure 1). Thus, although the crisis was viewed—especially in Europe—as mainly a U.S. problem, the eurozone felt virtually the same impact in the early stages of what was later called the “Great Recession.”

Figure 1: Stock and GDP Price Movements

Note: Stock prices are normalized to equal 100 on January 1, 2007, and GDP is normalized to equal 100 in the first quarter of 2007.


2 Eichengreen et al. (2012).
3 BIS (2008, Chapter VI, Graph VI.2). Indeed, Hyun Shin (2012) has argued that European banks actively participated in creating the U.S. subprime bubble and required special support from U.S. authorities.
Ironically, the recovery was much quicker in the U.S. than in the eurozone. By late-2011, U.S. stock prices and GDP were close to their pre-crisis levels. In contrast, these eurozone metrics were below their pre-crisis levels even in the first quarter of 2015. In the U.S., early, concerted, and proactive policy response helped renew investor confidence. Such improved sentiment, as George Akerlof and Robert Shiller have argued, is crucial to break the downward economic and financial spiral in a crisis and to sustain the recovery.\(^4\) Shiller has recently reemphasized the theme:

“… swift, effective intervention is needed in the face of financial collapse. We need to give free rein to fiscal and monetary authorities to take aggressive steps when financial turmoil turns into financial crisis.\(^5\)

The U.S. pushed early and aggressively in the use of all policy instruments. In 2008-9, they imparted greater fiscal stimulus than in the euro area; the U.S. also, returned to austerity later, in 2011, rather than in 2010 as in the eurozone.\(^6\) More important was the active resolution of banking sector stress in the U.S.; the eurozone banking problems were allowed to fester. And throughout, U.S. monetary policy was much more aggressive.

In this paper, we focus on the stark difference in the speeds at which policy interest rates were reduced. In the U.S., the policy rate (the Fed Funds rate) was reduced from 5¼ percent in September 2007 to close to zero in December 2008 (Figure 2).\(^7\) At that point, the Fed also initiated the so-called quantitative easing program and began “forward guidance,” which made public its intention to keep interest rates low “for some time.” In the eurozone, the first reaction to the Great Recession was to its raise policy rate

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\(^4\) Akerlof and Shiller (2009).  
\(^6\) Mody (2015, p. 2).  
\(^7\) The U.S. Federal Funds rate determines the rate at which banks lend to each other.
(the main refinancing rate) in July 2008. After the Lehman Brothers’ bankruptcy in September 2008, the ECB had no choice but to join a coordinated rate reduction on October 8. But then, the ECB’s slow pace of rate reduction was interrupted by two more hikes—in April and July 2011. Policy rates were brought to near-zero only in November 2013; quantitative easing began in a small way in September 2014 and was expanded in January 2015.

Figure 2: Policy Rates: the U.S. Federal Reserve and the European Central Bank


Our empirical analysis confirms that by moving more rapidly—and with a clear focus on averting a catastrophic outcome—the Fed was also more effective in reviving confidence, essential for economic recovery. In contrast, the ECB’s hesitant response sent mixed signals of its focus and intent and, therefore, did little to help revive the euro area economies.

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8 The eurozone’s main refinancing rate is the interest rate banks pay to borrow from the ECB. Normally, this rate also determines the euro overnight index average (EONIA), the rate at which banks lend to each other in the “unsecured” market. But because banks relied principally on the ECB for their funding through much of the crisis, there was little activity in banks’ unsecured market and the EONIA was close to the much lower rate at which banks deposit money at the ECB (European Central Bank, 2010 and 2015b).
To reach this conclusion, we use a mix of approaches. Ultimately the goal is to relate monetary policy decisions to growth and inflation outcomes. But tracing a link between any policy announcement (or even a set of these) to macroeconomic developments is difficult. Our approach offers, we believe, the most reasonable possibility of isolating the ECB’s role during the crisis. We study the link between the policy intent accompanying the announcement and the change in sentiment that followed. The change in sentiment is inferred by the stock market’s immediate reaction and the concurrent market commentary. We interpret this story in a framework that emphasizes macroeconomic risk management, with credibility achieved by matching words and deeds.

To examine the stock market’s response to the announcement of interest rate cuts, we use an event-study methodology similar to that of Ait-Sahalia et al. (2012). We measure the “cumulative abnormal change” in stock prices on each trading day after the announcement. The “abnormal difference” is measured as the change in the stock price on that day minus the average daily change over the twenty days before the announcement (the presumption is that absent the announcement, stock prices would have continued to change at the same pace over the next five days). Adding up the daily abnormal differences, the cumulative abnormal difference shows the post-announcement divergence in the stock price movement from the trend in the preceding twenty days. The results are summarized in Figure 3. The Fed, by cutting rates down to nearly zero by December 2008, helped boost stock markets in 2007-8. For the slower-moving ECB, the market reaction was, on average, negative throughout.

9 While event studies are common in micro (firm-level) studies, Ait-Sahalia et al. (2012) adapt the method to assessing macro outcomes.
Figure 3: Stock Market Reactions to the Reduction of Interest Rates

Note: In computing the average reaction for 2007-2009, we do not include the market reaction on October 8, 2008, as explained below. “t-1” refers to the market closing stock price on the day before the announcement. The market reaction is measured as the abnormal difference starting with the market closing price on the day of the announcement (“t”) and on the following four days. The abnormal difference is measured as the cumulative change relative to the change based on a continuation of the past 20-day trend.

Such event-study analyses, while customary, have clear limitations. The first concern is that the stock market’s reaction is assessed within a small time window around the announcement. This is necessary to best isolate the announcement from other influences on stock prices. But, as a result, we cannot be sure if the effect observed in the narrow time window persisted beyond it. Consistent though with our findings around the announcements, the U.S. and euro area stock indices diverged, as seen in Figure 1.

Second, stock price changes are an imperfect measure of real economic change. A particular concern could be that stock prices do not reflect monetary policy decisions in the euro area because firms more on banks than on market funding. However, Bohl, Siklos and Sondermann show that even before the crisis, tighter ECB monetary policy was accompanied by an adverse market reaction as if anticipating slower economic
activity.\textsuperscript{10} During the Great Recession, moreover, as Figure 1 shows, stock price movements tracked relative differences in GDP performance, consistent with the Akerlof-Shiller view that improved investor sentiment helps stem the fall and begin the recovery.

A final concern with the event-study methodology is that markets may have anticipated the announcement and so may already have made the necessary adjustments. This would presumably be more likely for the ECB because the Fed’s earlier actions may have led markets to expect that the ECB would eventually act similarly. We report whether or not the announcement was expected—and also whether the rate cut was less or more than expected. And we narrate the market reaction immediately following the announcement. The unexpected announcements did trigger a stronger response than expected announcements in the U.S., but the anticipation of the announcements was not the primary influence on stock prices. We argue that even when anticipated, announcements provided new information about the central bank’s commitment (or the lack of it).

The Fed’s early and aggressive moves conveyed a willingness to counter the risk of prolonged financial and economic distress. Acting preemptively, the Fed was perceived as leading the markets. In contrast, the ECB, preoccupied with inflation risk, acted grudgingly to build protection against the gathering financial and economic storm. As such, markets were never sure what the ECB was trying to achieve, and often viewed the rate cuts as harbingers of bad news or as inadequate to the task at hand.

The central banks’ differing mandates were not the reason for the differences in their response to the Great Recession. True, the Fed has a clear dual mandate to support

\textsuperscript{10} Bohl, Siklos and Sondermann (2008).
employment (and output) and maintain price stability.\textsuperscript{11} But the ECB—despite its formal focus on price stability—has also, in the past, acted as if it had a dual mandate. Indeed, as Lars Svensson has pointed out, it could not be otherwise. The ECB’s focus on “medium-term” price stability (over a two-year horizon) implies that, like other central banks, it does not seek to bring inflation down instantly since attempting to do so would cause an unreasonable drop in output.\textsuperscript{12} The result, Svensson argues, is that ECB’s stated objective is indistinguishable from that of central banks with dual mandates.\textsuperscript{13} Not surprisingly, therefore, John Taylor found, that between 2000 and 2006, the ECB and the Fed both responded to output shortfalls and inflationary pressures.\textsuperscript{14} Fernanda Nechio reached a similar conclusion.\textsuperscript{15}

The difference between the Fed and the ECB during the Great Recession was not due to their differing mandates but was due rather to the perception of risks associated with the crisis. During the Great Recession, the Fed, Alan Blinder says, the Fed went beyond its “dual mandate.” It operated on the “dark” view that a huge loss of wealth could tip the economy into a deep recession, and even into a meltdown.\textsuperscript{16} The priority was to prevent or manage that risk.\textsuperscript{17} The Fed’s monetary policy was, therefore, more aggressive than if it had followed its previous norms. It played down inflation risk in 2007-8 and made, instead, the judgment that the risk of prolonged economic contraction

\textsuperscript{11} Steelman (2011).
\textsuperscript{12} Svensson (1999, pp. 83, 96, and 107).
\textsuperscript{13} Svensson (2013, p. 33, footnote 2) makes the same point in a different way. A primary mandate of price stability requires that the inflation target gets priority over a medium-term horizon (i.e., the mean inflation rate must be close to the target rate without regard to an employment or output goal). However, short-run macroeconomic fluctuations (the variance) must also be managed, which requires paying attention also to economic activity.
\textsuperscript{14} Taylor (2010).
\textsuperscript{15} Nechio (2011).
\textsuperscript{16} Blinder (2013, p. 94).
\textsuperscript{17} See BIS (2008, p. 64) for an early description of the Fed’s actions in these terms.
required special attention. To that end, the Fed ramped up its provision of market liquidity to facilitate financial transactions just as the ECB did, but the Fed also brought down interests rates quickly. And once the policy interest rate could not be lowered further, easy monetary policy was maintained through quantitative easing and through “forward guidance.” These “nonconventional” measures were bolstered in 2010 to fend off the risk of price deflation even after the haltingly economic recovery had begun.

In contrast, the ECB interpreted the onset of the Great Recession as a primarily a liquidity crisis. In other words, the ECB took the view that a temporary scare had caused banks to hoard cash and thus restrict lending to other banks. These financial market disruptions, the ECB determined, mainly required additional liquidity provision. The ECB’s interest rate policy continued to assign relative weights to output and inflation objectives as in the past. And the fear that commodity price inflation would feed into wage inflation, led to a hike in the policy rate in July 2008.

The essential difference between the Fed and the ECB, therefore, boiled down not to their mandates but to how each institution viewed the likely evolution of the economy. As Hetzel has emphasized, commodity price inflation should have been expected to naturally come down in a weakening economy and should not have been seen as a threat to the ECB’s goal of less-than-but-close-to 2 percent. The overemphasis on price stability at the ECB was accompanied by insufficient appreciation of the financial and economic risks. The passive provision of funds to banks was insufficient to induce them

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18 Blinder (2013, p. 94).
19 Stark (2008).
20 BIS (2008, Graph IV.3, p. 63).
21 Hetzel (2014).
to lend more and, thereby, stimulate economic growth.\textsuperscript{22} The loss of confidence and severe demand contraction required active monetary stimulus. The Fed’s more aggressive monetary policy emerged from a more dire view of the future, which led it to attempt preemptive protection from unusual economic and financial distress.

The ECB also rejected a risk-management approach in 2013-14, when the euro area clearly began to slide towards deflation. While interest rates were gradually lowered, the ECB followed rather than anticipated the deceleration in inflation. Ironically, the ECB concluded that deflationary tendencies would be temporary because they were caused by falling commodity prices. Thus, ECB acted asymmetrically: rising commodity prices were expected to feed persistent inflation but falling commodity prices were expected to reverse course.

Thus monetary policy added to the economic drag and deflationary tendencies due to fiscal austerity and lingering banking problems. Such delays in stimulating economic recovery have permanent consequences, as recent analysis reaffirms.\textsuperscript{23} We conclude also that the Fed gained credibility even though it appeared to temporarily suspend its commitment to price stability. Managing the immediate and overriding risk was appropriate for the extraordinary circumstance of the Great Recession. Michael Bordo and Finn Kydland have argued that setting aside a policy rule to deal with the immediate contingency is consistent with commitment to long-term goals.\textsuperscript{24} As Blinder has emphasized, credibility requires that words be matched with deeds.\textsuperscript{25} For all its rear-

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\textsuperscript{22} Hetzel (2012).
\textsuperscript{23} Fatas and Summers (2015).
\textsuperscript{24} Bordo and Kydland (1995).
\textsuperscript{25} Blinder (2000 and 2012).
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guard action, the ECB misread the crisis and will be associated with the legacy of a weak recovery and more entrenched deflationary tendencies.

In the rest of this paper, we first discuss the global crisis of 2007-9 and then the following years of deflationary risk. In each phase, we first describe the policy thought process at the two central banks. This is followed by the event study analysis to assess the market’s response to the policy actions. Finally, a narrative of market commentary helps interpret the market’s response. In a final section, we discuss what this episode has taught us about central bank credibility.

**The Global Crisis, 2007-2009**

Through the first half of 2007, the Fed and the ECB were both encouraged that the economy had slowed only modestly. Both were instead concerned that the commodity price boom had persisted and was fueling inflation despite the fading economic boom. And while they were both worried about financial stability, neither saw an upheaval coming.

In May 2007, Fed Chairman Ben Bernanke insisted that the financial crisis would remain restricted to the so-called “subprime” sector: “[…] we believe,” he said, “the effect of the troubles in the subprime sector on the broader housing market will likely be limited, and we do not expect significant spillovers from the subprime market to the rest of the economy or to the financial system.”\(^{26}\) Across the Atlantic, with no evident financial stability concerns, the ECB’s mid-June decision to raise its policy rate was not controversial. The OECD’s Chief Economist spoke for many when he said that monetary

\(^{26}\) Bernanke (2007).
authorities should “err on the side of tightness.””\textsuperscript{27}

By early August, the financial rumbles had grown in the United States. The members on the Federal Open Market Committee (FOMC)—the Federal Reserve’s rate setting body—were concerned that inflation was not letting up, but neither was the financial crisis. At their August 7 meeting, the question for them was whether to raise the policy rate to fight inflation or to lower it to counter a possible economic slowdown due to continuing financial dislocations. The members compromised by keeping the rate unchanged. Blinder—a former Vice Chairman of the Board of Governors of the Federal Reserve System—writes: “Many Fed watchers blinked in disbelief. What were those guys thinking?”\textsuperscript{28} Two days later, on August 9, the French bank BNP Paribas refused to let customers withdraw their money from three funds with exposure to US subprime mortgages.\textsuperscript{29} To alleviate the liquidity shortage, the Fed and the ECB immediately pumped cash into the world’s financial pipelines.\textsuperscript{30}

Blinder is appalled that the Fed waited until September 18—“a full forty days after Paribas day”—before lowering its policy interest rate by 50 basis points (100 basis points equal one percentage point).\textsuperscript{31} But from that point on, the balance at the Fed shifted slowly but decisively from concerns about inflation to worries about financial disruption. The FOMC members grew increasingly alarmed that the financial crisis may snowball. In January 2008, they lowered interest rates twice, on the 22\textsuperscript{nd} and on the 30\textsuperscript{th} by 75 and 50 basis points respectively. The rates were cut despite considerable

\textsuperscript{27} Cotis (2007).
\textsuperscript{28} Blinder (2013, p. 92).
\textsuperscript{29} BNP Paribas said that because market liquidity had “evaporated,” it was not possible to value the funds and so redemptions could not be permitted. \url{http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aW1wj5i.vyOg}. See also BIS (2008, p. 95).
\textsuperscript{30} The Federal Reserve System (2007a).
\textsuperscript{31} Blinder (2013, p. 93).
disagreement in the committee on the direction of the U.S. economy. The transcripts of
the FOMC meeting the January 29-30 reveal that some members were mainly concerned
by the risk of rising inflation while others—especially Janet Yellen, then President of the
Federal Reserve Bank of San Francisco, and Chairman Bernanke—highlighted the
“downside risks” of a recession. They were concerned that an imminent recession might
evolve into an unacceptably serious credit crisis.

The mortgage business kept unraveling and on March 14, the Fed began a rescue
of Bear Stearns, which was bought two days later by J.P. Morgan. At the FOMC
meeting on March 18, some members concluded the United States was in a full-blown
financial crisis. Yellen described the situation as a “financial market implosion.” Frederic (Rick) Mishkin said: “[…] the reality is that we are in the worst financial crisis
that we’ve experienced in the post–World War II era.” The Committee members took
note of the data that continued to warn of medium-term inflationary risk. And some were
concerned that the Fed’s reputation for fighting inflation would be damaged if interest
rates were lowered. But despite the diversity of views, the members recognized that the
U.S. economy was at a very important crossroads. Ultimately, the debate was between
either a 50 or 75 basis points cut, with the larger reduction winning to protect against
further financial market disruption.

The inflation rate had continued to rise, from an annual rate of 2 percent at the
start of 2008 to a 3 percent annual pace by April. Even so, at its April 30th meeting, the
Fed reduced the rate by another 50 basis points. Some FOMC members did feel that the

33 Appelbaum et al. (2014).
rate cuts were being overdone. In their view, monetary policy was already “accommodative”—low enough to stimulate investment and consumption—and the risk was that inflation might get out of hand. Yellen, however, emphasized:

“Although the real federal funds rate is accommodative by any usual measure, [this] is a situation in which spreads have increased so much and credit availability has diminished so much that looking at the real federal funds rate is just a very misleading way of assessing the overall tightness of financial conditions.”

Yellen argued that a lower policy rate would help revive employment without hurting the “attainment of price stability over the medium term.” Her argument carried the day.

Finally, at its June meeting, with inflation still on the rise, the FOMC did finally hold rates through the summer before resuming rapid rate cuts after the Lehman Brothers bankruptcy. Hetzel is critical of even the brief pause in the summer of 2008 as creating a contractionary force. The contrast with the ECB is, however, striking.

The ECB does not make public the transcripts of its Governing Council meetings. But at his press conferences through 2007 and much of 2008, President Jean-Claude Trichet emphasized that run-away inflation was the primary threat and, hence, the Governing Council was focused on whether and when to raise the policy rate. At the September 6, 2007 press conference, Trichet described the ECB’s philosophy. When asked what weight the ongoing global financial turbulence was being given in the ECB’s decision making, he explained that fighting inflation was twice blessed—not only was inflation countered but so was the risk of financial instability. “The anchoring of inflation expectations,” Trichet said, “is all the more important in a period of volatility of financial markets, […] because it provides for all agents, investors, savers, in Europe and in the

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37 Hetzel (2009).
world a solid base for their medium-term and long-term decisions.” In the following months, Trichet stuck to this theme even as the Fed aggressively cut its policy rate.

In November 2007, a journalist asked Trichet whether “another large central bank is doing [things] differently” was creating confusion in the global financial markets. Trichet responded at some length:

“With regard to your subtle last question, I have no advice for other central banks! I have noted since the beginning of the period of “turbulences” that we were all in different economies with various characteristics and with various instruments at our disposal, taking into account our own histories and our own structures. I take it that what has been done has been responsible and I think we could certainly prove that we – each of us, in our own environment – probably did what was required by the situation. In the Governing Council, we will continue to consider that we have a major responsibility […] to be credible – particularly in the eyes of our fellow citizens – in the delivery of price stability over the medium term.”

Underlying Trichet’s response was the implication that the Fed and the ECB were responding to different economic conditions. While the Fed was obsessed with financial disruption, Trichet remarked that the ECB had “observed a progressive appeasement of tensions in the money market ….” Again, in January 2008, Trichet emphasized that the indicators “generally remain at levels that continue to point to ongoing growth.” He restated that the greater concern was further rise in inflation and that, while the Governing Council had held off from raising rates, it maintained a “tightening bias.”

On February 7—after the Fed had reduced its policy rate by 125 basis points in January—a reporter again asked: “... do you interpret this [the Fed’s steady interest rate cuts] as an effort to stop an economic contraction that is already underway or highly

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38 Trichet and Papademos (2007b).
40 Trichet and Papademos (2007d).
41 Trichet and Papademos (2008a).
proactive risk management ...?\textsuperscript{42} The question was a relevant one. Although its growth prognosis was not different, the Fed was busy slashing its policy rate. Trichet repeated that each central bank needed to consider the specific features of its economy but, in the final analysis, both the Fed and the ECB had a primary focus on maintaining price stability. Trichet did acknowledge that the economic slowdown in the United States could have adverse effects in the eurozone, but that “domestic and foreign demand” were expected to support ongoing growth.”\textsuperscript{43} He emphasized that corporate profitability had been “sustained” and that unemployment rates had “fallen to levels not seen for 25 years.”\textsuperscript{44} Once again, the Governing Council was more concerned about taming inflation.

After the Bear Stearns rescue in mid-March 2008, the ECB took note that “the level of uncertainty resulting from the turmoil in financial markets remains unusually high and tensions may last longer than initially expected.”\textsuperscript{45} But this had little influence on the policy decision. Inflation continued to dominate the ECB’s thinking. Governing Council Member and the ECB’s Chief Economist insisted:

“The best contribution the ECB can make to foster confidence in the current situation is to continue to firmly anchor medium to long-term inflation expectations in the euro area by keeping its policy uncompromisingly geared to pursuing price stability. Adopting a more activist policy stance in the current situation, as some outside observers recommend, would only exacerbate uncertainty without helping to resolve the causes of the turbulences, which are outside the realm of monetary policy.”\textsuperscript{46}

In May, Trichet said that the Governing Council was unanimous in not easing monetary policy and in June he reported that the possibility of raising the interest rate had been

\textsuperscript{42} Trichet and Papademos (2008b).
\textsuperscript{43} Trichet and Papademos (2008b).
\textsuperscript{44} Trichet and Papademos (2008b).
\textsuperscript{45} Trichet and Papademos (2008c).
\textsuperscript{46} Stark (2008).
discussed before deciding to leave it unchanged.

The glaring policy difference between the Fed and the ECB unfolded despite virtually identical inflation rates in the U.S. and in the euro area. The Fed, as we have seen above, made the judgment that prolonged recession was the greater risk. The ECB’s management feared that inflation would become “entrenched”: as prices rose, people would come to believe that prices were set to rise further, which would increase the demand for higher wages and render the expectation of higher inflation self-fulfilling.\(^\text{47}\) But this fear was unfounded, as even the hyper-ventilating French President Nicolas Sarkozy understood. In late June, he said:

> “Inflation today is due to the explosion in commodity prices. You cannot tell me that in order to fight against inflation you must raise interest rates. You can double, triple interest rates and that will not decrease the price of a barrel of Brent.”\(^\text{48}\)

Instead, Sarkozy warned, raising interest rate could choke the economy.\(^\text{49}\) The Spanish Prime Minister José Luis Rodriguez Zapatero made similar remarks.

Nevertheless, the widely anticipated rate increase by 25 basis points came on July 3. At the press conference, Trichet said the measure was intended to control inflation, which had soared to 4 percent, and wage pressures had also increased.\(^\text{50}\) Critics were concerned that the rate hike coming on top of the economic drag from rising commodity prices would further dampen growth, and euro area stock prices had fallen in anticipation.\(^\text{51}\) Trichet’s tone did soften during the press conference, and observers, who

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\(^{47}\) Trichet and Papademos (2008d).

\(^{48}\) Wiesmann (2008).

\(^{49}\) Hetzel (2014) later reached the same conclusion on the basis of a more scholarly analysis.

\(^{50}\) Bloomberg Businessweek (2008) and Gow (2008).

had feared that this might be the start of a series of hikes, interpreted Trichet’s comments
to imply that another hike was unlikely soon. Markets rallied.52

The Lehman bankruptcy on September 15 threatened to tear apart the network of
global commerce and finance. On October 8, the major central banks coordinated a rate
cut of 50 basis points. This was the ECB’s first rate reduction since the start of the Great
Recession. Recall that Blinder was dismayed that the Fed had waited “a full forty days”
before reducing its policy rate on September 18, 2007. Reporting the date of the ECB’s
first rate cut—October 8, 2008—Blinder exclaimed, “yes, that is 2008 not 2007.”53 With
a global financial catastrophe looming, the ECB could not stay out of the internationally
coordinated rate cut.

But the Fed-ECB differences continued. The Fed pushed its policy rate rapidly
down to 0-0.25 percent by December 2008, at which time it also initiated its first
quantitative easing program and began “forward guidance” by promising to not to raise
rates for a “some time.” The ECB resumed its conservative stance. Despite the free fall in
the euro area economy, the ECB gingerly lowered its policy rate down to 1 percent on
May 13, 2009.

To assess if these policy differences were relevant to financial sentiment and, by
implication, to economic performance, we compare the stock market response to
lowering of interest rates. For the U.S., we use S&P 500 and for the eurozone, we use the
“FTSEurofirst 300 Eurozone.” The response to the announcement is measured by the
“abnormal” change in the stock prices. This is the change in excess of the change that
would have occurred if the daily change over the 20 days before the announcement had

52 Atkins (2008a), Lander (2008), and Watts (2008).
53 Blinder (2013, p. 94).
persisted. The closing price on the day before the policy announcement is the starting point, identified as date “t-1” in the analysis. Since the announcement is made mid-day, the first day on which the market responds is date “t.” We track the response over the five days from “t” to “t+4.” With continuous news flowing in, a period longer than this would not be appropriate since, by then, other influences would have set in.

**Figure 4: Stock Market Reactions to the Reduction of Interest Rates, 2007-9**

Note: For the reaction to the Fed interest rate reductions, we use the S&P 500 and for the reaction to the ECB reductions, we use the FTSEurofirst 300 Eurozone. “t-1” refers to the market closing stock price on the day before the announcement. The market reaction is measured as the abnormal difference starting with the market closing price on the day of the announcement (“t”) and on the following four days. The abnormal difference is measured as the cumulative change relative to the change based on a continuation of the past 20-day trend. There were 10 rate reductions by the Fed and 7 by the ECB during this period from September 2007 and May 2009. For the Fed, 8 of the 10 cuts had a positive outcome, if we consider the average of 3rd to 5th day and 7 of the 10 had a positive outcome if we consider only the 4th day (December 16, 2008 is the one that is different); on the same basis, for the ECB, 3 of the 7 cuts had a positive outcome if we consider the average of 3rd to 5th day, and 4 out of 7 had a positive outcome if we consider only the 4th day (since for the October 8 cut, the market recovered to a small positive outcome after a sharp initial fall).
Markets typically reacted enthusiastically to the Fed's rate cuts. The abnormal differences rose an average of 2½ percent by the fourth day (Figure 4). In contrast, for the ECB, the rate cuts in 2008-2009 were, on average, associated with a small negative abnormal difference—in other words, the eurozone stock market performed slightly worse after an ECB rate cut than it had in the 20 days before the announcement.

Figure 4 reports the findings with and without October 8, 2008, the date on which (as noted above) the rate was coordinated across major central banks. Following the Lehman bankruptcy, markets were still in a panic mode and no policy action seemed sufficient. Stock prices fell sharply after the announcement in both the U.S. and the euro area although they recovered ground by the fourth day (Figure 5). With or without the October 8 announcement, Figures 4 and 5 confirm the more positive response to the Fed. And although including October 8 in the analysis strengthens the Fed’s advantage over the ECB, in the rest of this analysis we do not include that date because the extreme market volatility that followed cannot reasonably be associated with the rate cut.
Note: “t-1” refers to the market closing stock price on the day before the announcement. The market reaction is measured as the abnormal difference starting with the market closing price on the day of the announcement (“t”) and on the following four days. The abnormal difference is measured as the cumulative change relative to the change based on a continuation of the past 20-day trend.

The announcements were almost always anticipated. We rely either on a survey of analysts, where available, or on news reports to assess if the policy action was expected. Other than October 8, only the Fed’s January 22 rate cut was unexpected. The abnormal differences are, indeed, larger for the sole unexpected announcement (Figure 6). Note, however, that even the expected Fed announcements prompted a favorable market response, with abnormal differences rising to about 2 percent on the fourth day. For the ECB, all 6 of the non-October 8 announcements were anticipated and the average abnormal differences for these were negative over the five-day window. Thus, the Fed did better when comparing just the expected announcements. The implication also is that the favorable response to the Fed was not because it surprised markets. Rather, the Fed’s actions revealed its increasingly longer-term commitment to keeping interest rates low.
Note: Whether an announcement was expected or not, is judged by a survey of analysts, where available, and by reports in news articles in case no surveys are available. If markets correctly anticipated a cut, but not its size, we classified the cut as expected. As explained in the text, we do not consider October 8, 2008. Of the remaining announcements, one of the Fed announcements was unexpected (January 22, 2008) and 8 of the Fed announcements were expected, whereas all of the ECB’s 6 cuts were expected. “t-1” refers to the market closing stock price on the day before the announcement. The market reaction is measured as the abnormal difference starting with the market closing price on the day of the announcement (“t”) and on the following four days. The abnormal difference is measured as the cumulative change relative to the change based on a continuation of the past 20-day trend.

We see the news value of the longer-term commitment especially from the “aggressive” rate reductions. “Aggressive” announcements are defined as those for which the interest rate was reduced by at least 50 basis points. By this metric, for the Fed, 6 of the 9 non-October 8 rate cuts were aggressive. Figure 7 show that these were associated with an average abnormal increase over 4 percent on the 5th day, and statistical tests say that the response was clearly positive.\textsuperscript{54} In contrast, the Fed’s non-aggressive

\textsuperscript{54} Welch’s t-test was performed on the cumulative abnormal differences at t+4, as well as on the average of the cumulative abnormal differences from t+3 through t+5. The results showed the cumulative abnormal differences to be statistically different from zero at the 10% and 5% levels, respectively. In addition,
announcements were followed by a decrease of around 1½ percent (although this was not statistically significant). The ECB, in contrast, gained little traction even with its aggressive rate cuts; the average response to such cuts was negative, although not statistically different from zero.

**Figure 7: Aggressive and Non-Aggressive Rate Cuts, 2007-2009**

![Figure 7: Aggressive and Non-Aggressive Rate Cuts, 2007-2009](image)

**Note:** Rate cuts were defined as aggressive if they were 50 basis points or larger, and non-aggressive otherwise. Once again, omitting October 8, 2008, 6 of the Fed’s 9 rate cuts were “aggressive,” and 4 of the ECB’s 6 rate cuts were “aggressive.” “t-1” refers to the market closing stock price on the day before the announcement. The market reaction is measured as the abnormal difference starting with the market closing price on the day of the announcement (“t”) and on the following four days. The abnormal difference is measured as the cumulative change relative to the change based on a continuation of the past 20-day trend.

The Fed’s early and aggressive actions represented not just a response to economic weakness but amounted to a change in strategy. Specifically, these actions engineered a departure from the Taylor’s rule norms and, thereby, signaled that the Fed was not just responding to economic and financial news but was acting to preempt

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Bootstrap inference was performed on the cumulative abnormal differences from t-1 through t+5, which found the cumulative abnormal differences to be statistically different from zero at the 5% level.
potentially more worrisome outcomes. While formal “forward guidance” came only with the December 16, 2008 rate cut, the actions up until then cumulated to establish a presumption that the Fed was creating a safety net. In effect, through its actions, the Fed was committing to a change in the conduct of monetary policy. Notice, on the occasions, when the rate cuts were not aggressive, the market responded negatively, presumably because of the concern that change in strategy was being abandoned. It is to the Fed’s credit that it correctly read those messages and achieved greater consistency in its actions over time.

In contrast, by the time the ECB geared up, even its aggressive rate cuts were only playing catch up with the developments. The ECB’s actions were a response to worse news, rather than with a change in the conduct of policy. In this sense, the norm of what constituted “aggressive” had changed: cuts that were regarded as aggressive when the Fed acted were now not ambitious enough to signal a new strategy. The ECB’s actions came after the storm was already raging and were, for example, overshadowed by the even more aggressive cuts by the Bank of England and other central banks.

Two themes emerge from the market commentary. First, because this was uncharted territory, the Fed was determining new norms and guiding the markets. Second, while some market commentators did want to be reassured that the Fed would not neglect inflationary pressures, most sought the clarity and continuity of the crisis-fighting message.

As noted, the Fed began the rate reduction cycle with a 50 basis points cut on September 18, 2007. Although market participants had expected a rate cut, they were

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55 See Woodford (2012) on the distinction between policy response to news and a change in the policy.
surprised by its size. Most observers applauded, and stock markets surged. The Fed’s announcement said it was acting to “forestall some of the adverse effects” from the financial disruptions, which was read as a signal that Fed would do what it could to limit the damage. One commentator remarked: “They said we’re going to be a little bold and remove at least one source of uncertainty.”

On October 31, 2007, the Fed cut rates by 25 basis points, as market participants had expected. Stock markets rose initially but then fell steadily back into negative territory. The ambiguity in the announcement was unwelcome. The Fed’s concern about inflation implied that further easing could not be presumed. The reference in the Fed’s statement to a “housing correction” drew particular comment. One analyst said: “My core view is that they really don’t get it. This is not a housing correction. It is a massive, once-in-three-generation bursting of a housing bubble. It’s a catastrophe, not a correction.”

On December 11, 2007, the Fed again cut rates by an anticipated 25 basis points, although some had hoped for a 50 basis points cut. Stock markets again reacted negatively. The move was judged as too timid. Market participants had hoped for a more decisive cut, or at least a clear indication of future cuts. The Fed would not say whether it was more worried about inflation or economic growth, and only stated that “recent developments, including the deterioration of financial market conditions, have increased

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59 La Monica (2007a).
60 Andrews (2007).
62 La Monica (2007b).
63 Irwin (2007b).
the uncertainty." Thus, although the Fed had started well in September, the next two actions in 2007 proved insufficiently ambitious.

On January 22, 2008—a day after global stock prices had plummeted—the Fed cut interest rates by 75 basis points. This was the Fed’s biggest cut in 25 years, and came a week ahead of the Fed’s next regularly scheduled meeting on January 29-30. It was also a complete surprise to market participants. The Fed said it “took this action in view of a weakening of the economic outlook and increasing downside risks to growth,” and indicated it could lower rates further. The stock market reacted positively. Some analysts did wonder if the Fed was merely panicking to global financial turbulence. But others saw it as catching up on ground lost in late-2007 and as a commitment to stay ahead of the markets. Former Fed official and Brandies University Professor Steve Cecchetti said: “The signal is that there is a new sheriff in town; when he see[s] changes in the economy that compromise medium-term stabilization objectives, he will do what needs to be done and do it right away.”

A week later, at its regular meeting on January 30, the Fed cut rates by another 50 basis points. Stock markets again reacted positively. On this occasion, the Fed noted that it expected inflation to moderate. The message by now was clear: the Fed would

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64 The Federal Reserve System (2007c).
65 BBC News (2008a).
67 BBC News (2008a).
68 Guha (2008a), BBC News (2008a) and CNBC (2008).
69 Cecchetti (2008).
70 Seager (2008).
cut rates further.\textsuperscript{72} And while this worried some market participants, most now saw the Fed as “ahead of the curve.”\textsuperscript{73}

At its next meeting on March 18, coming after the Bear Stearns bailout, the Fed cut rates again by 75 basis points. Some analysts had anticipated a 100 basis point cut, but the action satisfied many as an appropriate response to clearer evidence that a recession had begun.\textsuperscript{74} The market rally was also helped by relief that Goldman Sachs and Lehman Brothers had posted positive results.\textsuperscript{75}

On April 30, the Fed held back with only a 25 basis points, in line with market expectations.\textsuperscript{76} The market commentary was lukewarm; even so the abnormal differences rose modestly. Market participants interpreted the small size of the cut and the relatively heavy emphasis on inflation in the accompanying statement as signs that the Fed would now take a wait-and-see approach.\textsuperscript{77} That interpretation proved correct since the Fed did pause for almost six months, at which point its hands were once again forced.

In the panic after the Lehman bankruptcy, there were no norms. On October 8, a 50 basis point reduction was coordinated with five other central banks, including the ECB and the Bank of England.\textsuperscript{78} Stock markets reacted very negatively initially, dropping by more than 6 percent on the second day after the announcement. Markets worried if central banks had the capacity to contain the spreading global turmoil.\textsuperscript{79} The U.S. markets did recover by the 4\textsuperscript{th} day, but it is unclear if that was because of the rate cut.

\textsuperscript{72} Isidore (2008a).
\textsuperscript{73} Isidore (2008a).
\textsuperscript{74} Isidore (2008b) and Andrews (2008).
\textsuperscript{75} Guerrera & White (2008) and Guha (2008b).
\textsuperscript{76} NPR (2008a).
\textsuperscript{77} Barr (2008).
\textsuperscript{78} Dougherty and Andrews (2008) and Isidore (2008a).
\textsuperscript{79} Isidore (2008a).
Three weeks later at a regular meeting on October 29, 2008, the Fed again cut rates by 50 basis points, as expected by market participants.80 Explaining its decision, the Fed stated, “[…] the pace of economic activity appears to have slowed markedly, owing importantly to a decline in consumer expenditures.”81 Stock markets reacted positively. The Fed appeared to regain the market’s confidence that it was back in-charge, and observers interpreted the Fed’s accompanying statement as promising further monetary easing.82

Finally on December 16, 2008, the Fed slashed rates by 75 basis points down to 0-0.25 percent, which was a larger cut than the 50 basis points that markets had anticipated.83 With no more room to cut rates, the Fed announced its first quantitative easing program even as it said that “weak economic conditions are likely to warrant exceptionally low levels of the federal funds rate for some time.”84 Bloomberg Businessweek commented: “It’s a measure of the severity of the financial crisis that there were no dissenters from the Fed vote. Even inflation hawks such as Philadelphia Fed President Charles Plosser and Dallas Fed President Richard Fisher voted ‘yes’ on the measures.”85 Market observers were reassured that the Fed was not about to run out of options.86 And the “unusually strong” message left little doubt that countering the economic downturn would receive priority over fighting inflation.87 Stock markets gained initially but these tapered by the 3rd and, especially 4th day after the announcement.

80 Isidore (2008b).
81 The Federal Reserve System (2008g).
83 Coy (2008).
84 The Federal Reserve System (2008h).
85 Coy (2008).
Meanwhile, the ECB’s first rate cut on October 8 was off an inauspicious start. Analysts noted that the coordinated action had, “failed to calm gyrating markets […] amid the growing realization that a serious and prolonged recession [would] be difficult to avoid.”\(^88\) Then, the markets correctly anticipated the ECB’s November 6 cut of 50 basis points, although a “stunning” 150 basis point cut by the Bank of England earlier that day had stoked expectations that the ECB would be more aggressive.\(^89\) Abnormal differences turned negative following the announcement, falling to almost negative 11 percent by the fourth day after. A commentator remarked: “The prospects for the euro-zone avoiding recession now look virtually non-existent, and the ECB will be challenged to change its relatively conservative approach quickly to boost prospects across the continent, before a bad situation gets decidedly worse.”\(^90\) Despite this feedback, the ECB remained cautious. Executive Board Member Bini Smaghi said: “The present crisis is partially due to interest rates that remained at low levels for too long. […] rates were lowered too much in order to stimulate growth. We need to avoid repeating the same mistakes.”\(^91\) Trichet emphasized the risk of a wage-price spiral in his November 2008 press conference.

On December 4, 2008, the ECB surprised markets with a bigger-than-expected 75 basis point rate cut, larger than any cut the ECB had made before. This helped. Stock markets rallied strongly. Even so, the commentary was generally skeptical. The rate cut was a reaction to bad economic news rather than a harbinger of a new approach. Some

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\(^{88}\) Dougherty and Andrews (2008).


\(^{90}\) CBS News (2008).

\(^{91}\) Vits (2008). Bini Smaghi was a frequent spokesman on the ECB’s operating philosophy. As member of the 6-person Executive Board, which included the ECB President and Vice-President, he participated in managing the ECB’s day-to-day business.
observers found the ECB cut tame, considering “horrific” economic data, and large concurrent rate cuts of 100, 150, and 175 basis point rate cuts by the Bank of England, Reserve Bank of New Zealand, and Sweden’s central bank, respectively.\textsuperscript{92} Moreover, Trichet refused to hint at further easing. “I will say nothing about January,” he said.\textsuperscript{93}

On January 15, 2009, the ECB cut its policy rate by 50 basis points. The anxieties were deep and even the ECB’s growth forecast from the previous month had been marked down.\textsuperscript{94} Some had hoped for a 75 basis points reduction, and the ECB’s so-called Shadow Council had called for a 100 basis points cut.\textsuperscript{95} Instead, Trichet revealed that the Governing Council had considered no rate cut at all so as to avert the risk of falling into a “liquidity trap;” moreover, he offered no prospect of further rate reduction in February, saying the next “important” policy meeting would be the one in March.\textsuperscript{96} Thus, although the policy rate was reduced at that meeting, the tone was grudging. Analysts accused the ECB officials of “dragging their heels” and “being behind the curve.”\textsuperscript{97} A currency strategist remarked, “Trichet is focused more on inflation, which is not really a concern in the eurozone. The bigger issue at hand is growth prospects.”\textsuperscript{98} Abnormal stock price differences turned negative after the announcement, decreasing steadily to almost negative 4 percent by the 5\textsuperscript{th} day.

Before the next meeting on March 5, 2009 decision, an exasperated Thomas Mayer of Deutsche Bank called for a 100 basis points reduction, predicting that the ECB

\textsuperscript{92} Strupczewski (2008).
\textsuperscript{93} Trichet and Papademos (2008f).
\textsuperscript{94} Suoninen (2009) and Gow (2009).
\textsuperscript{95} Suoninen (2009) and Meier (2009). The Shadow Council is an unofficial panel of 15 prominent European economists, founded at the initiative of Germany’s Handelsblatt newspaper. Every month, it reports the majority view of its members.
\textsuperscript{96} Atkins (2009a) and Trichet and Papademos (2009a).
\textsuperscript{97} Rooney (2009) and Gow (2009).
\textsuperscript{98} Rooney (2009).
would settle for 75 basis points: “You suspect the ECB just wants to close its eyes to what’s going on. That’s not good for the economy.”\(^{99}\) When, instead, the ECB reduced its policy rate by 50 basis points, a Goldman Sachs analyst not surprisingly reiterated: “The ECB remains vastly behind the curve.”\(^{100}\) Another observer remarked, “We need action from their side. They really should be exhausting the traditional weapons of monetary policy …”\(^{101}\) At his press conference, Trichet conceded that growth prospects had continued to weaken and that inflation rates were “now expected to remain well below 2% over 2009 and 2010.”\(^{102}\) While he did indicate the possibility of more action, he held off on announcing anything concrete. The market reaction was mixed. After an initial fall, abnormal differences which clawed back to end in positive territory.

At the April 2, 2009, the ECB again disappointed markets. Instead of the anticipated 50 basis points cut, Trichet announced a reduction of only 25 basis points.\(^{103}\) Markets held up nevertheless, in part, because on April 1 world leaders had agreed on a $1.1 trillion injection of financial aid into the global economy.\(^{104}\) The rate cut itself, however, was not well received. “It sends the signal,” said one analyst, “that they don’t mean business …”\(^{105}\) Moreover, Trichet said the ECB would not announce non-standard measures (additional liquidity or quantitative-easing style measures) until the following

\(^{99}\) Kennedy (2009).

\(^{100}\) Kennedy (2009).

\(^{101}\) Dougherty (2009).

\(^{102}\) Trichet and Papademos (2009b).

\(^{103}\) Thesing (2009a).

\(^{104}\) Ljunggren and Wroughton (2009), Lander and Sanger (2009). Of the $1.1 trillion, $750 billion was meant to increase IMF resources, including $250 billion for international reserve assets (Special Drawing Rights) meant to supplement countries’ official reserves. Additionally, $250 billion was allocated to support trade finance, and $100 billion was allocated to support additional lending by multilateral development banks.

\(^{105}\) BBC News (2009b).
month. Instead, he asserted that “the ECB has the capacity to be nonstandard.”\textsuperscript{106} This frustrated some market participants. “You cannot buy time forever,” said one observer.\textsuperscript{107}

As widely expected, at its meeting on May 7, 2009, the ECB cut the policy rate by 25 basis points. It also announced that it would: (a) buy €60 billion in covered bonds to promote lending, (b) extend the maturity of its long-term refinancing operations by one year, and (c) make the European Investment Bank an eligible counterparty in money-market auctions.\textsuperscript{108} Abnormal differences fell steadily starting a day after the announcement, decreasing by 6 percent by the fourth day after the announcement. While some observers welcomed the broader package, others were worried that the “non-standard” measures were a sign of bad news, and hence a “desperate bid to pull the eurozone's stricken economy out of recession.”\textsuperscript{109} An analyst remarked: “The fact that the ECB felt compelled to take this wide-ranging action highlights the fact that the eurozone economy remains in serious trouble, despite some recent signs that the rate of economic decline is moderating.”\textsuperscript{110}

Altogether, between 2007 and 2009, the ECB achieved little traction with financial markets because the policy actions came well after the financial economic dislocations had become serious. And when they did come, the actions always appeared to be playing catch up.

Why did the Fed and the ECB act so differently? We know from the data that the economic and financial movements in the U.S. and the euro area were nearly identical between 2007 and 2009 (Figure 1 above showed that for GDP and stock market trends

\textsuperscript{106} Atkins (2009b) and Saltmarsh (2009).
\textsuperscript{107} Fraher (2009).
\textsuperscript{108} CNN Money (2009), Dougherty and Werdigier (2009), Randow and Meier (2009).
\textsuperscript{109} Hopkins (2009).
and Figure 8 below shows the same for inflation). The ECB position was based on three considerations: inflation risk was serious, lower interest rates would reward errant investors, and it was necessary to keep some powder dry for a true emergency. To be clear, these alternate perspectives were alive within the United States, indeed within the FOMC. The decision to not lower the policy rate at the August 7, 2007 meeting was based precisely on considerations that the ECB Governors would have found familiar and agreeable.\textsuperscript{111} And the Fed hesitated at times in the later months for those same reasons.\textsuperscript{112}

So, one part of the difference between the Fed and the ECB was, ultimately, a matter of judgment. At the FOMC, the “doves”—those in favor of aggressive rate reductions—made their case well. A Wall Street Journal analysis compared the forecasts by individual FOMC members.\textsuperscript{113} The “doves” had the better forecasts on growth and inflation. The best forecasts were by Janet Yellen, who anticipated slower growth and milder inflation than her peers did. In contrast, the “hawks” underestimated the decline in growth and overestimated the inflation risk.

The balance at the Fed began to shift in favor of the “doves” in late August 2007 and was first reflected in the September 2007 rate cut. This shift in balance also changed the metric of decision making. While policy is normally guided by “baseline” forecasts, “downside risks”—the low probability outcomes—became increasingly more central to the determining the decisions at the Fed. The Fed could, therefore, stay ahead of the curve as the risks quickly became reality. The ECB’s Governing Council did not make that shift. Thus, although living through the same macroeconomic developments, the

\textsuperscript{111} See Ip (2007) on the debate at the August 7 meeting as also in the weeks before the next meeting.
\textsuperscript{112} Obrien (2014) and Ip (2007).
\textsuperscript{113} Hilsenrath and Peterson (2007).
ECB operated—as Blinder pointed out—within an economic and financial framework that treated the adverse developments as mainly temporary.

To be clear, the ECB was not alone in making the judgments it did. The BIS, for example, said in its June 2008 Annual Report, “… inflation is actually rising, while significantly slower growth remains only a possibility in many parts of the world. In general, this should imply a bias of global policy towards being much less accommodating.”\textsuperscript{114} When the incoming data repeatedly conflicted with this view, the ECB was left to acknowledge that things had turned out worse than the baseline anticipated (the “downside risks” had materialized). But with each such acknowledgement, reasons were identified to expect some relief and improvement (demand from emerging markets, for example, would mitigate the reach and severity of the crisis).\textsuperscript{115}

The ECB position was also bolstered by European rhetoric that the U.S. was in crisis because of its incurable tendency to live beyond its means, aggravated by its complex financial structures. European policymakers and leaders often referred (with great self-confidence and, indeed, condescension) to reckless Americans.\textsuperscript{116} Joaquim Almunia, the European commissioner for monetary affairs, said in January 2008, “[…] big imbalances have built up over the years in the US economy - a big current account deficit, a big fiscal deficit and a lack of savings.” Almunia added that he was “not engaged in any criticism but these [US] imbalances are the root cause of the current

\textsuperscript{114} BIS (2008, p. 143).
\textsuperscript{115} Trichet and Papademos (2008b), Trichet and Papademos (2008c), Trichet and Papademos (2008e)
turbulence.” In contrast, he said, because the eurozone’s positive current account, sound fiscal position, and plentiful savings, “we are well prepared to weather this situation.” Echoing those remarks, Jean-Claude Juncker, who headed the group of eurozone finance ministers, said: “We have to be concerned, but a lot less than the Americans, on whom the deficiencies against which we have warned repeatedly are taking bitter revenge.” At the ECB, Jurgen Stark expressed similar views.\footnote{Stark (2009).}

Some American commentators also criticized the Fed for bailing out investors and for panicking.\footnote{See, for example, Hanke (2007).} But while the U.S. critics remained marginal, the European portrayal of the Great Recession as an American problem being mishandled by Americans melded into the general European narrative and, thus, became their cognitive frame for interpreting U.S. policy actions.

Lars Svensson, formerly Deputy Governor of the Swedish Riksbank, has argued that the ECB’s Governing Council is too large and the members of the Council are not adequately trained to deal with complex economic challenges.\footnote{Svensson (2002).} But it is also the case that member nations represented on the Governing Council had differing interests. While we do not know what views were expressed in the ECB’s Governing Council, French President Nicolas Sarkozy repeatedly called on the ECB to do more for euro area growth; he and Italian Prime Minister Silvio Berlusconi demanded that the ECB “look beyond its mandate to combat inflation” and “help spur eurozone economic growth.”\footnote{Weisman (2008) and Di Leo and Celeste (2008).} Spanish Prime Minister Zapatero also favored a more growth-oriented ECB.\footnote{Weisman (2008).}
French national press similarly called for more proactive monetary stimulus.\textsuperscript{122} In contrast, Axel Weber, Bundesbank President and a member of the ECB’s Executive Board publicly spoke of the need for restraint in monetary stimulus.\textsuperscript{123} And at the height of the economic anxieties in January 2009, German Finance Minister Pier Steinbruck pushed back on Sarkozy’s demands for a more activist ECB.\textsuperscript{124} While, in principle, Germany does not have a veto on the ECB’s Governing Council, the net effect of the heterogeneity in national views was that the German perspective was able to hold back early reduction in interest rates.

In sum, optimistic rhetoric on economic prospects, the “Europe is different” view, and the German influence in policy decisions reinforced each other. These traits carried over in the next phase.

**The Euro Area’s Inglorious Interlude: 2011**

The world economy bounced back in 2010 and, to some, the Great Recession seemed over. The IMF’s October 2010 World Economic Outlook forecast that the world economy would grow at an average annual rate of 4½ percent over the next five years, close to the heady pace in the years before the crisis. The U.S. economy did achieve a modest recovery, although it repeatedly stumbled. In contrast, between 2011 and 2013, the euro area was the world’s hot spot. Virtually all euro area countries fell in and out of recession and those in the periphery remained under the perpetual threat of a crisis. It was in this phase that the U.S. clearly stepped ahead of the euro area, as Figure 1 showed.

\textsuperscript{122} Izraelewicz (2007) and El País (2008).
\textsuperscript{123} Shellock (2008).
\textsuperscript{124} Marsh (2009).
The U.S. had largely dealt with its banking system problems by 2010: the most stressed banks had either been closed or adequately recapitalized. By comparison, the euro area had barely started dealing with its banks. The U.S. also had the advantage of a larger fiscal stimulus between 2007 and 2009 and had returned to austerity in 2011 rather than in 2010 as in the euro area. On top of the already much larger monetary stimulus, Bernanke made clear that the Fed was not yet done.\footnote{Bernanke (2010).} Ken Wattret of BNP Paribas said it best: Bernanke’s message focused on “what the Fed could still do;” the message from Trichet was “we have done all these measures and they appear to be working.”\footnote{Kennedy and Lanman (2010).}

Now a new challenge appeared. Inflation rates had picked up with the spurt in commodity prices that accompanied the brief global economic bounce back in 2010. Once again, the U.S. and euro area authorities faced virtually identical inflation data (Figure 8a).\footnote{We use the 12-month average of monthly year-on-year inflation rates.} After the sharp fall in 2009, inflation rose to above a 2 percent annual rate in March 2011 and kept rising for the rest of the year. The so-called “core” inflation, which strips out the volatile food and energy prices, was rising in parallel but was well below 2 percent level (Figure 8b). Most economists consider it appropriate to focus on core inflation since food and energy price movements are expected to reverse. The ECB, however, pays attention to headline inflation, presumably, because the volatile component of headline inflation can feed into higher wage demands and hence become entrenched. But an uncontrolled wage-price spiral was an unreasonable worry with unemployment still rising.
Figure 8: Headline inflation and core inflation for the US and Eurozone

(a) Headline inflation

(b) Core inflation

Sources: Federal Reserve Bank of St. Louis, for figure 8(a) “Personal Consumption Expenditures: Chain-type Price Index, Index 2009=100, Monthly, Seasonally Adjusted,” and for figure 8(b) “Personal Consumption Expenditures Excluding Food and Energy (Chain-Type Price Index), Index 2009=100, Monthly, Seasonally Adjusted”; Eurostat, for figure 8(a) “All-items HICP,” Index, 2005=100, monthly data, and for figure 8(b) HICP “Overall index excluding energy and unprocessed food,” Index, 2005=100, monthly data.

Note: The inflation rate is calculated from the index as follows: \( \ln(t) - \ln(t-12) \), where \( t \) is the index for the current month. Subsequently, the rate is smoothed by taking the average rate over the past twelve months.

The Fed acknowledged the rise in inflation but even as early as their meeting on June 22-23, 2010, many FOMC members cited the risk of deflation.\(^{128}\) They noted that, “a continuation of lower-than-expected inflation and high unemployment could eventually lead to a downward movement in inflation expectations that would reinforce disinflationary pressures.”\(^{129}\) Even though inflation was still on the rise at the November 2-3 meeting, FOMC members were still worried about deflation; they reassured themselves that “that the stimulus provided by additional securities purchases would help protect against further disinflation and the small probability that the U.S. economy could

\(^{128}\) The Federal Reserve System (2010a).

\(^{129}\) The Federal Reserve System (2010a).
fall into persistent deflation.” And even inflation continued to rise, Bernanke said that the episode of inflation would be “transitory.”

The second round of the Fed’s quantitative easing program continued through to June 2011, after which it did pause. But on August 9, the FOMC strengthened its “forward guidance.” The announcement said: “The Committee currently anticipates that economic conditions … are likely to warrant exceptionally low levels for the federal funds rate at least through mid-2013.” The announcement was followed by a jump in the length of time over which market participants expected rates to remain unchanged, and the expected path of interest rates fell.

QE and forward guidance had stemmed the rise in the value of the U.S. dollar, which had helped keep import prices up. The Fed was, therefore, supporting economic recovery through lower interest rates and a weaker dollar while also trying to raise price inflation.

Operating in parallel, the ECB’s perspective could not have been more different: the ECB read the same data to raise interest rates twice in that same period. In June 2010, with some members of the FOMC already worried about deflation, a reporter said to Trichet, “many economists say that there is a clear risk of deflation.” Trichet responded: “I don’t think that such risks could materialise. On the contrary, inflation expectations are remarkably well anchored in line with our definition—less than 2%, close to 2%—and

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130 The Federal Reserve System (2010b). Once again, this view was challenged in the U.S. public debate. In an open letter to Ben Bernanke, many prominent economists warned that monetary stimulus would unleash uncontrolled inflation (Asness et al., 2010). But, as before, this view remained marginal.
131 De Leo and Derby (2011).
133 Woodford (2012, pp. 17-20).
134 Mody (2014).
have remained so during the recent crisis. As regards the economy, the idea that austerity measures could trigger stagnation is incorrect.”\textsuperscript{135}

The ECB was unable to stop agonizing about inflation. In January 2011, the ECB’s Governing Council kept the policy rate at 1 percent—where it had been since May 2009. But at his press conference, Trichet said that in view of the positive momentum in economic activity, the upward inflationary pressures needed monitoring. He, therefore, described the decision to keep the interest rate unchanged as “accommodative.”\textsuperscript{136} His claim, in other words, was that the ECB was helping by not raising interest rates. When asked whether the attention to inflation was distracting the ECB from helping euro area countries in crisis, Trichet answered: “We do not see a dilemma in terms of hampering growth.”\textsuperscript{137} He referred to the July 2008 decision to raise the policy rate and maintained that it had appropriately provided price stability. The ECB, he said, was supporting financial stability through liquidity provision. At the February press conference, he used similar reasoning for maintaining rates.

By March, the ECB had concluded that the inflationary pressures required “strong vigilance.” For this reason, Trichet repeated that the ECB remained “accommodative” and had held back from raising rates only because of the financial turbulence.\textsuperscript{138}

And then, as was widely expected, the policy rate was raised by 25 basis points on April 7.\textsuperscript{139} At the press conference, Trichet justified the hike as necessary to “firmly anchor” inflation.\textsuperscript{140} This was three days after Bernanke had commented that inflation

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\textsuperscript{135} Polidori (2010).
\textsuperscript{136} Trichet and Constâncio (2011a).
\textsuperscript{137} Trichet and Constâncio (2011a).
\textsuperscript{138} Trichet and Constâncio (2011b).
\textsuperscript{139} Carrel (2011) and Trichet and Constâncio (2011c).
\textsuperscript{140} Censky (2011a) and Carrel (2011).
was likely to be transitory. A reporter expressed concern that the rate was being raised prematurely; others worried about the effects on financially stressed peripheral economies.\textsuperscript{141} Some remarked that the ECB got it wrong in July 2008 and might be making the same mistake a second time.\textsuperscript{142} Trichet’s hawkish comments at the press conference worried some market participants. One analyst said: “These remarks leave the door open for a follow-up rate hike from the ECB despite Trichet’s insistence that the Governing Council had not decided to carry out a ‘series’ of hikes.”\textsuperscript{143} Stock prices fell faster than implied by the trend of the past 20 days.

Although the policy rate was kept unchanged in May and June, the call for “strong vigilance” was repeated, indicating that another interest rate rise was likely soon.\textsuperscript{144} And, indeed, the rate was raised by 25 basis points on July 7. Although Trichet acknowledged that economic growth had moderated, he emphasized there still was a “positive underlying momentum of economic activity in the euro area.”\textsuperscript{145} As such, he said, it was of “paramount importance” to prevent the spread of inflationary pressures fueled by rising energy prices. He underlined that controlling inflation was essential to preserving the central bank’s credibility.\textsuperscript{146} Although the decision was not a surprise, stock prices fell faster than the recent trend. Once again, observers noted that Trichet’s statement “leaves the door open to more hikes,” with one analyst predicting: “it is obvious that the ECB has further to go, there will be one more rate hike at least this year.”\textsuperscript{147} This worried market analysts, who were increasingly concerned about slowing

\textsuperscript{141} Trichet and Constâncio (2011c).
\textsuperscript{142} Ignacio Crespo (2011), Kaiser and Felsenthal (2011).
\textsuperscript{143} Carrel (2011).
\textsuperscript{144} Trichet and Constâncio (2011d).
\textsuperscript{145} Trichet and Constâncio (2011e).
\textsuperscript{146} Censky (2011b).
\textsuperscript{147} Thesing and Black (2011a).
economic growth and the tensions in the debt markets. “We are not seeing the inflation risk that the ECB is seeing,” said one such analyst.\textsuperscript{148} Trichet did, however, announce that the credit rating threshold would be lowered for Portuguese banks so that they would not denied the right to borrow from the ECB.\textsuperscript{149}

The two rate hikes in April and July had raised the ECB’s policy rate to 1.5 percent. Financial turbulence a few days before the August press conference prompted Trichet to recognize that “… downside risks may have intensified.”\textsuperscript{150} But there was no change in the policy rate. By the September press conference, the ECB’s assessment of growth prospects had become even more pessimistic. Trichet said: “Looking ahead, a number of developments seem to be dampening the underlying momentum in the euro area, including a moderation in the pace of global growth, related declines in equity prices and in business confidence, and unfavorable effects resulting from ongoing tensions in a number of euro area sovereign debt markets. As a consequence, real GDP growth is expected to increase very moderately in the second half of this year.”\textsuperscript{151} But despite the tighter financial conditions, Trichet insisted that the ECB’s stance was still “accommodative.”\textsuperscript{152} He emphasized that the decision to maintain rates was unanimous and that no member of the Governing Council had argued for an interest rate cut.\textsuperscript{153}

Trichet’s actions had influential supporters. The BIS saw the fight against inflation in much the same way as Trichet did: as necessary to maintain price and financial stability. In implied criticism of the Fed and defense of the ECB, the BIS, in its

\textsuperscript{148} Ewing and Werdigier (2011).
\textsuperscript{149} Reuters (2011).
\textsuperscript{150} Trichet and Constâncio (2011e).
\textsuperscript{151} Trichet and Constâncio (2011f).
\textsuperscript{152} Trichet and Constâncio (2011f).
\textsuperscript{153} Trichet and Constâncio (2011f).
June 2011 report, said: “[...] policy rates are too low. The current loose stance of monetary policy therefore reinforces concerns about risks to price stability. At the same time, it may foster a renewed buildup of risks to financial stability.”\textsuperscript{154}

The opposing view, bluntly expressed by Paul Krugman, was: “Adding to the [euro area’s] problem is the E.C.B.’s obsession with maintaining its ‘impeccable’ record on price stability: at a time when Europe desperately needs a strong recovery, and modest inflation would actually be helpful, the bank has instead been tightening money, trying to head off inflation risks that exist only in its imagination.”\textsuperscript{155} Hetzel, in his analysis of the rate hikes in 2011, favored the Krugman view, arguing that those hikes had come at a moment when the euro area economy was weak and commodity price inflation could have been reasonably expected to reverse.

It was time for Trichet to hand over the baton after 8 years as ECB President. The euro area was about to enter a particularly stressful period. The Fed had had its policy rate at 0-0.25 percent since December 2008. The ECB’s rate was 1.5 percent. It was only a matter of time; the rates cuts did come—but soon the threat of deflation was gathering.

**The Unwillingness to Preempt Deflation**

Mario Draghi succeeded Trichet as ECB President on November 1, 2011. Starting November 3 2011, the ECB under Draghi tried to regain lost ground. But it was only two years later, on November 13, 2013, that the policy rate was finally brought down to 0.25 percent. The rate was further lowered to 0.05 percent by September 2014. In between, in June 2014, the ECB also announced that rather than paying interest to banks on funds that

\textsuperscript{154} BIS (2011, p. 61).
\textsuperscript{155} Krugman (2011).
they deposited at the ECB, the banks would have to pay a fee to park money at the ECB—this was described as a “negative” interest rate. The intention, presumably, was that banks would seek income sources and thus lend more to households and businesses.

Our event study analysis suggests that markets reacted adversely to the post-Draghi rate cuts. On average, following the rate cut, the abnormal difference was around negative 2 percent (Figure 9). Of the seven rate cuts, three came as a surprise to market participants, who seem to have lowered their expectations regarding the likely pace of monetary stimulus. Unexpected cuts, on average, showed an initial positive abnormal difference of 1 percent, but then fell steadily, reaching the same negative 2 percent as expected cuts. This loss in market momentum in the later days and the negative outcome for the unexpected cuts is statistically significant.

**Figure 9: Expected and Unexpected Rate Cuts, 2011-2014**

![Figure 9: Expected and Unexpected Rate Cuts, 2011-2014](image)

**Note:** There were 7 rate reductions by the ECB during this period. Of these, 3 were unexpected. Although, the average is clearly negative, 2 of the 7 announcements had a positive outcome, measured either on the 4th day or as average of the 3rd to the 5th days. “t-1” refers to the market closing stock price on the day before the announcement. The market reaction is measured as the abnormal difference starting with the market closing price on the day of the announcement (“t”) and on the following four days. The abnormal
difference is measured as the cumulative change relative to the change based on a continuation of the past 20-day trend.

Although now in kinder words, the market commentary continued to tell a story of disappointment. The markets perceived Draghi as more proactive, but by this stage, rate cuts had lost their appeal. When the ECB announced a 25 basis points rate reduction after Draghi’s first rate-setting meeting on November 3, the initial response was favorable. The Wall Street Journal reported: “[…] this is a sign that the ECB is finally waking up to the fact that financial conditions are too tight in Europe, and that’s good news.”\textsuperscript{156} But after the brief surge in the hours after the announcement, abnormal differences fell steadily into deeper negative territory. Draghi had hinted that the euro area may be falling back into recession but had rejected calls to scale up the bond-buying program.\textsuperscript{157} A critical view gained ground: “[The latest] move, while welcome, was too modest, given the problems faced by the European economy.”\textsuperscript{158}

Interest rates were lowered by 25 basis points on December 8, as widely expected.\textsuperscript{159} The ECB also announced a number of measures to ease credit flows. To encourage banks to lend, banks would have access to stable funding under the newly-constituted longer-term refinancing operations (LTROs). The standards for collateral required to borrow from the ECB were lowered by, for example, bringing down the rating threshold for asset-backed securities that could be used as collateral.\textsuperscript{160} And the reserve ratio, which determines the minimum amount of reserves a bank must hold with the ECB, was lowered from 2 to 1 percent. None of this helped. Abnormal differences fell steadily,

\textsuperscript{156} Gongloff (2011).
\textsuperscript{157} CNN Money (2011) and Kuehnen (2011).
\textsuperscript{158} CNN Money (2011).
\textsuperscript{159} Thesing and Black (2011b).
\textsuperscript{160} European Central Bank (2011).
down by more than 6 percent on the 4th day after the announcement. Draghi’s words and actions were not well matched. A week earlier, Draghi had hinted that “other elements might follow,” which was read as a signal that the ECB would step up bond purchases to lower longer-term interest rates, as the Fed had done under its quantitative easing programs.\textsuperscript{161} Instead, the continued absence of an “ECB bond buying bazooka,” apparently, “roiled markets.”\textsuperscript{162} It did not help that on the same day, German Chancellor Angela Merkel said that no “big-bang” solution should be expected.\textsuperscript{163}

The ECB waited half-a-year before lowering rates again. On July 5, 2012, accompanying a widely expected 25 basis points cut in the policy rate was a more surprising cut in the deposit rate (the rate at which banks place overnight deposits at the central bank) from 25 basis points to zero. Analysts were cautiously optimistic about reduction in the deposit rate. “It’s not a silver bullet, but everything helps,” said one observer.\textsuperscript{164} And, yet, markets responded adversely. The key question for some was “how far” the ECB would “go into unconventional measures to stabilize the economy and save the euro.”\textsuperscript{165} Other analysts were similarly concerned that the ECB was running out of conventional policy tools.\textsuperscript{166} These concerns were reinforced by Draghi, who was skeptical that more could be done in the financially “fragmented” European market.

Rate cuts went on pause for almost a year. On May 2, 2013, the policy rate was reduced by 25 basis points to 0.50 percent. In a Bloomberg news survey, 45 of 70

\textsuperscript{161} McHugh (2011).
\textsuperscript{162} Thesing and Meier (2011).
\textsuperscript{163} Thesing and Meier (2011) and BBC News (2011). Merkel was meeting with other European leaders at Marseille. The leaders had agreed to pursue a tax and budget pact outside the EU’s legal framework, because the UK had blocked a change to the EU treaties. The European Stability Mechanism (ESM)—the euro area’s “bailout fund”—was capped at €500 billion, and it was decided that the ESM and the European Financial Stability Facility would not run at the same time.
\textsuperscript{164} Black and Randow (2012).
\textsuperscript{165} Lawton and Feher (2012).
\textsuperscript{166} Birnbaum (2012) and Wilson (2012).
economists had anticipated the cut. The market response on this occasion was favorable. Market participants were not impressed by the cut, but the possibility that unconventional measures may be on the way was welcomed. At the press conference, Draghi said that the ECB was in the early stage of discussions on how to kick-start the market in asset-backed securities and hinted the ECB could cut the deposit rate into negative territory.

Headline inflation in the euro zone fallen quickly from an annual rate of 2½ percent at the start of the year to just above 1½ percent in October (Figure 8a). Much of this fall was attributed to the decline in commodity prices, which ECB officials maintained would reverse. The ECB did not acknowledge—or missed—a more persistent deflationary force on account of weak consumption and investment demand in large parts of the eurozone. This deficiency became clear by October as the slippage in the eurozone’s core inflation could no longer be ignored, especially because core inflation in the U.S. had stabilized (Figure 8b).

On November 7, the ECB surprised markets with a rate cut of 25 basis points. Draghi said that the prospect of prolonged low inflation had prompted the cut. Several market participants praised the move as a counter to deflationary risk and the Financial Times said that the ECB deserved “to emerge with enhanced credibility.” But the abnormal stock prices differences quickly turned negative despite favorable review of the action taken. The concern was that the ECB was backing itself into an “uncomfortable

167 Radow and Black (2013).
169 Draghi (2013b).
170 Irwin (2013).
172 Barber (2013).
position.”173 Since even the rate cut appeared to have been controversial in the ECB’s Governing Council, observers worried if the ECB had the ability to do the “big stuff.”174

The dissonance with the market arose, once again, because of differences in the sense of urgency. Draghi insisted that the ECB had “a whole range of instruments that we can activate.”175 But he was equally firm that the ECB would deploy additional measures only “if needed.” Among others, Guntram Wolff of Bruegel called for more aggressive monetary policy.176 For some market observers, however, the ECB was already too late.177

Draghi repeatedly insisted during this phase that while inflation was low, the medium term outlook for inflation expectations remained “anchored.” Thus, in April 2014, Draghi stated that the ECB would act only if inflation remained low for “too prolonged a period.”178 Draghi was asked what he meant by “too prolonged a period,” but he had no clear answer. Despite gathering information, the message still was that inflation had fallen because of weakness in commodity prices, and so would reverse. Notice the asymmetry. When commodity prices were pushing inflation up, the ECB sought to nip it in the bud; but when commodity prices pushed inflation down, the ECB preferred to wait in anticipation of a return to more normal inflation rates.

On June 5, the ECB cut the policy rate by 10 basis points to 0.15 percent, while also lowering the deposit rate into negative territory. Both these moves were expected.179

The ECB also delivered on other promises, announcing a new liquidity program to

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175 Draghi (2013b).
176 Wolff (2014).
177 Black and Randow (2013).
178 Draghi (2014).
encourage lending.\textsuperscript{180} Draghi signaled that he was willing to go further, leaving the door open to a bond-buying program.\textsuperscript{181} Analysts were pleased that the ECB was doing “everything short of full QE.”\textsuperscript{182} The announcements that day were read as a strong message that the ECB “is determined to put Europe on a path to stronger growth.”\textsuperscript{183} Markets were pleased, with abnormal differences ending positively by the fourth day.

Finally, on September 4, 2014 the ECB surprised markets with a 10 basis point reduction of the policy rate down to 0.05 percent.\textsuperscript{184} The ECB also announced it would embark upon an asset purchase program. Observers were initially pleased.\textsuperscript{185} Abnormal differences rose on the day after the announcement. The commentary was cautiously complimentary. “For years the ECB has been very slow to react and often frustrated markets,” said one asset manager. “[Today], in the face of dire and clearly worsening economic indicators Draghi has actually gone beyond markets’ expectations. […] it is certainly progress.”\textsuperscript{186} Despite such favorable reviews, the mood changed quickly and the abnormal differences fell into negative territory. The concern was that deflationary tendencies would prove hard to reverse. Headline inflation had fallen to 0.3 percent by August 2014. As Andrew Balls, a senior executive at the bond investor PIMCO, said some weeks later, “The eurozone is one shock away from sinking into deflation. There are real costs of acting too late.”\textsuperscript{187}

\textsuperscript{180} Black and Riecher (2014).
\textsuperscript{181} Ewing and Irwin (2014a).
\textsuperscript{182} Thompson (2014).
\textsuperscript{183} Ewing and Irwin (2014a).
\textsuperscript{184} Horta e Costa (2014). Not surprisingly, Jurgen Stark, who was now no longer at the ECB, described the move as sign of “desperation,” arising from “feverish” preoccupation with deflation (Stark, 2014).
\textsuperscript{185} Ewing and Irwin (2014b).
\textsuperscript{186} BBC News (2014b).
\textsuperscript{187} Balls (2014).
The QE did come. On January 22, 2015, the ECB announced it would “add the purchase of sovereign bonds to its existing private sector asset purchase programmes,” with combined monthly purchases amounting to €60 billion.\(^\text{188}\) Purchases started on March 9 and are expected to continue until at least September 2016.

Once again, we must ask why the ECB continued to act slowly, this time allowing deflationary tendencies to set in. Unlike between 2007 and 2009, the Fed could not be easily accused of reckless behavior and the eurozone was more clearly in the doldrums; hence, there was little rhetorical leverage in criticizing the U.S. Instead, to differentiate the ECB’s sedate actions from the Fed’s forceful measures, Draghi used a more structural argument. He noted that 80 percent of financial intermediation in the euro area was done by banks, whereas financial markets played a much bigger role in the United States.\(^\text{189}\) The implication, he argued, was that quantitative easing would have a smaller impact in the euro area and, thus, its introduction was not urgent.

Optimistic rhetoric again played an important role. In March 2012, as it was becoming clear that the euro area economy was contracting, Draghi said that he expected the economy to “stabilize,” with gradual recovery later in 2012. He noted that interest rates were “very” low and, importantly, he claimed that the sense of risk and uncertainty in the global economy had declined.\(^\text{190}\) Draghi reiterated the ECB’s time-honored advice for national governments to boost growth through structural reforms. Although he recognized that such reforms generally help lift growth only with a lag, Draghi said they would deliver immediate dividends by increasing confidence in the future. A few months later, at the June 6 press conference, an incredulous reporter asked Draghi if he was

\(^{188}\) European Central Bank (2015a).  
\(^{189}\) Draghi (2013a).  
\(^{190}\) Draghi (2012a).
aware of how bad things were and of the extent of panic in the markets.\textsuperscript{191} Draghi acknowledged that “downside risks” were high. But he restated that there also were positive signals: interest rates were low and buoyant foreign demand would help. Thus, “modest improvement” could be expected. In other words, Draghi’s message was that things could go badly wrong but the ECB was counting on that not happening. That optimism—more appropriately, wishful thinking—did not quite pan out. Starting the first quarter of 2012, the euro area contracted for seven straight quarters.

The reluctance to deal with deflation has been recounted in detail above, but one encounter with a journalist is revealing. At the press conference on November 7, 2013, the journalist described the ECB as a “pea-shooter dealing with an approaching deflationary tank,” and asserted that financial markets had given up on the possibility of decisive action.\textsuperscript{192} Once again, Draghi acknowledged that things had, indeed, become worse: the slowdown in inflation had spread across more goods and services and across more countries. But, he said, that the ECB was waiting for more data. He insisted that the ECB was taking action and would do more, “if needed.” In effect, Draghi was saying: we will not jump ahead—we will respond.

As between 2007 and 2009, the Europe-is-different theme and optimistic interpretation of the economic data were, in part, needed as covers for the hold-up due to the disagreements in the ECB’s Governing Council. Draghi reported on the disagreements and, on one occasion, even identified the dissenter: the new Bundesbank President, Jens Weidmann. For months, Weidmann insisted on moving ahead slowly and cautiously. These Governing Council differences were mirrored in the political debate.

\textsuperscript{191} Draghi (2012b).
\textsuperscript{192} Draghi (2013b).
The Germans and their “Northern” allies pushed back French Presidents Sarkozy and Hollande who kept pressing the ECB to do more for growth.\textsuperscript{193} Thus, once again, heterogeneity of national interests slowed down the decision-making. But the asymmetry in dealing with inflation and deflation also suggests that the ECB has internalized an ideological bias against inflation, a bias that runs so deep that the deflationary tendencies are—possibly, subconsciously—welcomed as a safeguard against inflation.

**Central Bank Credibility**

As of this writing (in November 2015), the euro area economic recovery has been decidedly weaker (GDP is just about at the pre-crisis level) and core inflation rate remains stuck below a 1 percent annual rate. Core inflation is particularly low in important member states, including Italy and Spain. Thus, despite the decline in nominal interest rates, they face high real interest rates (Figure 10). These countries will continue to struggle to lower their public and private debt burdens and hence risk remaining trapped in a low-growth, high-debt environment in the near future. In contrast, Germany, with a negative real interest rate is benefiting from monetary stimulus.

\textsuperscript{193} Blackstone and Karnitschnig (2012); Barre (2011) for a French and Costas (2013) for a similar Spanish view.
Figure 10: Real Long-Term Interest Rates (Based on Core Inflation)


Note: The nominal interest rate is smoothed by taking the average rate over the past twelve months. Annual inflation is computed as the moving 12-month average of monthly year-on-year change. The real interest rate is calculated as \( r = (1 + i) / (1 + \pi) - 1 \). Where \( i \) is the nominal interest rate, and \( \pi \) is the inflation rate.

This paper tells the story of how we got to this point. The Fed acted early and, despite minor lapses, conveyed a consistent message that it would use monetary policy to create an economic and financial shelter from the gathering storm. By thus establishing the premise that it was prepared, the Fed was able to establish the benchmarks by which its seriousness of purpose would be judged. Indeed, when the Fed hesitated or strayed from the clarity of its message by referring to worries about inflation, the adverse market feedback came quickly. To the Fed’s credit, it typically read the market’s message quickly and correctly.

The ECB was always ready to provide liquidity to banks, and, indeed, was briefly one step ahead of the Fed in this regard in August 2007. But the ECB also made it clear that its macroeconomic priority was to fight inflation. The policy interest rate was,
therefore, increased in July 2008, and was reduced only under the threat of global financial meltdown in October 2008. Markets, therefore, gave the ECB little credit for the rate cuts from October 8 to May 2009.

After the brief global economic recovery in 2010, the ECB responded to renewed commodity price inflation by hiking interest rates twice in 2011. These hikes, Trichet said, were justified because to subdue inflation was also the right way to maintain financial stability.\(^{194}\) As in July 2008, the ECB was fighting an enemy that, though fearsome at time, was in retreat.

When the inevitable interest rates cut did come, starting in November 2011, observers were kind but markets were not. More clearly than in the 2008-9 period, the market reaction was adverse. The ECB had been forced to reverse its rate increases under the pressure of worsening economic and financial conditions. Moreover, it was soon clear the euro area was slipping into a phase of persistent low inflation, with outright deflation in some member states. Markets called for ever more forceful action, but the ECB delivered in half measures.

ECB officials have often justified their decisions on the basis that price stability is its primary mandate. Bini Smaghi, in a June 2009 speech, emphasized that the ECB was guided by the goal of maintaining inflation at less than but close to 2 percent over the medium term. Short-term initiatives to pump up growth through easier monetary policy, he said, risked sparking inflation in the medium-term.\(^{195}\) With a not-so-veiled reference to the U.S. Federal Reserve, he said, “if a central bank is concentrated on near-term results, on the pursuit of growth at all costs, this leads it to conduct policies that increase

\(^{194}\) Trichet and Papademos (2007b).
\(^{195}\) Bini Smaghi (2009).
instability.” Similarly, in September 2011, Trichet highlighted the price stability mandate, which he said had delivered an average inflation rate of 1.55 percent since the introduction of the euro.

While the ECB had a mandate to maintain price stability, in the years before the crisis, it had paid attention to economic activity, as Taylor and Nechio had independently shown. Indeed, Taylor found that between 2000 and 2006, when the Fed’s rate fell below that implied by the Taylor’s rule, so eventually did the ECB’s, as if the ECB was following the Fed’s lead. Once the crisis started, the Fed placed its focus on the risk of prolonged recessionary conditions. The ECB firmly diverged from the Fed’s stance. Trichet emphasized in his press conferences that since the two central banks were equally committed to maintaining price stability, the Fed’s difference in approach likely reflected imbalances that were specific to the U.S. economy. Whatever the specific U.S. imbalances, the Fed saw more clearly that inflation was not a threat. As Mishkin, a former Governor of the Federal Reserve System, later remarked, low interest rates did not create the risk of a credit-fueled uncontrollable inflation when financial institutions were deleveraging.

What does the Fed’s success tell us about central bank credibility? After all, the commonly held view emphasizes that a steadfast commitment to containing inflation is the touchstone of central bank credibility. Taken literally, the ECB acted properly and the Fed did not.

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196 Atkins (2009c).
197 Trichet and Constâcio (2011f).
201 Blinder (2000).
The Fed, however, operated on a broader view of central bank credibility, one which incorporates the need and ability to deal with contingencies. Under the gold standard, for example, the monetary policy objective was to maintain the value of the currency relative to gold. But it was also considered reasonable to depart from that commitment in extraordinary circumstances, as Bordo and Kydland have explained.\footnote{Bordo and Kydland (1995).} Despite the departure from the rule, credibility is maintained when the central bank’s return to its original commitment can be presumed once circumstances normalize.

The markets accepted—indeed, welcomed—the premise that countering the Great Recession merited unusual action. The Fed gained credibility by departing from the single-minded pursuit of containing inflation. As Blinder emphasizes, more so than managing inflation, credibility is achieved by matching deeds to words.\footnote{Blinder (2000, p. 1422) and Blinder (2012) for a similar analysis of the Fed’s credibility during the Great Recession.} The Fed learned towards the end of 2007 that attempting to juggle two balls—controlling inflation and achieving financial stability to revive confidence and growth—would send mixed messages and dilute the pursuit of both objectives. The focus on a clear goal helped match deeds to words, and to, thereby, retain credibility.

If, as is entirely possible, the euro area’s core inflation rate remains below 1 percent a year—and even if the eurozone does not fall into outright deflation—the ECB’s credibility will be twice hurt. Not only would it have failed to provide stimulus when needed, but by allowing the euro area to slip into a low inflation trap, it would have failed also in maintaining the inflation rate close to 2 percent a year. With a eurozone-wide inflation rate of less than 1 percent, some countries will experience close to zero or even negative inflation rates. They will face high real interest rates, stymying their ability to
recover. This will be all the more the case with large segments of euro area small- and medium-banks still under stress and a fiscal stance, though no longer contractionary, is not stimulative either.204

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