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Forward Guidance crosses the Atlantic. Can it work?

Mario Draghi announced that "*the governing council expects the key ECB rates to remain at present or lower levels for an extended period of time*" (see the complete announcement). According to Free Exchange this announcement marks a substantial change in the communication strategy of the ECB, which had refrained in the past from pre-committing to the future path of interest rates—in sharp contrast to the strategy followed by the U.S. Federal Reserve and more recently the Bank of Japan as highlighted by Neil Irwin at WonkBlog. The first Monetary Policy Committee statement issued under the chairmanship of Mark Carney, the new governor of the Bank of England contained similar attempts to assuage investor fears of imminent tightening of monetary stimulus: "*the implied rise in the expected future path of Bank Rate [was] not warranted by the recent developments in the domestic economy*." (See the statement of the BoE).

Can forward guidance be effective? This question is crucial, as FreeExchange remind us with a contrasting analysis between the euro and the breaking-up of the gold standard. The blog argues that the ability to ease monetary policy is a key difference with that period. Michael Steen at FT Money Supply notes that the ECB's announcement only mentioned a continuation of previous policies and not a genuine change of track. David Keohane, at FT Alphaville, insists on the lack of specific engagement on the duration of the policy, noting the evasive answers provided by Mario Draghi. On the other hand, Tony Yates, argues that forward guidance could be a step backward, as it aims at "inducing the expectation that rates will stay at that floor for longer than might previously have been guessed given how the central bank responded to inflation and real activity in the past". Its influence depends in part on the fine-tuning of the communication strategy adopted.

Guiseppe Daluiso and Franceasco Papadia, in a Bruegel article, write that the answer is "a hesitant yes, bordering with a timid no"—because of the impaired transmission channel between the official rate, the funding rate, and the loan rate. The bottom line of the article is that funding rates in different member states may depend on factors only partially dependent on the ECB, in particular the negative sovereign-bank feedback loop. (Alexander Popov and Neeltje van Horen, in a VoxEU entry, provide further evidence that tensions in Eurozone government-bond markets were transmitted internationally through the bank lending channel). They stress that the situation is different from that in the US, the UK, Switzerland and Japan in two respects; (i) the risk of an endogenous tightening of monetary policy in the eurozone, through commercial banks in their refinancing choices—a situation that does not arise in other countries due to outright provision of liquidity, and (ii) the presence of differential pull-push factors in the eurozone.

As a vivid remainder of delicacy of communicating about monetary policy, a recent "joke" by Glenn Stevens, governor of the Reserve Bank of Australia about the amount of time the board had spent deliberating about an eventual rate cut ("a very long time") sent the Australian dollar to a three-year low against the US dollar (Quartz). Prompting frantic effort by the RBA to precise the "light-hearted" nature of the comment (The Telegraph).

The Economic Woes of Croatia… and the European Union

On July 1st 2013, Croatia became the European Union's 28th member state—the first country to join since 2007. A welcome achievement (as noted by Reuters and Joe Biden in the FT), just two decades after the end of its war of independence from Yugoslavia and after a decade-long procedure in a particularly worrisome context, both for Croatia and the European Union— as highlighted by Corina Stratulat in an EPC publication. One radical, negative, view was presented by a Bild editorial that wondered if after Greece and Cyprus, the "indebted, corrupt and haunted by high unemployment" Croatia was the next place where the EU was planning to "sink [Germans'] billions".

The economic outlook for Croatia is of concern, illustrated by Eurostat's statistical outlook. The country's economy has been either stagnant of in recession during the last five years. The European Commission forecasts a contraction of 1.0 percent in 2013 and a zero growth rate in 2014. The country's sovereign debt has been downgraded to "junk" status (Bloomberg). Public Deficit is expected to reach 4.7 percent this year, almost 2 points above the EU's 3 percent limit (Global Post). And a survey by Ernst & Young ranked Croatia 3rd on its worldwide list of business people who considered bribes normal (90 percent). As of May 2013, the unemployment rate stood at 19.6 percent, (Croatian Bureau of Statistics). Youth unemployment reaches 51.8 percent, more than twice EU-28 average and the third highest in Europe, after Greece and Spain

(The Guardian).

Portugal: no turnaround in view in spite of the political turmoil…

And, just as an agreement has been reached on the bail-in regime for Europe (see our last BlogSpot), the woes of some European Countries seem to have returned, with political turmoil in Portugal—following the resignation of two cabinet ministers (FT). The full consequences of these resignations are still unfolding (WSJ), with a direct negative impact on yields discussed by Kate Mackenzie in FT Alphaville and spreading to the broader eurozone (Economonitor and Money Beat). Eurointelligence suggests that early elections could jeopardize the ability of the country to meets its budgetary obligations and targets, especially when a troika delegation is due to arrive in less than two weeks.

The short view… In a VoxEU article, Guiseppe Bertola argues that how redistribution policies are at the root of the eurozone crisis. A robust and coherent European market and policy-integration process would require implementation of the behavioral constraints and redistribution schemes that operate, not without difficulties, within established national socioeconomic systems.