Frankfurt
November 2, 2001

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Economic Research note

The Euro area MCI's failure as a policy guide

- **The simple monetary conditions index (MCI) portrays Euro area monetary policy as expansionary**
- **But global forces are depressing GDP growth**
- **Expansionary MCI readings may have slowed the ECB's rate-cutting moves this year**

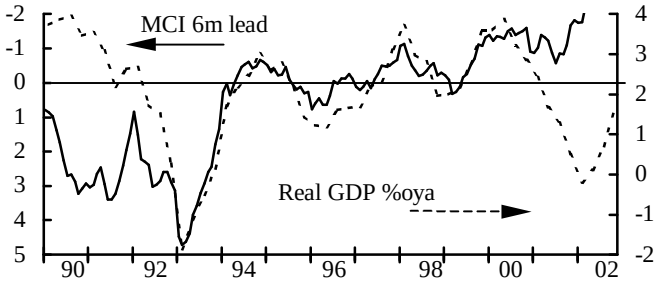
Monetary conditions indices (MCI) combine deviations of real interest rates and real exchange rates from their respective equilibrium levels to assess the stance of monetary policy. The concept was helpful for predicting Euro area GDP growth in the 1990s. Taking account also of fiscal policy would have explained the area's relatively low economic growth in 1996-97 in the run-up to EMU. However, the relationship between the simple MCI and economic growth has broken down this year.

The ECB does not officially use an MCI, but some council members have made statements consistent with such a framework of assessment. In addition, some private-sector growth forecasts may have been pitched too high this year because they used the MCI. This may have had an indirect impact on the ECB. The simple MCI currently indicates that ECB policy is very expansionary, pointing to real GDP growth in six months time of almost 4%. This is clearly not happening. But it may have contributed to the ECB's slow response to this year's economic weakness.

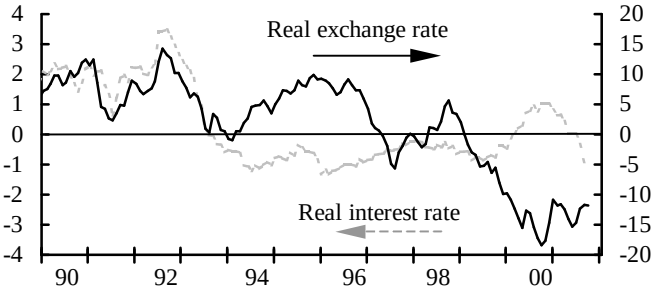
The MCI can only be a useful guide to GDP growth if all other potential influences on the economy remain roughly in line with long-term trends. The issue is not whether monetary policy is expansionary gauged by the MCI alone, but whether policy is appropriate given the other influences on the real economy. At present, several powerful forces are dampening Euro area growth. As a result, the MCI is unlikely to provide a reliable signal for some time to come.

Higher headline inflation is a drag on real income. The MCI takes out the effect of higher energy and food prices on real interest rates by using the core inflation rate. Therefore, higher inflation because of supply-side price shocks does not show up as lower real interest rates and easier monetary policy. However, the MCI does not account for the negative income effect of higher headline inflation on consumers. One easy way to address this is to subtract the difference between headline and core inflation from core

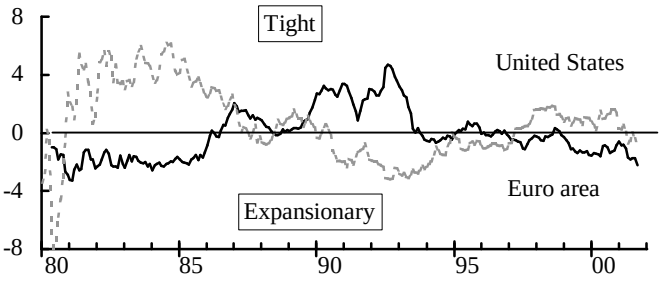
Euro area monetary conditions index (MCI)
% both scales (zero MCI = trend GDP)



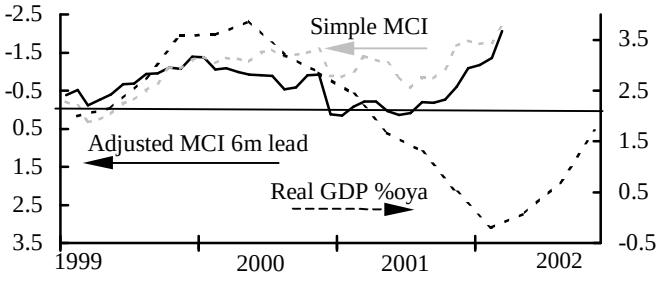
Euro area MCI components
%-point deviation from neutral *% deviation from neutral*



Monetary conditions indices in the Euro area and the U.S.
percent



Euro area simple and adjusted MCI
% both scales (zero MCI = trend GDP)



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inflation. This "core-and-drag" inflation fell to a low of zero in November 1999, when core inflation was 1.4% and headline inflation stood almost 1.5% points higher. The adjusted MCI points to softer GDP growth in early 2001 (chart). However, as core and headline inflation are quickly converging, this drag is fading. Only second-round effects remain at the moment, and these are difficult to quantify. The adjusted MCI still suggests almost 4% real GDP growth in early 2002. Other forces must be at work too.

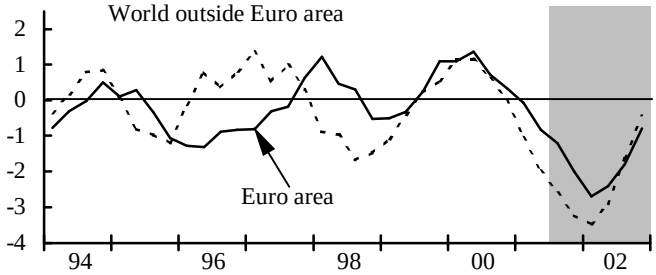
Global trade plunges. The sharp slowdown of global trade growth is probably the main reason why even the adjusted MCI fails to give the right message on the outlook for Euro area GDP growth. The world economy is more integrated today than it has been since the second world war. And it is falling into recession for the first time since the early 1980s. During 1994-2000, GDP growth outside the Euro area averaged 3.2%, but it is likely to turn negative now (chart). Even the slowing of GDP growth abroad to a pace of less than 2% in early 1998 brought Euro area export growth to a standstill. The much more severe global slowdown currently is likely to subtract significantly from Euro area GDP growth via slower exports and investment spending.

Tech bubble has burst. Another drag on Euro area GDP growth comes from the bursting of the tech bubble during the past year and the reaction that that triggered in early 2001. Many projects turned out less promising than expected. Lower equity prices imply that companies can no longer finance at virtually no cost. Investment plans are scaled back. The overall effect is difficult to quantify and probably smaller in the Euro area than in the United States. But the MCI does not take account of it. One hint at the magnitude of the effect comes from the gap between the adjusted MCI and actual 2000 GDP growth.

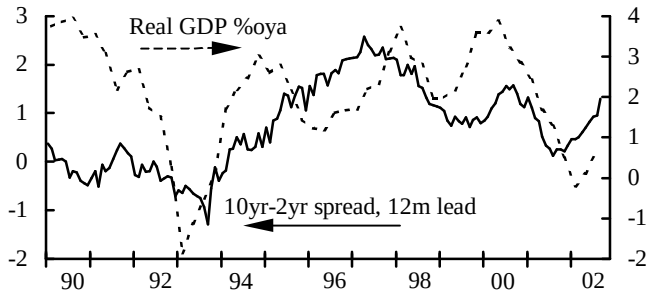
Lower equity markets. Closely linked to the tech drop, equity markets sold off from spring 2000, reversing the household wealth gains of previous years, and reducing companies' financing possibilities. (While still smaller than in the United States and the United Kingdom, the ratio of German household's financial assets in shares and mutual funds has jumped from 13% in 1993 to 23% at year-end 1999.) The impact on GDP growth is hard to assess, but is probably more than in previous equity market downturns.

The currency may not be so undervalued. Over time, the equilibrium level of the euro may change. For example, larger productivity gains abroad may have made the Euro area relatively less competitive than the CPI-adjusted real effective exchange rate indicates. While this effect is very difficult to quantify, the suspicion is that the MCI overstates

GDP growth in the Euro area and abroad
%oya, deviation from trend



Euro area yield curve and GDP growth
% both scales



the expansionary impulse. If the euro were to appreciate, the ECB is likely to offset this by cutting interest rates. A rough rule of thumb suggests that every 2% strengthening of the trade-weighted euro would justify a 25bp rate cut.

Flat yield curve. Usually, flat yield curves go hand in hand with soft GDP growth. The Euro area yield curve flattened on trend from 1996 to late 2000. This could have been a consequence of too little easing from the ECB, or of the closer link of global long-term yields and lower global fiscal deficits. Either way, the relatively flat yield curve in late 2000 may help explain why GDP growth is weaker now than the MCI indicated.

The equilibrium real interest rate may be lower. The simple JPMorgan MCI assumes a neutral real interest rate of 2.3%, in line with current trend real GDP growth in the Euro area. The average real policy rate there between 1980 and 1995 was 4.0%, in a very different macro environment. If the trend rate of GDP growth is lower than 2.3%, then the true MCI may be less expansionary now (chart).

Fiscal policy. Because fiscal policy has been expansionary in 2001, adding a fiscal impulse to the MCI would not explain the undershoot of GDP growth this year relative to what the MCI would have indicated. On the contrary, it would imply that global forces have been even more powerful, offsetting both the monetary and the fiscal impulses.