ECB Rate Cut Justified

By Antonio Fatas , INSEAD Professor of Economics

Hans-Werner Sinn, the president of the Ifo Institute for Economic Research says the ECB was wrong to cut rates. I disagree.

When I teach these days about the negative performance of the Euro economies over the last six years I always get asked about how policy makers could get it so wrong. The answer can be found in the article that Hans-Werner Sinn published today in the *Financial Times* (**Why Draghi was wrong to cut interest rates**). It is hard to know where to start commenting on the article. It is not only inconsistent but also full of arguments that go against any economic logic supported by misleading use of partial data.

Interestingly, the article starts with the argument that given that inflation in the Euro area is below its target and falling (down to 0.7% in October), it seems that "last week's interest rate cut is understandable". Correct. That's the only reasonable paragraph of the article as the next one opens with the sentence:

"*However, deflation in parts of a currency union is not the same as deflation of a union as a whole, because its internal effects on competitiveness cannot be compensated for by exchange rate adjustment.*".

Let me start with the first part of the sentence. It is an interesting proposition to argue that the ECB should not manage just average inflation (and growth?) but also try to manage these variables at the regional level. This is not the mandate of the ECB. And that is exactly what Hans-Werner Sinn proposes, that the ECB tries to keep inflation in any region (country?) of the Euro area below 2%.This will imply overall deflation in the Euro area.

The second part of the sentence is even worse. If it is true that we need a realignment of relative prices within the Euro area, you will NOT get it by keeping inflation low. The article argues that the "printing presses" from Southern Europe have slowed down the realignment of the relative prices of goods needed for improving competitiveness. Wrong. There is plenty of evidence that prices and wages exhibit downward nominal rigidity and that it is much easier to allow changes in relative prices when inflation is positive. It is the low inflation level of the Euro area that is limiting the adjustment in relative prices (**Krugman** makes this point today in his blog).

The article also argues that the ECB policies have kept the value of the Euro down and this is one of the reasons why the German economy is running a current account surplus (not sure which chart he is looking at to argue that the value of the Euro is low...).

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