



## THE MONETARY POLICY ORIGINS OF THE EUROZONE CRISIS

---

The standard view of the economic tragedy of the Eurozone crisis is that the crisis was caused by a buildup of private and public debt that was amplified by the imposition of austerity measures. Upon closer examination, it becomes evident that excessively tight monetary policy was the real culprit in the sharp economic decline of 2008 and 2010–2011.

In a new study for the Mercatus Center at George Mason University, Visiting Scholar David Beckworth demonstrates that poor monetary policy set by the European Central Bank (ECB) played a key role in the two recessions, sparked the sovereign debt crisis experienced by several Eurozone countries, and exacerbated the impact of the austerity programs. The study makes the case that the Eurozone requires a new monetary policy regime that targets a growth path for nominal gross domestic product (NGDP), or total money spending.

To read the study in its entirety and learn more about its author, see [“The Monetary Policy Origins of the Eurozone Crisis.”](#)

### THE STANDARD VIEW OF THE CRISIS

The standard explanation of the Eurozone crisis that began in 2008 and intensified again in 2011 focuses on three developments. However, an examination of each of these points shows serious timing problems:

- 1) *The 2008 financial panic in the United States spread to the Eurozone and triggered the initial recession.* Industrial production, however, peaked in January 2008 both for core countries (Germany, France, etc.) and for periphery countries (Greece, Italy, etc.), well before the financial panic. This suggests that the economic slowdown caused the financial panic and debt crisis rather than the other way around.
- 2) *The Eurozone’s periphery accumulated too much debt in the years leading up to the crisis.* This also cannot be the case, because the core countries, which held less debt, contracted at the same time as the periphery countries.

For more information, contact  
Kate De Lanoy, 703-993-9677, [kdelanoy@mercatus.gmu.edu](mailto:kdelanoy@mercatus.gmu.edu)  
Mercatus Center at George Mason University  
3434 Washington Boulevard, 4th Floor, Arlington, VA 22201

- 3) *Fiscal austerity was imposed on the periphery countries without offsetting fiscal policy in the core countries.* This asymmetric fiscal policy further depressed total money spending during the second recession. While there is a positive correlation between government spending and economic growth for European countries, this correlation is much stronger for Eurozone countries than it is for non-Eurozone European countries. Furthermore, the effect of fiscal policy depends on monetary policy, at least outside the zero lower bound of interest rates. The ECB only lowered its interest rate in November 2013, indicating that monetary policy was more of a driving force than fiscal policy during the crisis.

## THE MONETARY POLICY ORIGINS OF THE CRISIS

The alternative view, that the crisis was caused by tight monetary policy in 2008 and 2010–2011, provides a simple but thorough explanation of the crisis's causes and severity:

- Despite economic contraction in early 2008, the ECB kept its interest rate pegged at 4 percent and then raised it to 4.25 percent in July that year. This shock triggered the first crisis.
- After keeping rates low for two years, in late 2010, the ECB began signaling that it would raise its policy interest rate to stem burgeoning inflation. The ECB raised rates in April and July 2011. The Eurozone was still recovering from the first recession, and this second shock intensified the crisis in 2011.

## POLICY IMPLICATIONS FOR THE EUROZONE

Tight monetary policy explains the Eurozone crisis that began in 2008 and reoccurred in 2010–2011. Typically, central banks cut interest rates during an economic slowdown, so why did the ECB tighten during these times? In both cases, the ECB was mistakenly worried about the rise in headline inflation (i.e., inflation that includes volatile prices for commodities such as energy). A temporary surge in commodity prices caused headline inflation to rise in both 2008 and 2010–2011, though core inflation remained stable.

The ECB's tremendous mistake was responding to these changes in inflation as if they were symptoms of a demand shock when they were really symptoms a supply shock. Such confusion over inflation is a common problem for inflation-targeting central banks.

- For example, the US Federal Reserve misread declining inflation in 2002–2004 as a symptom of weak demand rather than rapid productivity growth. Consequently, it kept interest rates low even though the United States was in the midst of a housing boom.
- Similarly, in September 2008, as the economy was imploding, the Federal Reserve decided not to lower interest rates because of a concern about inflation. This inflation, however, was the result of a temporary surge in commodity prices rather than excess demand.

Instead of targeting inflation, central banks should target demand directly by targeting the growth path or level of total money spending on finished goods and services (NGDP). There are several important reasons for this:

- *NGDP targeting responds only to demand shocks.* For example, if there were a positive supply shock owing to new technology that lowered prices, the ECB would do nothing other than maintain stable money spending. The composition of spending would change—more goods and services would be bought at lower prices—but the total amount of spending would not. By focusing on money spending (NGDP), the ECB would not be tempted to respond to supply shocks as it did in 2008 and 2010–2011.
- *A growth path or level target for NGDP would commit the ECB to make up for past misses both above and below the target, so that the targeted growth path would be maintained.* If, for example, the ECB targeted a growth rate of 3.5 percent for NGDP and an adverse economic shock caused money spending to fall below that value, then the ECB would make up for it by increasing money spending faster than 3.5 percent until money spending caught up to the ECB's targeted path. Similarly, if growth were higher than 3.5 percent in a given year, the ECB would slow down spending until it hit the target path.

If the ECB were to adopt this NGDP target today, it would help facilitate a more balanced recovery. Under such a target, a period of catch-up in total money spending would occur and cause prices to temporarily rise. Prices would first rise in the core countries with the least excess capacity. Goods and services from the periphery countries would therefore become relatively cheaper, making them more competitive.

## CONCLUSION

NGDP targeting would not solve all the deep structural problems that plague the Eurozone, but it would provide a monetary policy that does not push the currency union further into a recession. It would also facilitate a more balanced recovery among the member countries. The Eurozone sorely needs such a monetary policy regime.