Rare sensible move from Mario Draghi and ECB [1]

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Nominal interest rates cannot be brought below zero, because non-cash assets can be sold for cash, which always effectively bears an interest rate of zero [3]. Monetary policy affects the economy through changing nominal interest rates, which given somewhat sticky inflation changes real interest rates, which affects spending, saving and investment decisions?a cut in the interest rate makes saving more expensive and investment cheaper. Essentially working on these two facts (there are much more complex versions, but this is the core) New Keynesian economists [4] argue there is a "zero lower bound" on monetary policy. The Fed cannot support demand by targeting a Fed Funds rate [5] lower than zero, the Bank of England cannot support demand by lowering Bank Rate [6] any further than zero, and the same for the European Central Bank. This means, they say, fiscal policy is necessary to stabilise demand when the interest rate that would be needed to do falls below zero.

Now I think this argument is false [7]. Monetary policy does not mainly work through interest rates [8]. Monetary policy mainly works through affecting consumers' and firms' expectations about future demand conditions. But even if this argument were true, the simple Keynesian story?that fiscal policy must be employed to get the Eurozone out of recession because monetary policy is ineffective at the zero lower bound?will not fly. Why? Because the ECB, headed by Mario Draghi, cut interest rates by 0.25% today [9], bringing them from 0.5% to 0.25%. The ECB was not yet at the zero lower bound.

Monetary policy doesn't seem to need long and variable lags [10] of the type typically assumed in models. As I write, the Euro is down 1.4% against the dollar [11] 1% against the pound and 0.7% against the yen. The Bloomberg 500 measure of European stocks is up 1% [12] and the Euro Stoxx 50 measure is up 1.3%. That means the value of the Euro has already fallen. That means that money is already slightly easier [13]. If there were a good measure of nominal income expectations?the best definition of money easiness or tightness?I'd wager that that would be up.

It's true that this is unlikely to be enough. Nominal GDP is not growing at pre-trend rates, never mind catching up to the pre-recession trend. The ECB is letting the euro area slip into deflation when it is barely out of its double-dip recession. Sovereign debts have grown to eye-watering levels despite very tight fiscal policies in many of the hardest-hit member nations. And none of this is to mention the excessive regulation and badly-designed tax systems that contribute to low long-run productivity growth and high rates of unemployment even in good times. But it's both a step in the right direction, and evidence against the simplistic Keynesian arguments that get trotted out all too often in macroeconomic debate.

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