the gap between potential and actual GDP) and the deviation of inflation from its target (in the euro area, 2% or less). Most estimates of the rule suggest that interest rates are broadly correct for the euro area as a whole.

However, this does not get the ECB off the hook. The first concern is that the central bank has reacted too slowly to the recent rise in the euro, which could seriously reduce future growth and inflation. This week the euro rose to a four-year high against the dollar, above $1.11. By one rule of thumb, a 5% rise in the euro's trade-weighted value has the same impact on growth and inflation as an increase of one percentage point in interest rates. This year's quarter-point cut has therefore been nowhere near enough to offset the euro's 6% gain since mid-December.

Moreover, the euro is likely to rise further. Not only have investors become less eager to finance America's huge current-account deficit, but with little room left to cut interest rates to boost their own economy, American policymakers will be more than happy to let the dollar slide. Economists at HSBC are tipping the euro to reach $1.20 by the end of this year. Yet most economic forecasts, such as those of the OECD, assume no change in the exchange rate. If the euro rises strongly, growth will be weaker and inflation lower.

Japanese lessons
A second criticism of the ECB's policy is that, in current circumstances, it may not be sensible to focus, as the central bank does, on the average inflation rate in the euro area, if this risks creating deflation in Germany. The zone's headline inflation rate has stayed stubbornly above 2% in the past year, although core inflation (which excludes energy and food) is now 1.8%. However, Germany's core inflation rate is only 0.6%, perilously close to deflation.

Japan's experience has shown how dangerous deflation can be. Falling prices increase the real burden of debt, and real interest rates cannot be reduced to boost the economy, because interest rates cannot be negative. The lesson from Japan is that, if there is the slightest risk of deflation, monetary policy needs to be loosened more than warranted by current economic conditions. For once deflation has taken hold, monetary policy becomes a blunt tool. This is even more important when fiscal policy is also severely constrained by Europe's stability and growth pact.

Interest rates are already too high for Germany. Given the harm deflation can do, the ECB arguably needs to cut interest rates by more than seems appropriate for the euro area as a whole in order to prevent deflation in the zone's biggest economy. It may be too late. Even assuming more rate cuts soon, economists at Dresdner Kleinwort Wasserstein (DKW) forecast that core German consumer prices will fall by 0.3% in the year to June 2004. Using the Taylor rule, and his own forecasts for inflation and output gaps, David Owen of DKW calculates that Germany would need negative nominal interest rates (if that were possible) by early next year.

Indeed, the ECB may be underestimating the risk of a big fall in inflation across the euro area. If growth remains well below trend and the euro rises, the average core inflation rate will fall below 0.7% next year. That is a strong argument for cutting rates now. There is also a risk of deflation in France, where core inflation is expected to fall near to zero next year.

It is popular to blame Europe's sluggish growth on structural rigidities. On a long-term view, that is surely right: structural reforms are essential to improve economies' performance. But the benefits of reforms will take a long time to appear, and they will do nothing to prevent deflation. The euro area's immediate problem is overly tight monetary and fiscal policies.

Germany's low inflation rate, its limited room to ease monetary or fiscal policy and the problems in its banking system look horribly like the early symptoms seen in Japan in the mid-1990s before it sank into deflation. How appropriate, therefore, that Heiko Takenaka, Japan's economics minister, is calling for the ECB to ease policy more aggressively than it has hitherto. Hopefully, the ECB has better hearing than the Bank of Japan.