GROUPEMENT D'ÉTUDES ET DE RECHERCHES
NOTRE EUROPE

President: Jacques DELORS

THE ECB AND MONETARY POLICY

Hugo ZSOLT DE SOUSA

Policy Papers N°3
June 2003

STUDY AVAILABLE IN ENGLISH

This publication benefits from the financial support of the European Commission. Nevertheless its content is the sole responsability of the author. Niether the European Commission nor *Notre Europe* are to be held responsible for the manner in which the information in this text may be used.

CONTENTS

INTRODUCTION

The European Central Bank announced last December that it would review the current monetary framework which was finalised and presented to the public on May, 8th. The objective of this paper is to contribute to an ongoing debate on the European Central Bank and its monetary policy, by assessing the main features of the current system and pointing out some ideas that could make the current framework more efficient in transparency and policy effectiveness.

In order to reach that goal, I shall start by briefly describing the historical perspective with the aim of explaining the main steps that were taken to reach that current system.

Following that, I will illustrate the composition of the ECB and its mandate as defined by the treaty. Some of the criticisms to the way price stability is supposed to be achieved will be mentioned.

In section three, the objective of price stability along with the role monetary policy plays in economic policy will be explained. Moreover, the costs of inflation will also be briefly discussed.

Section four aims at explaining how efficiently the ECB has been managing monetary policy. When doing so, the critiques to the current system will be mentioned and the possibility of introducing employment as a policy goal will be discussed. Furthermore, some ideas put forward by academics to improve the present situation will also be analysed.

In section five, central bank independence and the way it affects the setting of monetary policy will be mentioned and some ideas to improve dialogue between all economic policy agents will be put forward.

Section six will provide an overview about the ECB's transparency and accountability. In order to do so, some indexes on the subject will be presented. This paper will finish by arguing that the FED type of solution would not be optimal to the ECB and finally some suggestions to improve the current system will be presented.

I - HISTORICAL PERSPECTIVE

In June 1988 the European Council gave a mandate to a committee chaired by the then European Commission President, Jacques Delors, to propose the road to the realisation of the economic and monetary union. This committee, formed by Jacques Delors, Alexandre Lamfalussy, Niels Thygessen, Miguel Boyer and the governors of the EC central banks eventually produced a document, that became known as the "Delors report" that contained clear proposals on how the economic and monetary union should be achieved.

It proposed this ultimate goal to be reached in three different stages: the first stage began in 1990 and it referred to the abolition of all capital movement restrictions. Moreover, the committee of Governors of the Central Banks of the EEC was given extra powers that included the promotion of monetary policy co-ordination with the objective of achieving price stability. They also started the preparations for stages two and three.

However, these stages, due to their complexity (most notably concerning a transfer of competencies), implied a treaty revision and for that purpose an Intergovernmental conference on EMU was held in 1991. Eventually the TEU was agreed (December 1991) and signed in February 1992. The Maastricht treaty that included a protocol on the statute of the European System of Central Banks and of the European Central Bank came into force in November 1993.

The stage two meant the creation of the European Monetary Institute. The EMI had as main tasks the strengthening of co-operation amongst Central Banks and consequently of monetary policy and it was also supposed to make the necessary preparations needed for the establishment of the ESCB.

In December 1995 the European Council confirmed that the stage three of EMU would start on January, 1st, 1999. In June 1997, the Stability and Growth pact was agreed, with the aim of ensuring budgetary discipline in the EMU. The ECB was then established (June 1998) and on the first day of January of 1999, the exchange rates of the then 11 countries that had been approved to form the single currency (Greece joined on January, 1st, 2001) were irrevocably fixed, meaning the European Central Bank would now be conducting a single monetary policy for all countries forming the EMU.

II - THE COMPOSITION AND MANDATE OF THE ECB

The ECB is composed of a President, a Vice President and four members that form the executive board. They have been in office since June 1998.

Their mission is, according to article 2 of the protocol, to maintain price stability. To be more precise, article 2 says "the primary objective of the ESCB shall be to maintain price stability. Without prejudice to the objective of price stability, it shall support the general economic policies in the Community as laid down in article 2 of this Treaty". Article two of the treaty says that the EU has as task the promotion of a "harmonious and balanced development of economic activities, and of sustainable and non-inflationary growth, a high degree of convergence of economic performance, a high level of employment and social protection, the raising of the standard of living and quality of life, and economic and social cohesion and solidarity among Member States".

Hence, the ECB aims at achieving price stability but also acting in a way so as to promote economic growth in the EU, as long as that does not imply a higher level of inflation.

In order to achieve that objective, the ECB recurs to a two pillar strategy. On the one hand it consecrates a prominent role for money by announcing a quantitative reference for its growth rate and on the other hand, an assessment of the outlook for price developments and risks to price stability for the Euro area. Namely, the ECB aims at achieving "an increase in harmonised consumer prices of below 2%".

This definition of price stability, according to Svensson (2002) is "ambiguous and asymmetric and therefore less effective as an anchor for inflation expectations". Indeed the definition of price stability adopted by the ECB (the Maastricht treaty did not specify a definition) has been constantly criticised, mainly due to the fact that whilst it provides a ceiling for inflation in the Eurozone, it does not specify a floor. This has led some to argue that the threat of deflation is not ruled out, at least if one bases oneself solemnly on the Treaty. However, the TEU does mention a price increase, which in principle should rule out deflation. Notwithstanding, the inexistence of a clear floor for inflation may also raise transparency related questions and create some uncertainty in economic agents. I will come back to this issue later in this paper.

III - THE OBJECTIVE OF PRICE STABILITY

As mentioned before, price stability was defined as the economic policy goal to be pursued by the European Central Bank, partly because countries like Germany and the Netherlands had a long history of price stability and were reluctant that it would be put aside in a monetary union which was being formed by 11 countries, some of which had no tradition on achieving price stability in the past. But is price stability a German obsession or is there an economic rational to aim at it?

1. Why is inflation a bad thing?

The classical dichotomy which implies a separation between real and nominal variables is the hallmark of classical macroeconomic theory. In other words, it allows one to explain the allocation of output recurring only to real variables while ignoring the nominal ones. It arises because in the classical theory changes in the money supply do not influence real variables. Money is therefore neutral and the irrelevance of money was named monetary neutrality. Nominal variables include for example, the price level, the inflation rate, the wage a person earns and so on. However, this theory is rather simplifying. If monetary neutrality might be correct in the long run, the same does not apply to short run fluctuations. Due to the fact money can play a role in the short run, monetary policy can play a useful role when leading with short run fluctuations in output and employment. In this section, the objective is twofold: firstly to show price stability is a public good, and in order to do that the costs of inflation will be explained. Secondly, the role monetary policy can play in the short run will be explained.

2. The costs of inflation

Inflation can either be expected or unexpected. This in turn depends upon a series of different factors, namely the way the policy has been run by a Central Bank or by a government as this seriously influences the expectations of citizens. Usually unexpected costs imply larger welfare costs, due to expectations that take time to adjust. Textbooks usually identify a series of economic costs that are associated with inflation (the so called shoe-leather costs, menu costs, price variability, income and the tax system distortions it causes, the way it affects savings as these are usually linked to a nominal interest rate and finally the inconvenience of living in a world where prices are difficult to compare).

The costs associated to unexpected inflation are more serious than the ones described before because they directly affect income distribution. Firstly, it seriously affects the wealth of individuals as it is directly related to long term loans (e.g. mortgage to buy a house). This is usually linked to a nominal interest rate x. If inflation turns out to be higher than expected, the debtor wins because the debtor pays back his loan with less valuable euros. If inflation turns out to be lower than expected, than the creditor wins and the debtor loses.

A second and very important cost associated with unexpected inflation is that it seriously hurts retired people, that is to say, the less privileged and the most vulnerable. Indeed,

pensions depend on past deferred earnings and are usually fixed. If an unexpected change occurs than the retired individual will be hurt as its pension will now be valuing less.
Finally, unexpected inflation is usually very painful to eliminate.

3. The role of monetary policy

All these costs lead to the view that it is very important to target price stability. That responsibility in Europe has been entrusted to an independent body (independent refers to being independent from the political sphere), which is the European Central Bank. The ECB, said before, aims at achieving price stability in the long run, but it can play a role in the short run. Indeed, the ECB can make use of monetary policy to curb short run output and employment fluctuations. This, however, should not jeopardise the objective of price stability. *How can monetary policy be effective in the short run?*

Monetary policy has two main functions: it aims at providing price stability in the long run and thus determines the inflation rate in the long run. Hence the objective of price stability that has been attributed to the ECB is appropriate. Monetary policy is however constantly confronted with a choice between the long term objective of reaching price stability and the short term role it can play by helping to stabilize output and employment levels. If it often succumbs to short term objectives, than the long run objective may not be attainable. Therefore, the ECB must be cautious when using monetary policy in the short run and this is mainly due to the phenomenon that became known as time inconsistency. Indeed, monetary policy acts by anticipation and not by reacting to past events and it is estimated that the monetary policy time lag (the time it takes for a change in monetary policy to have effects in real variables) is between twelve to twenty four months. Still, the ECB can not neglect this responsibility and it should aim at trying to find a more efficient policy mix, while always preserving the goal of price stability. I shall return to this topic again in a later section.

IV - THE INFLATION GOAL AND THE POLICY OF THE ECB

The monetary policy conducted by the ECB has been criticised mainly, on two different grounds. On the one hand, Svensson argues that the two pillar strategy is ambiguous and not practical. Indeed, the current framework is divided in two pillars, one that specifically looks at money and a second one that takes into account all the other monetary aspects. The argument is that money is indeed important but can be taken into consideration together with the other monetary phenomena. A one pillar strategy encompassing all variables would therefore be more appropriate.

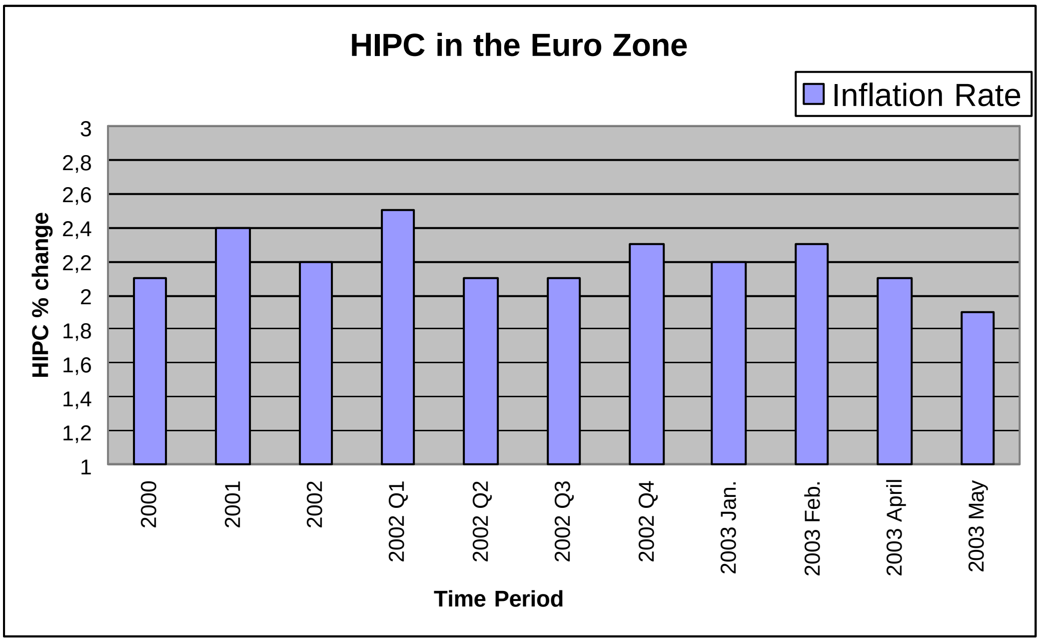
On the other hand and as seen before, the current framework aimed at achieving price stability does not clearly mention a floor for inflation. Given that the objective is to aim at price increases below 2%, financial markets, analysts, academics and even the media have to guess what the ECB's preferred inflation level actually is. This leads to lower transparency and credibility. It is argued by Svensson (1992) that "a symmetric explicit point inflation target, say 1.5%, 2% or 2.5%, would be better and provide a better anchor for inflation expectations". Indeed the current system does not provide a clear floor for inflation although the 2% ceiling is made quite clear. Accordingly, the definition of an explicit floor for inflation could make the policy of the ECB more clear, transparent and henceforth credible to the markets. Moreover, he believes that a range of "1-2% would be a significant improvement over the current definition". Hence one of the proposals put forward would be to join both pillars in one while at the same time keep the current inflation objective (below 2%) but with the inclusion of an explicit floor for inflation.

One of the advantages of such a proposal is that, as pointed out before, it would make the monetary policy of the ECB more clear and transparent and the effects on the bank's credibility could be positive as its inflation objective would not be changed.

On the other hand, some criticise the ECB's policy because it is too cautious. The argument is that the ECB does not change interest rates as often as it should; in other words it does not perform the function of stabilising the economy in the short run as efficiently as it should. It is argued the ECB worries too much about inflation whilst completely disregarding growth. However, one should not forget that the inflation objective the ECB has set itself implies an inflation rate below 2% and that objective has not been fully achieved as only recently inflation went below the 2% reference value[1]. Therefore, the margin of manoeuvre for the ECB to lower interest rates was reduced as that would imply further inflationary pressures that could lead to higher inflation. It could also damage the bank's credibility because markets could perceive it as not enough committed to the objective of price stability. One should recall that the ECB is a new institution and that its credibility will only be gained through time and through the pursuing of consistent policies. Hence, changing interest rates when the price stability objective has not been fully met could be counter productive.

[1] According to a press release by Eurostat, on 02/06/03, the inflation rate in May was of 1.9% against the 2.1% recorded in April , 2003.

Therefore, all these factors make the policy decision of lowering interest rates more difficult as it could damage the credibility of the ECB and send the wrong signal to economic agents.



Source: ECB monthly bulletin, February 2003 and Eurostat figures for April and May, 2003.

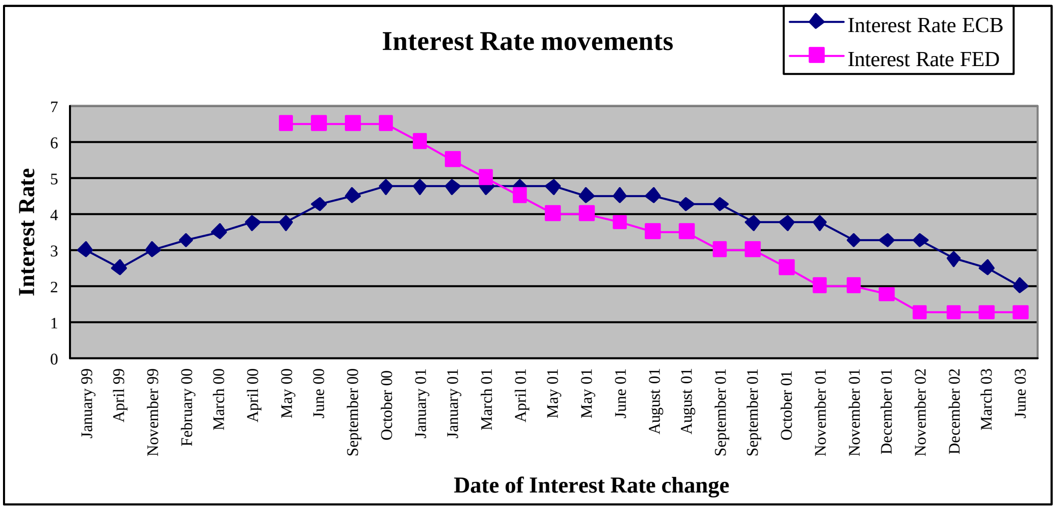
As can be seen from the above graph, the inflation rate in the Euro zone countries has been persistently higher than the two percent objective[2]. Accordingly, is it really appropriate to criticise the ECB for not lowering interest rates enough, meaning it does not pay enough attention to economic growth? Research carried out by Wyplosz and Artus (2002) concludes that "*en effet, les apparences sont trompeuses. Les craintes exprimées par ses détracteurs les plus virulents, parfois confirmées par des déclarations stéréotypes, peuvent laisser croire que la BCE est obnubilée par la seule évolution des prix. Mais, dans son action, elle a su, conformément à son mandat tenir compte du besoin de stabilisation de la conjoncture. En 2001, la BCE a ainsi assoupli sa politique monétaire en réaction au fort ralentissement de l'activité dans la zone euro, alors même que l'inflation était au-dessus de la limite des 2%. Les estimations de la fonction réaction de Taylor, présentées dans ce rapport et dans de nombreuses autres études, s'accordent à confirmer que la BCE a intégré un objectif de stabilisation du cycle économique au-delà de son seul impact sur l'inflation future. »*[3].

Hence, the ECB does seem to be taking into account its role of stabilising the economy in the short run, thereby giving proper attention to the objective of economic growth as mandated by

[2] As mentioned before inflation just came below the 2% reference value in May 2003. This, however, is the rate in the whole eurozone. Individual eurozone members have recorded rather differently. Germany, for example has been having an inflation rate below 1% and some analysts have indicated that it might be approaching deflation. The ECB however is required to match the eurozone overall and not individual countries.

[3] Appearances are misleading. The worries expressed by the most violent detractors, sometimes confirmed by some stereotyped statements, might lead one to believe the ECB is obsessed with nothing but price developments. However, the ECB, according to its mandate, was efficient on taking account of the need to stabilise the economy. In 2001, the ECB relaxed its monetary policy in reaction to a weaker economic activity in the Euro zone even when inflation was above the 2% threshold. The estimates of the Taylor reaction function, presented in this study and in many others confirm that the ECB also pursued an objective of stabilisation of the Business cycle that went beyond an effect in future inflation.

article 2 of the protocol annexed to the TEU. Recent research in economic theory tells us that monetary policy by itself cannot aim to foster economic growth in the long term but that it can help in the short run. Indeed, monetary policy should not be confused with economic policy. It is one of the instruments of economic policy as well as fiscal policy and the pursuing of structural policies. One should not rely on monetary policy to perform the functions of all these different but inter-related policies. As stated before, monetary policy can be most effective in determining the inflation rate in the long run and in helping to stabilise the economy in the short run. The most common way it has to do so is by making use of interest rates, whereby lowering interest rates tend to increase investment and to foster economic growth while increasing interest rates can slow down the economic activity. The interest rate movements of both the FED and the ECB are shown below.



Source : OECD economic data

A close look to interest rates movements done by both the ECB and the FED tell us that they have been, more or less parallel, at least from the moment where they both intersect (March 2001). Moreover, European interest rates are now at the lowest level in more than forty years. Again, research undertaken by Wyplosz finds that there is no evidence the FED would have managed monetary policy differently. Hence, the ECB does seem to have been taking into consideration the short term role in economic growth it has when implementing monetary policy.

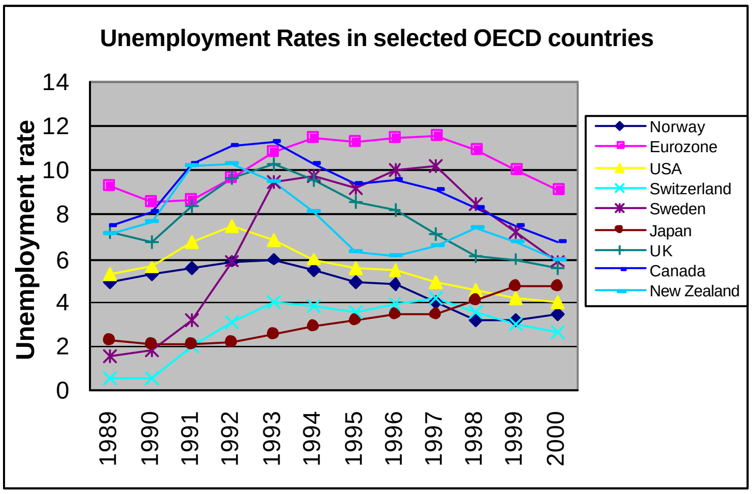
V - CENTRAL BANK INDEPENDENCY

Another important issue when assessing monetary policy and its effectiveness is the issue of central bank independence and credibility. The ECB is widely perceived as one of the most independent central banks in the world. The issue of central bank independence became relevant mainly after the 1970's events that led to stagflation[4]. The reason was that politicians were regarded as short sighted as their focus is on winning elections and that tendency might lead them to not use monetary policy in the most efficient way, for example to lower interest rates when these should be increased. The most typical example of this happened during the 1970's and was due to a sequence of oil price increases that caused a simultaneous increase in overall prices and a reduction in economic growth. The choice of a central bank becomes than more difficult: should it tackle growth and henceforth reduce interest rates or should it try to keep inflation low by raising interest rates? In the 1970's, the option taken was the former which led to stagflation. This episode is one of the reasons behind the focus on price stability. Indeed, monetary policy has since then been perceived as more efficient if it aims at achieving price stability. However, as mentioned before, politicians might be tempted to prefer a loose monetary policy especially during downturns (which might be appropriate under certain circumstances but not under others as seen) and, to avoid that scenario central banks around the world have been granted full independence (examples include the UK, New Zealand, Norway, Canada, Sweden and Switzerland as well as the ECB). The reasoning was that monetary policy would be more efficient if entrusted to an independent body that would aim to achieve price stability. But does higher central bank independence and more focus on price stability lead to lower growth and higher unemployment?

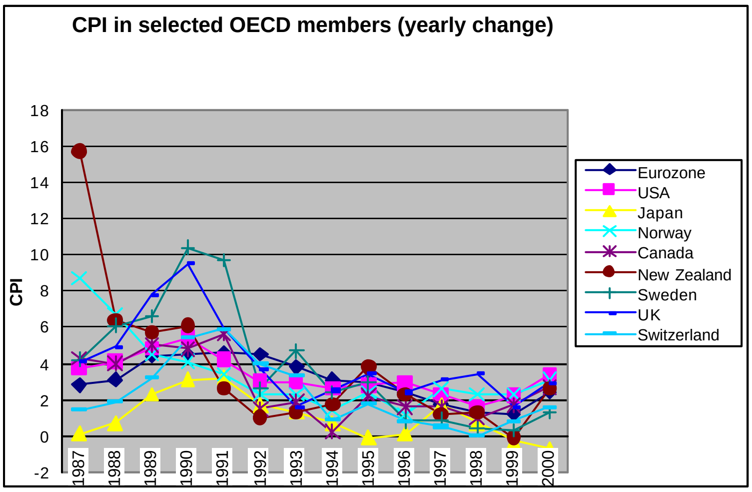
According to the data shown below central bank independence seems to be positively correlated with lower inflation. In other words, independent central banks appear to have been successful in bringing down inflation. However, literature and research carried out on the subject shows that the issue of central bank independence and its effectiveness on growth and unemployment still remains unclear. Indeed, earlier research pointed out that central bank independence was a "free lunch", which in this context refers to ensuring lower inflation as well as no extra costs imposed on growth and unemployment, as compared to politically influenced central banks. Nevertheless, more recent research points out that despite being associated to lower inflation, central bank independence might also be linked to higher disinflation costs[5]. This is defined by the output and unemployment cost incurred when bringing inflation down. This point is worth noting: more independent central banks might imply higher disinflation costs but not necessarily higher costs when maintaining inflation around a pre-determined level. This is the case of the ECB as, so far it has not yet had to carry out any disinflation policy as inflation as been more or less, around the two percent figure.

[4] Stagflation refers to a combination of slower economic growth and rising prices.

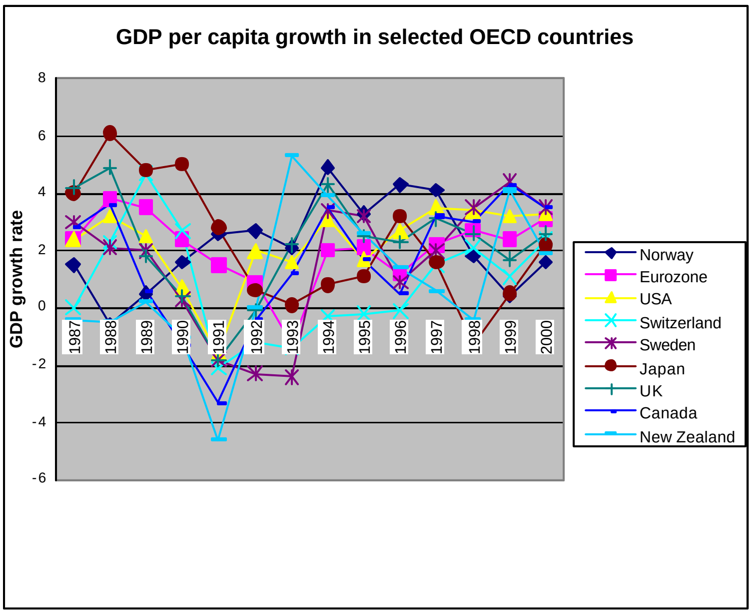
[5] For more on disinflation costs and central bank independence refer to "the output-inflation trade off and central bank reform: evidence from New Zealand by Michael M. Hutchison and Carl E. Wash.



Source : OECD



Source : OECD



Source : OECD

Thus, there is still controversy when determining the effects of central bank independence on economic growth and unemployment but it is widely accepted that independent central banks are identified with lower inflation values. Japan, the only country of the above mentioned without an independent central bank is also the only one that has been undergoing a constant deflation period along with rather weak, sometimes negative, economic growth.

Given the lack of evidence supporting the link between central bank independence with output and employment, the objective of price stability does seem to be coherent. Low and stable prices are conducive to growth in the long term and, more importantly, avoid the need to undertake disinflation polices, which are always painful[6].

However, more dialogue between the ECB and the political authorities could be a way to promote a more efficient policy mix without jeopardising the independence of the ECB. In other words, Member States should inform not only their peers but also the ECB when pursuing structural reforms that would be likely to have spillover effects across the Eurozone. By systematically informing each other, MS and the ECB could aim at a better policy outcome. The ECB would be able to undertake a more appropriate monetary policy for the Eurozone thereby contributing to a better policy mix. How an improved dialogue should take place is dealt with next.

[6] When choosing the disinflation type of policy, Governments or central banks have two options: They either take a gradualist or a shock therapy approach. The choice will ultimately depend upon the preferences of the entity that undertakes the policy. A shock therapy approach usually implies higher output and unemployment costs in the short run but is faster than a gradualist option. At the end of the day, the gradualist type of approach will imply higher costs in the long run but the shock therapy will have higher short run costs.

VI - DIALOGUE AND CREDIBILITY

The TEU recognises the need for dialogue. Indeed, article 113 (former article 109b.1) states that the President of the ECOFIN Council may participate in the meetings of the governing council of the ECB without the right to vote. Usually, the President of the ECOFIN is replaced by the President of the Eurogroup when they are not the same person. Moreover, it allows for the President of the ECB to be invited to take part in the meetings of the ECOFIN Council when matters relating to the objectives and tasks of the ESCB are on the agenda. The ECB also participates with two members in the meetings of the Economic and Financial Committee. Furthermore and according to the same article "the President of the ECB and the other members of the Executive Board may, at the request of the European Parliament or on their own initiative, be heard by the competent Committees of the European Parliament". Consequently, since 1999 the ECB and the Committee on economic and monetary affairs of the European Parliament have engaged in a monetary dialogue on a periodical basis, usually every quarter. As a preparation for this meeting, the Committee on monetary and economic affairs commissions academic studies by experts which allow these meetings to be a sound and good basis for dialogue, by not only taking into account the role of the European Parliament, but also albeit indirectly the opinions and views expressed by the academics.

However, fruitful dialogue between the ECB and the ECOFIN Council has not always occurred. In 2001 there were public tensions between the Eurogroup President, the Belgian Finance Minister Didier Reyndars and the President of the ECB, Wim Duisenberg as Mr. Duisenberg failed to appear in some Eurogroup meetings[7]. As mentioned before, the treaty framework does provide a basis for dialogue but nevertheless some problems persist. One is clearly the fact that the ECB member who attends the Eurogroup meetings is outnumbered by the twelve finance ministers[8]. This might bring political pressure instead of fruitful dialogue which occurs for example in the FED or as the tradition that exists in the Netherlands. Indeed, there is an intensive dialogue between the Dutch Central Bank and the Ministry of Finance as both the President of the Dutch Central Bank and the Minister of Finance have always held bi-weekly luncheon sessions to informally discuss relevant topics. Top level officials of both institutions also meet regularly and this open and frank dialogue has actually increased the independence of the Central Bank rather than undermining it[9]. This model has been more or less put in practise by most national central banks in the EMU. The problem arises in the Eurozone because whilst there is a single monetary policy, there continue to be twelve different fiscal policies, without proper co-ordination and given that a dialogue in this case needs to involve more people, this may not lead to the most efficient policy outcome.

The fact that a single ECB member meets with the twelve finance ministers at the same time, may in turn bring more political pressure on the ECB to force it to lower interest rates rather than to bring about an open and frank dialogue[10].

---

[7] Financial Times, June, 22, 2001.

[8] Navarro, Lluis, "As the Euro prepares for take off: A critical review of the first three years of EMU, October 2001.

[9] Speech by Dr. A.H.E.M. Wellink, President of the Dutch Central Bank, in Berlin 1997.

[10] The theory of electoral cycles illustrates this point. Politicians might be tempted to follow short term considerations and disregard the long run because they need to win elections. Given that lowering interest rates is usually more popular than increasing them, they might feel tempted to pressure the monetary authority. Indeed, this is one of the reasons that led to grant independency to central banks all around the world.

Following the French-German proposal to the European Convention on economic governance that implied the election of a Eurogroup President for a period of two years, one possible way forward could be to foster informal meetings between the future Eurogroup President and the President of the ECB. This "tête-à-tête" meeting could bring a more open and frank dialogue than simply having the ECB's President participating in the meetings of the Eurogroup. However, this could only work if the Eurogroup could act as an informal forum that would enable economic policy co-ordination of national policies to move forward. The president of the Eurogroup could indeed only act efficiently if he/she would be able to properly represent the twelve finance ministers and that in turn can only occur if Member States share their views, discuss and inform each other of their fiscal and structural policy measures. This would not replace the current framework but simply add to it. If, however, the French-German proposal is not accepted, a similar solution could be found with the appointment of a Mr. Euro that would not only represent euro countries internationally but would also meet regularly with the President of the ECB with the same objective stated before. Any of the above presented solutions could only be efficient if Member States would efficiently co-ordinate their national fiscal and structural policies. More co-ordination of economic policies is, in any case the key. It is difficult to co-ordinate policies with the ECB if MS continue without properly co-ordinating their national economic policies. Moreover, the current economic co-ordination mechanisms, most notably the broad economic policy guidelines and the stability and growth pact although useful are far from being optimal co-ordination instruments. This, however, goes beyond the scope of this paper[11].

It is essential nonetheless that this increased framework for dialogue does not affect the independence of the ECB, which is also clearly mentioned in the TEU. But as seen in the Dutch case, more dialogue does not imply less independence. It might actually imply the opposite as both sides learn how to respect each other opinions when these are exposed in an open and frank atmosphere. Moreover, the independence of the ECB is an essential component of the credibility of monetary policy, because if an independent Central Bank such as the ECB starts to be perceived as politically influenced, financial markets will tend to react negatively. Furthermore, the expectations of economic agents that once were targeted at (living with) an inflation rate of x% might also change and this in turn is likely to affect the effectiveness of monetary policy, thereby negatively influencing economic growth.

[11] For more on economic policy co-ordination refer to De Sousa, Hugo, "Economic policy co-ordination in the Eurozone", Notre Europe, forthcoming

VII - TRANSPARENCY AND ACCOUNTABILITY

Central bank independence is however not the only element that influences the credibility of monetary policy. Other determinants include accountability and transparency. These are two distinct albeit complimentary concepts. The former relates to checking if the rules and principles that have been defined for a Central Bank to operate are in fact respected. Transparency refers to this but also to the way this is pursued. It is widely acknowledged that "transparency increases the credibility of the central bank, especially when the latter does not enjoy a particularly high reputation. It thus enables the central bank to conduct a less restrictive monetary policy that would otherwise be required[12]". But what determines accountability? There are several determinants that influence the extent to which a central bank is accountable. Examples include the existence of a clear objective for monetary policy as this facilitates public comprehension of the policy carried out, publication of minutes of the meetings where monetary policy has been formally defined, announcement of intermediary targets, independence from the political authorities, and so on. When assessing whether a central bank is or not accountable, the tendency of researchers is to build up indexes. The way this is done implies a definition of the parameters to be considered (ex: the existence of a clear objective for monetary policy) and then a weight is attributed to each parameter. The overall result will show the level of accountability of the central bank, usually compared to other central banks. Authors that have tried to compute indexes of central bank accountability, include Briault et al. (1996), De Haan and Eijfinger (1999 and 2000), Gros and Lorenzo Bini-Sanghi (2001). The latter study is the most comprehensive one as it takes into account 15 different parameters of central bank independence, including the ones that have been mentioned above plus some others[13]. This study came to some surprising conclusions summed up in the table shown below:

Table 1- An index of central bank transparency and accountability

	Total Score	Total score without the publication of minutes and individual votes
Eurosystem	19	19
Federal Reserve	16	14
Bank of Japan	14	10
Bank of Canada	15	15
Bank of England	24	20
Bundesbank	13	13

Source: Gros and Bini-Smaghi, 2001

[12] Is the ECB sufficiently accountable and transparent?, by Lorenzo Bini-Smaghi and Daniel Gros, ENEPRI, WP No. 7/September 2001.

[13] The full set of parameters used are: the existence of a clear task for the central bank (ultimate goal), the existence of a clear definition of the objective of price stability (quantification of the ultimate goal), announcement of a strategy, announcement of an intermediate target, announcement of indicators/publication of data, macro model used, data on targets, inflation forecast, the existence of Parliamentary hearings, the frequency in which reports are made, the frequency of press conferences, the publication of press releases, stating future moves, publication of minutes and the publication of individual votes.

This index shows that the ECB is one of the most accountable and transparent central banks in the world, just after the Bank of England. This is an interesting result and clearly goes against the public perceptions. This however is not new. Some studies came to similar conclusions whilst others concluded the opposite. Indexes do provide a useful framework to assess this issue but the lack of a generally approved set of criteria penalises their effectiveness. Hence, their results ultimately depend upon the weight each author gives to a particular criterion making the overall score arguable. The results shown below and the discrepancy towards the accountability index shown above illustrate this point.

Table 2 & 3- How financial markets evaluate transparency

Mean Score			
	Monetary policy effectiveness	Transparency	Presentation
ECB	6,2	3,8	3,4
FED	7,3	7,3	7,9
Bank of Japan	4,6	5	4,6
Bank of England	7,5	8	7,8
Bank of Canada	7,2	7	6,8

Source: "ECB ranked among G7 central banks in transparency", Reuters report by Pratima Desai.

Bank	Average Rating
Federal Reserve	4.3
Bank of England	3.3
Bundesbank (until 1999)	3.5
ECB	2.2

Source: Gros et al. (2000)

The first table is the result of a study conducted by Reuters whereby analysts were asked to rate from one to ten the major central banks that operate in the world. The result is clear and does not corroborate the indexes that place the ECB as one of the most accountable and transparent central banks. For the second table, financial market participants were asked how they understand the logics of monetary policy decision making of four of the most important central banks. In both studies, the sample is relatively short and hence results cannot be considered as representative but they should not be neglected as they do provide an indication of how financial markets participants view monetary policy decisions.

Indeed if the ECB scores less than most of the other central banks in the effectiveness of monetary policy, it is in transparency that the damage is greater. In fact, scoring less in monetary policy effectiveness is not surprising given that when these ranks were computed, the ECB had been in charge of monetary policy for a short time. The results for transparency are however more worrying and derive mainly from communication issues as well as the two pillar strategy (one for money and one for all the other monetary components). This two pillar strategy has been widely criticised by most academics and the ECB could gain by adopting a simple and clear one pillar strategy, where money would obviously be considered alongside the other components. Hence, changing to a one pillar strategy could improve transparency which in turn would improve the ECB's credibility and therefore allow for a better and easier use of monetary policy. Finally and as stated before, the fact that the current strategy does not specify an inflation floor also damages the credibility of the ECB.

VIII - WHAT MEASURES SHOULD BE TAKEN TO IMPROVE THE CURRENT ECB MONETARY POLICY?

Is the FED type solution preferable for the ECB?

As mentioned before one criticism often made of the ECB is that it is too concerned with inflation and not enough with employment and growth. This criticism arises from the fact that while the ECB has been given a clear priority to focus on the objective of price stability, the FED takes into account both factors equally. In recent years the North American economy has been performing better than the European economy and this, it is argued, might be due to the weight the FED gives to employment. Accordingly, some have called for the introduction of employment alongside price stability as an objective of the ECB (De Foucauld, 2002).

The ECB does not share this view and argues that "obviously, macroeconomic policies cannot be used to mitigate the main causes of Europe's serious unemployment problem. Other policies, aimed at the micro level, have the necessary instruments to do so and are, therefore, responsible for ensuring sustained growth and employment prospects. Essentially, structural reforms in the labour and goods markets must be undertaken as the key element of a comprehensive strategy for improving investment, growth and employment prospects in Europe[14]". The truth may lie somewhere in between. On the one hand, as said before, monetary policy cannot aim to target employment levels in the long run and is more effective if used to target long run price stability. On the other hand, structural policies although essential, cannot resolve the problem by themselves. Monetary policy, fiscal policy and structural policy are all instruments of economic policy and they all affect each other. Monetary policy affects interest rates and therefore investment, followed by deficits and public debt, fiscal policy affects inflation because it affects aggregate demand and finally structural policies affect the supply side of the economy. Moreover monetary policy does play a role in stabilising output in the short run. Hence, there is a theoretical background for co-ordination of economic policies with the aim of achieving a better policy mix for the eurozone and the instruments of economic policy should not be regarded as separate from each other. I shall return to this issue.

Nonetheless, the Federal Reserve does mention employment in their statutes and hence the question of introducing employment as one of the ECB's objectives remains. The statutes of the FED state the following: "to maintain growth of money and credit aggregates commensurate with the economy's long-run potential to increase production, so as to promote effectively the goals of maximum employment, stable prices and moderate long-term interest rates". This law, known as the full employment and balanced growth act is also a consequence of stagflation. This, however, is very unclear: it neither gives a precise definition of stable prices nor does it explain what maximum employment means and leaves open the question of moderate long term interest rates. The optimal monetary policy hence cannot be inferred from the FED statutes and may ultimately depend upon who is the chairman of the FED. Indeed, as argued by Axel Krause, Notre Europe (April 1999), *"it is sometimes said that the best way to understand the FED's relationship to the White House and other branches of the executive branch is to think of the bank in a somewhat paradoxical*

[14] Speech by Professor Otmar Issing, Member of the Executive Board of the European Central Bank, at the Brussels economic formum, May 2000.

way- being independent within the government, but not independent of the government. In practise, this role has proved relatively easy, difficult, strained, or virtually impossible to sustain, depending on the personalities involved and, of course, the historical economic contexts." Indeed, while the co-operation between Clinton and Greenspan was tranquil and fruitful this was definitely not always the case.

Moreover, modern economic theory throughout recent years has evolved to consider that monetary policy by itself cannot directly affect employment levels in the long run. This was reinforced by the events of the 1970's when stagflation occurred. Stagflation took place after a series of oil price increases by OPEC and led to double digit inflation and to lower economic growth at the same time. This was partly caused by the policy taken by the central bank that privileged growth by lowering interest rates rather than focussing on inflation. As argued by Cecchetti (2000), an oil price increase causes both prices to rise (and therefore inflation) and a reduction in economic growth. A Central bank is then faced with the dilemma of either lowering interest rates to foster economic activity or to increase them so as to prevent future inflation. In the 1970's, the option taken was the former, and that led to stagflation. As Cecchetti states "raising interest rates is never popular, and it is particularly so when the economy is slowing already. Nevertheless it is the right thing to do". In any case, this event led to the view that monetary policymakers needed to be imposed an objective. That objective is price stability and is currently found is several central banks (either through inflation targeting or by monetary targeting) such as Sweden, the UK, Norway, Switzerland, New Zealand, Canada and the ECB. Reintroducing other variables as the responsibility of a central bank could therefore be a step back, as it would lower transparency and accountability by causing further confusion on the market agents[15].

But if all this is true than why has the Fed produced such good results?

Some authors and a former Presidential candidate seem to have no doubts about the reasons. Senator John McCain, during a debate of Republican Presidential aspirants said the following: "*I would not only reappoint Mr. Greenspan, but if Mr. Greenspan should die, God forbid, I would do like they did in the movie Weekend at Bernie's. I would prop him up and put a pair of dark glasses on him[16]".* Alan Greenspan has been the chairman of the FED since 1987. He is widely regarded as very competent and markets have become familiar with his thinking, even if they do criticise him. Markets can evaluate and anticipate what Greenspan will do. This is recognised by several authors (Cecchetti, Bernanke, Mishkin, Posen, Nutting and Svenssen) and has led to speculations on how life will be after Greenspan. Cecchetti (1999) argues "*the problem is that we do not have well-articulated policy objectives, with an accompanying strategy or framework. What we have is a magician. As a result, we all live in fear of what will happen when the magician is replaced by a mere mortal"*. But Cecchetti, a former FED economist is not alone in thinking the success of the FED is mostly due to its chairman than to the FED's institutional framework. Indeed, Mishkin (2000), from the Federal Bank of Saint Louis also illustrates this fear very clearly *"I think it is fair to say that the nominal anchor in the United States right now is Alan Greenspan. The problem is that this leaves some ambiguity as to what the FED's target is, and even more importantly, the*

[15] As seen before, one of the criteria to assess central bank independence and accountability is the perceptions of financial markets, media and the public in general. If a policy sets too many targets and does not quantify, then it is likely that policy will be less credible.

[16] In this film two young men found their boss dead in their house to which they had been invited for a weekend. Not to spoil the fun, they placed him in a chair with sunglasses so that nobody would notice he was dead and therefore they could continue to have fun. Quoted from Cecchetti, 1999.

existence of this implicit nominal anchor depends on personalities. Alan Greenspan, despite his recent reappointment, will not be around for ever. When he steps down, will the public believe that there is a sufficient commitment to a nominal anchor to keep inflation from appearing again?". More recently, there was wide discussion as to whether or not U.S. President George Bush would or not reappoint Mr. Greenspan[17]. Financial markets, according to a CBSwatch poll seemed to believe Mr. Greenspan would continue even when his term finishes, in 2004. The opposite scenario was feared by some including Edward Lotterman, a financial market columnist *"Bush's only option would be to find someone like Greenspan. Maybe he should talk to those Raelians about human cloning"*. Many have therefore been calling for the statutes of the FED to become clearer in their purpose and advocate a system of inflation targeting whereby a central bank makes an open commitment as to what their price objective is. Such a system would obviously come into force after Greenspan (Mishkin 2000). Hence, the success of the FED does seem to be strongly linked to Greenspan. This scenario, although not very beneficial for monetary policy setting does not affect the public's perception of the FED because market agents have become familiar with Greenspan. However, the ECB cannot afford this, if for not other reason than because it only has four years of existence. Therefore, copying the lack of clarity of the FED statutes could also be a step back.

As stated before, the ECB announced in December 2002 that it will hold a complete review of its monetary policy during the first semester of 2003[18]. Some argue the ECB is likely to drop its widely criticised two pillar strategy and bring all monetary components into one pillar only. This is likely to increase transparency in policy making and make future expectations clear thereby easing the task of monetary policy.

There are some doubts however, concerning the issue of whether the ECB will ease its monetary policy strategy, in other words, to become more flexible over the 2% ceiling for inflation. The problem remains that it is still unclear how low inflation should be. Recently Wyplosz produced evidence that indicates that the current 2% level is likely to have high employment costs and therefore advocates a range of 1-4% or even 1.5-4.5%. However, as recognised by the author himself these figures have serious short comings and further research on the topic is needed before such conclusions can be endorsed. Moreover, such a drastic change in the ECB objective might bring high credibility costs, just 4 years after it has been created especially considering that most experts, at least to a certain extent, recognise that the ECB has been managing its price stability objective correctly. Indeed, as seen before, credibility is important and such a drastic change could produce high costs.

However, it does seem that the current strategy (below two percent) is neither clear nor does it allow for enough room for monetary policy to be used effectively in the short run. Regarding the former, some sort of inflation target model inspired by the practices of the Bank of England and the Bank of Sweden, setting a clear floor for inflation as well as a ceiling could be a solution. The latter is more sensitive and difficult, not only due to the lack of economic evidence on how low inflation should be but also due to political reasons as it is known that some countries are clearly more inflation averse than others (see Kenneth Scheve, Bank of England working papers, WP 172). Nevertheless, the adhesion, sooner or later, of 10 or 12 new countries to the Euro Zone is likely to put an upward pressure in prices, even if the weight of these countries on the EU's GDP will be relatively marginal. Even if one agrees with this fact, these 12 countries will be in a catching up phase, which will imply the famous

[17] George Bush has already publicly announced it is his intention to reappoint Alan Greenspan for another term.
[18] Please refer to the ECB's press conference of May, 8th for the outcome of this review.

Balassa-Samuelson effects[19] and these in turn are likely to put further pressure on the ECB's current 2% ceiling, which is already proving difficult to achieve given the current divergences in inflation amongst the current Member States. Indeed, the 2% inflation level is already difficult to attain with the current EMU members as these have heterogeneous economic structures and in some cases large inflation differentials. It is sufficient to see that just last May was inflation lower than the two 2% reference value (1.9%) and that despite this some countries are well above the 2% whilst at the same time Germany is starting to be seen by some as approaching deflation. Hence, this situation which is already difficult to manage will become more complicated in the future when the eurozone will be composed of 25 or 27 members, and the ECB could take this opportunity to come up with a revision of the current inflation level, that does not seem optimal to achieve. Failure to do so might imply a second monetary policy revision when the future member states eventually adopt the Euro, which is likely to be damaging to the bank's credibility[20]. This fact makes it not only economically but also politically justifiable to augment the 2% ceiling, possibly to 3 or 3.5%, giving the ECB more room for manoeuvre for interest rate cuts when future expected inflation will be likely to be under the limit and therefore contributing to long term growth. The introduction of an explicit floor would also make the whole system clearer. As other authors point out (Wyplosz, Svensson) 1% would have the advantage of bringing inflation away from the 0% value. Hence, the interval could be situated at 1-3% or 1-3.5%. With a well defined interval and a one pillar strategy, this new system of inflation targeting could also make it politically more appealing for the UK and Sweden to join the Euro, as these countries currently use a system of inflation targeting.

[19] The Balassa- Samuelson effects imply that when a country enjoys higher labour productivity in the tradable sector, than inflation will be higher in the non-tradable sector, meaning overall inflation will be higher. For details please refer to "the relevance of the Balassa-Samuelson effects to the euroisation debate" by Leon Podkaminer, WIIW.

[20] However, in the May 8, 2003 press conference, the ECB indicated it twill continue to rely on the 2% level even if it now allows for a level close to two percent. That "close" level, however, is not defined and monetary policy would strongly benefit if an actual parameter would be established as that would increase credibility.

CONCLUSION

This paper started by referring to the historical context that led to the current monetary policy framework whereby the ECB is the only institution responsible for the setting of monetary policy. On the one hand, several issues such as the price stability objective, transparency, accountability and dialogue were analysed. On the other hand, the criticisms to the current system and to the way the ECB has been managing monetary policy were deeply discussed. The main conclusions and possible suggestions to the future include:

- *Price stability is a public good and should be maintained;*
- *Monetary policy should aim at price stability in the long run but the short term role it can perform should not be neglected;*
- *It is however still unclear how low inflation should be. Nonetheless there is evidence supporting the view that the ECB has indeed been taking into account its short term function (helping to stabilise output and employment fluctuations) when pursuing its long term price stability objective;*
- *The issue of central bank independence and its effects in economic growth is still unclear for economists. Indeed, while it seems indisputable that more independent central banks are more efficient bringing inflation down, it is argued by some that central bank independence might be associated to higher disinflation costs;*
- *The ECB is perceived as less transparent as compared with other major central banks and that could be partly due to the current two pillar strategy as well as to the inexistence of a clear floor for inflation;*
- *More dialogue between the ECB, the European Commission and Governments is crucial if a better policy mix is to be found. However, it is difficult to claim for a better co-ordination of monetary and fiscal policies if Member States do not properly co-ordinate their economic policies first;*
- *A possible future President of the Eurogroup should hold regular meetings with the ECB with a view to better understand each other policies. This will only be effective if the Eurogroup can act as a forum for a true co-ordination of economic policies of the Eurozone countries.*
- *The ECB can ameliorate its current framework by making it more clear to markets. Possible improvements include the change to a one pillar strategy, setting an inflation floor, and make the inflation ceiling more flexible, especially taking into consideration the fact of enlargement that will imply more pressure on inflation. A range of 1-3(3.5)% for inflation could give the ECB more room for acting in the short run while at the same time improving its credibility in the financial markets.*

BIBLIOGRAPHY

Bernanke, Ben; Mishkin, Frederic and Posen, Adam "What happens when Greenspan is gone", Wall Street Journal, January 5, 2000.

Blanchard, Olivier "Country adjustments with Euroland. Lessons after two years", January 2000

Cecchetti, Stephen "The cult of Alan Greenspan: Why the FED needs a policy framework", occasional essays on current policy issues, n° 2, 1999

Cecchetti, Stephen "Remember the 1970's?", Occasional essays on current policy issues N° 11, October 2000

Cecchetti, Stephen "The limits to monetary stabilisation policy", Occasional essays on current policy issues N° 16, August 2001

Cecchetti, Stephen "The European Central Bank: A view from across the ocean", September, 2001

Cecchetti, Stephen "What we need is a forward looking fiscal policy strategy", Occasional essays on current policy issues N° 23, December 2002

Cecchetti, Stephen "Stable growth without inflation: The challenge for monetary policy", Occasional essays on current policy issues N° 19

Cecchetti, Stephen and O'Sullivan, Roisin "The European Central Bank and the Federal Reserve", December 2002

Clausen, Volker and Hayo, Bernd "Monetary policy in the Euro area-lessons from the first years", ZEI WP n°9, 2002

Collignon, Stefan "The European Republic and the challenge of a new constitution", LSE 2003

Collignon, Stefan "How to create an optimal policy mix in the European Union?", Presentation to the European Parliament, June 26, 2001

Down, Ian "Central bank independence, disinflation and the sacrifice ratio", University of North Carolina, Chapel Hill

Duisenberg, Willem "The ESCB: Independent, transparent and communicative", speech delivered at the Bankers' club annual banquet, London, 1998

Eijffinger, Sylvester; De Haan, Jakob and Berger, Helger "Central bank independence: An update of theory and evidence", CESifo Working paer series, WP n°255, February, 2000

Eijffinger, Sylvester "Is the European system of central banks too decentralized and what should happen with the introduction of the Euro in the enlargement countries?", briefing paper, European Parliament, 2002

Fitoussi, P., Jean "Does inflation strike back in Europe?", briefing paper n°2-2002, Committee for economic and monetary affairs, European Parliament

French-German contribution to the work of the European Convention on Economic Governance, December, 2002

Galli, Rossana and Hoeven, Van der, Rolph "Is inflation bad for income inequality: The importance of the initial rate of inflation", employment paper 2001/29

Gros, Daniel and Bini-Smaghi, Lorenzo "Is the ECB sufficiently accountable and transparent?", ENEPRI, Working paper N°. 7/September 2001

Henry, Liu "Life after Greenspan", June 2001

Horn, A., Gustav "An analysis of the ECB's monetary strategy and its contribution to growth and employment", DIW Berlin, 2002

Hutchison, Michael and Walsh, Carl "The output-inflation trade-off and Central bank reform: evidence from New Zealand", May 1998

Issing, Otmar "How to achieve a durable macro-economic policy mix favourable to growth and employment?, Speech in Brussels, May 4 and 5, 2000

Krause, Axel "The American federal reserve system: functioning and accountability", Notre Europe research and policy paper n°7, April 1999

Navarro, Lluis "As the Euro prepares for take off: a critical review of the first three years of EMU", Notre Europe, October 2001

Neumann, Manfred and Von Hagen, Jurgen "Does inflation targeting matter?", ZEI WP B01, 2002

Scheve, Kenneth "Public demand for low inflation", Bank of England, WP n°172

Svensson, Lars "The first year of the Eurosystem: inflation targeting or not?", January 2000

Svensson, Lars "The FED does not provide the solution to the Eurosystem's problems", Institute for International Economic Studies, Stockholm University: CEPR and NBER, May 2001

Svensson, Lars "A good thing could happen at the ECB: An improvement of the Eurosystem's definition of price stability", September 2002

Svensson, Lars "How should the Eurosystem reform its monetary strategy?", February 2003

Surowiecki, James "Will there be life after Greenspan?", August 1999

Wyplosz, Charles "The ECB should save its fire for when it will make a difference", CEPS commentary

Wyplosz, Charles "Do we know how low should inflation be?", Graduate Institute of International Studies, Geneva, February, 2001

Wyplosz, Charles and Artus, Patrick "La banque centrale européenne", Conseil d'analyse économique

Notre Europe

Notre Europe is an independent research and policy unit whose objective is the study of Europe – its history and civilisations, integration process and future prospects. The association was founded by Jacques Delors in the autumn of 1996, and consists of a small team of researchers from various countries.

Notre Europe participates in public debate in two ways. First, publishing internal research papers and second, collaborating with outside researchers and academics to contribute to the debate on European issues. The reports are intended for a limited number of decision-makers, politicians, stakeholders, academics and diplomats in the various European Union countries.

The association also organises meetings and seminars in association with other institutions and publications. In accordance with the statutes of the Association, the European Steering Committee meets at least two times a year. The members of the Committee are of various nationalities and diverse political and professional origins.