The Developing Role of the ECB

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With the imminent introduction of the euro, the importance of the European Central Bank seems set to grow and grow. Aidan Neill looks at the ECB and its overriding goal of price stability. He gives an overview of the theoretical issues on the subject, such as inflation targeting, and reviews the bank's experience so far. He brings his discussion to a close by advising on how best to manage the accession of more member states.

Introduction

The aim of this essay is to look at and define the general role that the European Central Bank, hereafter ECB, will play in an increasingly integrated Europe. I shall look at the design of the ECB and consider its effectiveness, both from the theoretical and empirical points of view, in particular focusing on the Maastricht Treaty statutes. From this initial perspective, I shall go on to look at the first experiences of the ECB and the role it has played thus far in the Euro-land economy. Finally, I will span the bridge towards the future, and look at the role of the ECB when further advances in economic and monetary integration will have taken place.

Theory and Design of the ECB

If we look at economic theory, and in particular the Barro-Gordon model, analysis suggests that high-inflation countries have a lot to gain economically from monetary union, in particular if it is combined with strong political independence. On the other hand low-inflation tending countries have nothing to gain.[1] This very defined asymmetry is clearly important in the design of the ECB. If Germany, as a low-inflation country, is to have any incentive to join a monetary union, then the ECB will have to be at least as focused on low inflation as the *Bundesbank* has been. Noticeably, the Maastricht Treaty statutes clearly incorporate this idea. In the creation of these statutes two main principles are implemented (which are also the key to the *Bundesbank* statutes).

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[1] The model emphasises how economic agents employ optimal strategies in reply to authorities' policies. These private sector responses influence the effectiveness those policies. In particular, governments' reputations in pursuing announced policies have a large impact on how these policies are going to affect the economy.

The first of these principles is that the primary objective of the ECB is the maintenance of price stability. The second principle is that of political independence, which is seen as a necessary principle for the first. It is seen as a necessary condition so that the printing of money will not finance budget deficits of national and European governments. Empirical evidence, to which I shall refer later, makes clear that it is inevitable that a government influenced central bank will be forced to finance budget deficits, which is a guaranteed way to cause inflation. The Treaty itself can be quoted to identify its focus on political independence:

> *"When exercising the powers and carrying out the tasks and duties conferred upon them by this Treaty...neither the ECB nor a national central bank, nor any member of their decision making bodies shall seek or take instructions from Community institutions or bodies, from any Government of a Member State or from any other body."*

De Grauwe (1997) suggests that the language used by the drafters of the statutes of the ECB is harder on inflation and political independence than the statutes of the *Bundesbank*. This would suggest that the drafters were aware of the asymmetry in incentives to join European Monetary Union. The political independence of the ECB will probably be stronger than that of a national bank like the *Bundesbank*, anyway, because of the sheer difficulty of obtaining changes in the statutes. A simple majority in the German parliament can change the statutes of the *Bundesbank*, whereas changes in ECB statutes can only occur through revision of Maastricht guidelines, which requires unanimity across EU authorities.

Possibly Germany was influenced in its decision to join EMU by these principles; this does not necessarily mean that they are desirable. Much theoretical and empirical evidence has convinced many economists that these principles are desirable. I shall discuss possible problems of the Maastricht strategy at a later stage.

At this stage, it is important to clarify with empirical evidence the strategy behind these principles. As commented, the principle of political independence of the ECB is apparently crucial to the ability of the ECB to maintain price stability. Much empirical evidence would suggest that this is true. Notably a regression analysis of 21 industrial countries by de Haan and Eijffinger (1994) identified a clear negative relationship between inflation and independence of central banks.[2] The regression sought to quantify the extent of independence, with each country's

[2] The regression had the result: Inflation = 11.2 – 9.4 independence; R-squared = 0.88

'independence' being rated between 0 and 1 (1 representing 'wholly' independent). The reason for this relationship is identified as political 'short-termism'. It is clear that governments seeking re-election may seek to lower unemployment close to election times and sacrifice the focus on inflation for a time, thus damaging any reputation for anti-inflationary policy it previously had. As a result, it is suggested that monetary policy should be put under the authority of an independent organisation.

One criticism of this analysis is that it is not clear whether the independence rating is an accurate guide. Research by Posen (1994) suggests that both inflation and political independence are the result of deeper running social and economic interests, such as the extent and power of economic pressure groups. So how 'independent' a central bank is may not be merely a function of actual political independence. As a result, even though the statutes of Maastricht may be even tougher on inflation than the *Bundesbank*, actual policymaking may deviate from this apparently hard line. This is due to a social and cultural interpretation of inflation. Some of the ECB's decision makers will come from countries whose dislike of inflation is not as intense as Germany's. Convergence criteria do not, therefore, give Germany a guarantee that EMU will produce price stability.

This, however, is the key role of the ECB and therefore it needs to be strong with incentives for low inflation in place. The Maastricht Treaty criteria fail in the respect of making the ECB accountable for poor performance. The *Bundesbank* is far more accountable than the ECB, as there exists a law describing the responsibilities of the *Bundesbank*. This can be changed by majority vote in the German parliament, which is largely representative of societal interests. In this respect, the ECB has the role of making itself strong with incentives for low inflation, holding its hands up if it fails on price stability credentials. Christian Noyer, the ECB vice-president, recently commented, "The Euro system has chosen a clear and transparent monetary policy strategy with quantitative definition of its primary objective of price stability."

I shall identify the nature of this 'clear and transparent policy' later, but the key point is that in the role of maintaining price stability the ECB needs to adopt harsh disincentives for poor performance. A New Zealand style policy of introducing penalties to central bank law needs to be run by the ECB: failure to hit the targets in New Zealand can lead to the removal of the governor of the central bank. Other possibilities include the reduction of salaries and demotion.

Other incentives will come as a result of direct action by the ECB, through the implementation of reforms of EMU country budgetary processes, to make them less prone to unsustainable budget deficits. The "stability pact" agreed in Dublin, 1996, aims at implementing this sort of mutual control between national financial institutions and the ECB. Another complementary approach put forward by Eichengreen and von Hagen (1995) is the streamlining of budgetary processes in the European Union. The suggestion involves instituting National Debt boards in each country, which would monitor and react to the growth of debt. Clearly the role for the ECB here would be as overlord to these, imploring strong budgetary processes.

The choice of inflation target

Having established that the key role for the ECB is the maintenance of price stability, the ensuing question is at what level inflation should be maintained. Theoretical approaches to answering this question have come up with differing conclusions. In the 1950s, Friedman suggested that the optimal inflation rate was zero because that level maximizes the total utility of holding money. Against this there are several considerations.

Firstly, there is evidence to suggest that conventional measures of inflation tend to overshoot the true inflation rate by around 1-2%. Also, the calculation of the inflation does not account for quality improvements. The price of a computer in 1980 is roughly similar to that now, but the price per unit of computing power is far less than that in 1980. As a result, a zero inflation rate may in reality be deflationary.

A second issue is that sectoral or micro-economic shocks require adjustments in real wages. If demand in a sector falls necessitating a reduction in the real wage rate, it is possible, if inflation is positive, to continue increasing the nominal wage rate at a rate below inflation thus achieving the desired effect. There is a lot of evidence that reduction in the nominal wage rate is very difficult. Keynes commented on this issue saying, "Wage rates are sticky downwards." Employees don't accept wage reductions easily, especially in a nominal sense.

In an environment of zero inflation, the increasing wage rigidity makes adjustments to asymmetric sectoral shocks difficult to achieve. In a recent speech (Feb '00) to "le Club des Affaires de Berlin e.V." the ECB vice-president Christian Noyer talks of the ECB inflation target:

"Price stability is defined as an annual increase in the Harmonised

Index of Consumer Prices (HICP) for the euro area of below 2%. The Eurosystem aims to maintain stability in line with this definition over the medium term."

Clearly the fact that Noyer is speaking to a German audience makes the emphasis on low inflation understandable. Perhaps, however, the target rate of inflation is too low compared to the optimal one, particularly on a Euro-wide basis. If we are to believe the analysis above, a 2% inflation rate may be zero in truth. Such a low inflation target will increase the risk of drawn-out deflationary monetary policies and a reduction in the already rigid level of real wage flexibility. The Treaty does not really stipulate who should determine the target of inflation, rather it stipulates the pursuit of price stability. This is an issue that needs to be resolved. It is not a major issue at the moment because growth is strong, the euro is weak and oil prices are stabilizing (following recent OPEC announcements of increases in supply), although the cracks are appearing.

The issue is that most societies expect the central bank not to abandon completely the ambition of stabilizing the economy during downturns in growth. With each recession pressure will build to relax its monetary stance, particularly from regions where there is low labour market flexibility. Thus the role of the ECB in this respect is to be all things to all nations, clearly a very difficult undertaking. Problems with this 'one size fits all' monetary policy are already being seen. Recently the euro slumped to new lows against the dollar, sterling and the yen as investors responded nervously to mounting evidence of economic strains within the euro area caused by the unilateral monetary policy of the ECB.

The proverbial whistleblower in this regard was the Central Bank of Ireland, which has warned that inflationary pressures are building up rapidly against a background of excess domestic demand and rapid growth. The Irish economy grew by 8.25% last year and is likely to achieve similar this year. The warnings of the bank coincide with crippling transport strikes with wage demands of 20% on top of an already generous three-year deal between government and unions. Also with further recognition of accelerating wages, increasing service sector inflation and sharply rising property prices, it becomes apparent that the 3.5% interest rate applicable across the eurozone is well off the mark required in the Irish context. Some estimates suggest that Ireland needs interest rates closer to 8% to dampen the possible inflationary effects of the present economic situation.

The ECB has pushed up interest rates in the recent period. In its statement, following the increase by 25 basis points, the ECB said that euro-zone economic conditions were better than at anytime in the past decade. Economic growth, the general weakness of the euro, oil price rises and excessively strong credit growth were all cited as reasons for the rate move. Suggestions have been made that we will see further rate rises in the next couple of months, but with recent OPEC announcements of increases in world oil supplies dampening the apparent inflationary pressures these rises may not occur. This leaves Ireland in a situation where interest rates are too low to maintain price stability in the long run. Clearly Ireland is not the only country in the EMU 11 that is not suited to the ECB 'one size fits all' policy.

Unlike German unification, EMU has preceded political union. This makes it necessary to introduce additional features in the framework of EMU so as to enhance the co-ordination between monetary and economic policies. For example the establishment of the Stability and Growth Pact fosters the co-ordination of fiscal policies among Member States on the basis of fiscal rule. One of the roles of the ECB in the future is in the co-ordination of fiscal policies, and help countries into the 'one size fits all' monetary policy.

Towards the future

There are important conditions to be met in order to achieve sustainable non-inflationary economic growth in the euro area. In particular, decisive measures to address the structural problems in Europe are needed, for example in the area of labour markets. As Romano Prodi, President of the EU Commission, in a speech to the EP (February 2000) recently commented:

> *"Even if we see some progress in reducing unemployment in the euro area over the recent months, the structural problems in Europe are still pressing."*

There is clearly no doubt that these problems need to be tackled by policies enhancing the flexibility of Euroland's labour and goods markets. Christian Noyer ("The short past and the long future of the Euro," Feb., 00) continues in this vein:

> *In coming years, the success of EMU demands that the division of policy responsibilities between monetary and government authorities, as set out in Maastricht, is followed. This allows the eurosystem's monetary policy to focus on its primary objective.*

At the same time as this, economic policies can be directed more efficiently towards structural problems prevailing in individual Member States. This sharing of tasks is transparent and therefore conducive to accountability, which will enhance the credibility of monetary and economic policies in Europe.

The focus on price stability does not allow the conditioning of monetary policy actions upon the prospective results of fiscal and structural measures. Similarly, monetary policy cannot be conditional on future wage developments promised by the social partners. It could be conceived that society could interpret such a form of policy co-ordination as the attempt to negotiate the ECB's monetary policy stance with other policy-makers. This might hinder the Eurosystem's direct response to shocks that threaten the maintenance of price-stability.

In the future, the EMU will see the accession of a number of new Member States. These new entrants will need to be subject to rigorous implementation of the 'convergence criteria' on a sustained basis. Exchange rate stability is also a measure of overall convergence, given that exchange rate movements typically reflect, in addition to market expectations, relative movements of economic variables. In this regard "...participation in ERM II fosters convergence for prospective euro area members."

The introduction of the euro in other countries will again require more than just compliance with the convergence criteria. Statistics need further adaptation so as to comply with the Eurosystem's reporting requirements and some changes in national legislation are needed to formally lay the foundations for the introduction of the euro. And "all procedures that involve the Eurosystem and the prospective member country will have to pass a number of real-time tests in order to demonstrate that the infrastructure is operational" (*ibid.*).

Conclusions

It is clear that the ECB will continue with the idea that stable prices are the best contribution monetary policy can make to sustained economic growth in the euro area. Maintaining price stability should continue to contribute to the credibility of the single currency, and can "...pave the way to a long future for the euro." Having said that the real issues for the ECB are in the 'one size fits all' nature of its monetary approach. The ECB should be blinkered in its approach to achieving price stability and not buckle under social pressure to relax monetary policy. Relaxation of the approach will have adverse consequences in the long-run. The ECB does, however have an important role in the transition of countries towards this united monetary policy. It needs to be very clear and transparent about all monetary policy. Continued work needs to be done implementing strategies like the Stability and Growth Pact to truly integrate countries into the union. It is going to be a long a difficult journey as many social and cultural changes may be required to fulfil the process.

It may be the case that properly designed monetary institutions, by adjusting the preferences of the ECB, may substitute for entrance requirements and other surveillance techniques (see Beetsma 1995). It would be interesting to explore in more depth what determines the optimal combination of, on the one hand, adjusting policy preferences of the ECB, and on the other hand, constraining national fiscal policies.

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