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Europe's Quest for Monetary Stability: Central Banking Gone Astray

by

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ABSTRACT

This paper provides an overview of central banking arrangements in those European countries that have adopted the euro. Issues addressed include the structure of the "Eurosystem" and its central banking functions, the kind of independence granted to the system and the role of monetary policy that central bankers have adopted for themselves, the "two-pillar policy framework," operating procedures, and actual performance since the euro's launch in 1999. The analysis concludes that, given the current macroeconomic policy regime, trends, and practices, the euro is on track for failure.

Keywords: Central banking, monetary policy, European Central Bank, Eurosystem, central bank independence, policy strategy, operating procedure.
JEL classifications: E42, E58, E61, E65

Since the late 1980s, the world has witnessed some truly fundamental changes in Europe. At the time when the then European Communities of 12 western European nations laid the foundation for Economic and Monetary Union (EMU) to replace the "zone of monetary stability" which constituted the aim of the European Monetary System (EMS), the iron curtain which had divided the continent since WWII crumbled to pieces and within 15 years the number of European Union (EU) member states has risen to currently 25. Proving many doubters wrong, the (Maastricht) "Treaty on European Union" (TEU) of 1992 led up to the unique event of a widespread replacement of national currencies by a common one, the euro. This involved the establishment of a supranational and highly independent guardian of the new currency, the European Central Bank (ECB). And to make the aspired soundness of the euro even more formidable, this was complemented by a fiscal regime designed to foreclose any potential threats from fiscal profligacy too: under threat of punishment in case of deficits exceeding three percent of GDP, the "Stability and Growth Pact" (SGP) prescribes balanced budgets in the medium term.

To be sure, the euro has not replaced all national currencies in Europe, at least not yet. In fact, it may never come to that, as the euro is currently on track for failure. While this assessment and gloomy (conditional!) forecast will be substantiated in what follows, let me begin by delineating what is not part of "Euroland"[1] today, and thus not subject of the analysis in this paper. Whereas the Danish krona is at least linked to the euro via a fixed exchange rate arrangement, of old (EU15) member currencies both the Swedish krona and the British pound have flexible exchange rates and their respective monetary stewards, the Sveriges Riksbank and the Bank of England, the world's oldest central banks, operate what are widely praised as state-of-the-art inflation targeting regimes. As to the new (EU25) members (as well as potential future members in eastern and southeastern Europe), a wide variety of monetary and exchange rate regimes is currently in place, ranging from currency boards to flexible exchange rates cum inflation targeting (ECB 2004a). While some might adopt the euro as early as 2007, others seem to be in less of a hurry. Finally, Switzerland and Norway have yet to express any desire to join the EU.

[1] Henceforth I will use the term "Euroland" for describing those EU members that have adopted the euro as their currency. All EU members are part of EMU, but those that have not adopted the euro are members with a "derogation" (in Treaty language).

Nor has the ECB replaced the formerly existing central banks in Euroland. Rather, the ECB was designed as the leader of the "Eurosystem," the structure of which will be discussed next.

THE STRUCTURE OF THE EUROSYSTEM

The Maastricht Treaty led to the establishment of *two* new institutions in the area of central banking in Europe: the European Central Bank (ECB) and the European System of Central Banks (ESCB), with the latter comprising the ECB and the pre-existing national central banks (NCBs) of EU countries (ECB 1999c). While not mentioned in the Treaty, it is the Eurosystem which is the actual entity performing the central banking functions for the euro and Euroland, comprising the ECB and the NCBs of only those EU countries that have adopted the euro. Within this narrower system of central banks, on which the following focuses, the ECB is supposed to be in the driving seat; as Article 107(3) of the Treaty establishing the European Community (TEC) says that the Eurosystem is "governed by the decision-making bodies of the ECB."

The relevant bodies are the Governing Council (ECB Council) and the Executive Board (ECB Board). The former includes the members of the ECB Board as well as the NCBs' Governors. The ECB Council's job is to adopt the guidelines and take the decisions necessary to ensure the performance of the tasks entrusted to the Eurosystem. Particularly, the ECB Council *formulates* monetary policy, including the decisions relating to intermediate monetary objectives, key interest rates, and the supply of reserves, and establishes the necessary guidelines for their implementation. Meeting twice monthly, since November 2001, decisions on the monetary policy stance are normally only taken at the first meeting of the month.

The ECB Board includes six members: the President, Vice-President, and four other members, to be "appointed among persons of recognized standing and professional experience in monetary or banking matters by common accord of the Heads of State of Government" (Art. 112 TEC). The Board is charged with *implementing* monetary policy in accordance with the guidelines and decisions laid down by the ECB Council, which involves giving the necessary instructions to the NCBs.

For the actual *execution* of the ECB's policies is largely left to the NCBs. This follows the *principle of decentralization*, requiring that "to the extent deemed possible and appropriate

… the ECB shall have recourse to the [NCBs] to carry out operations that form part of the tasks of the [Eurosystem]" (Art. 12 Statute of the ESCB). While the ECB is the supposed head of the system, the NCBs, in turn, "are an integral part of the [Eurosystem] and shall act in accordance with the guidelines and instructions of the ECB. The Governing Council shall take the necessary steps to ensure compliance with the guidelines and instructions of the ECB, and shall require that any necessary information be given to it" (Art. 14(3) Statute).

This peculiar design of the Eurosystem's structure reflects a balancing act of national interests and European aspirations that raises a number of issues. On the one hand, a single currency means a single monetary policy common to all member countries, which requires clear leadership in policymaking and commonality in policy execution. On the other hand, completely abolishing existing NCBs (together with the national currency symbols) and starting from scratch was deemed inopportune. As a solution, the NCBs were combined to a system of central banks, with a new head added to it. The point is that while the NCBs lost their previous authority in monetary policy matters,[2] they may still be engaged in other central banking functions that have a more national rather than system-wide focus. Recall here that Euroland lacks a common fiscal authority, as for the time being fiscal policy remains under national control.

One issue is that conflicts can thus arise between system-wide responsibilities and other more national functions and interests. Another that the NCBs, given their loss of monetary policy authority, could also be expected to keenly fight against any further drains of their prerogatives vis-à-vis their respective national authorities and players. However, not least due to budgetary pressures, but perhaps also for reasons of envy and suspicion concerning the NCBs' *shared* monetary policy authority for Euroland over which national political authorities have lost any control, many NCBs have found themselves caught up in more general overhauls concerning their functions.

While overstaffing characterizes Euroland's central banking landscape anyway, there appears to be a tendency to slim down the NCB's non-monetary policy functions too. In particular, responsibilities for financial regulation and supervision, apart from being amalgamated following the single-agency approach, tend to be transferred to separate

[2] Arguably, NCBs other than the Bundesbank had long lost their actual power in that area but could at least hold on to some of the public esteem that tends to come with the—apparent—power over money.

authorities (ECB 2003c, 2004b).[3] Another interesting example is the Bundesbank's loss of its debt management mandate, as this function was outsourced to a newly founded authority. In this on-going struggle for self-preservation, there is also the potential for rivalries among NCBs as to the fulfillment of functions and services that reach beyond national borders (perhaps most visible in the area of payment systems in the context of establishing a shared TARGET 2 platform).

A closely related issue is that in their operations the NCBs act within and focus on their respective national financial systems, which, traditionally, they are trying to foster (and protect). As part of the overall agenda to fully integrate Europe's economies, a fully integrated pan-European financial system is both an important goal in its own right as well as a precondition for running a common monetary policy efficiently. Yet, as this is likely to involve a concentration of financial activity in certain financial centers, it also raises the question as to which should be the foremost financial centre in Europe.

Right from the start London would have seemed the natural candidate, and one might speculate here whether locating the ECB in London would have done more to lure the U.K. into EMU. As it happened, Germany—doing its utmost to bequeath the Bundesbank stability mantra to the ECB—got its way in this matter too, by hosting the ECB in Frankfurt (Dyson and Featherstone 1999). Yet, just as the location of the Federal Reserve Board in Washington has never prevented New York from being the U.S.'s premiere financial centre, London is thriving with the U.K. staying outside EMU, and the quest for financial hegemony within Euroland is still on-going. While the Eurosystem's design had thus left it for markets to decide where financial activities might concentrate, issues of rivalry among NCBs once again emerge here, just as national governments remain engaged with EU institutions in the area of financial regulation too.

In comparing the ECB to the Federal Reserve Board, it is important that the former is not a mere board, but a proper bank with a balance sheet capable of carrying out central banking *operations* on its own. This is especially important when it comes to foreign exchange

[3] Euroland's next-door neighbor to the west may be leading the way here, as a Financial Services Authority was established at the time when the Bank of England gained operational independence; reflecting the U.K.'s more balanced democratic traditions and attitudes towards a concentration of power. The ECB lends its support for the NCBs' efforts to retain their powers in the area of financial supervision though. The Treaty says that the Eurosystem "shall contribute to the smooth conduct of policies pursued by the competent authorities relating to the prudential supervision of credit institutions and the stability of the financial system" and that specific tasks in this area may be conferred to the ECB (Art. 105(5 and 6) TEC).

operations, as a large part of the ECB's balance sheet consists of foreign exchange reserves (largely U.S. dollars). The ECB's reserves resulted from the transfer of such assets from the NCBs, which however continue to hold large foreign exchanges reserves themselves too, so that both the ECB and the NCBs are in a position to carry out foreign exchange operations.

Given that authority in the area of exchange rate policy is less than clearly defined by the Maastricht Treaty,[4] securing a common stance of the Eurosystem is much more of an issue though.[5] This is the case since NCBs' foreign exchange reserves (and similarly in the case of gold) remain part of *national* wealth, and profits and losses on these assets (as part of NCB's overall profits/losses) thus affect *national* budgets. Also, since the NCBs own the ECB, the latter's profits (losses) are distributed to (borne by) the NCBs too; in accordance to their respective capital shares.

For instance, in 2004, the ECB incurred a significant loss that was mainly due to the depreciation of its U.S. dollar reserves (as well as falling interest rate earnings in the context of "historically low" interest rates). It is worthwhile to recall here that back in 2000, when the euro was plunging, the Eurosystem could have put its dollar reserves to good use. Apart from stabilizing the euro, the resulting profits would have delivered welcome relief to Euroland's public finances. Indeed, the profits of the year 2000 would have provided scope for anti-cyclical measures when domestic demand slumped in 2001. Alas, apart from two occasions in September and November 2000, central bankers refused to make timely use of their abundant ammunition, allowing this opportunity to slip through taxpayers' fingers. It does not take too much imagination to consider this behavior as related to the Eurosystem's notorious pressure for fiscal consolidation. Central bankers may still come to regret this though. As the ECB's losses aggravate the NCBs' financial situation and thus further add to today's general plight in public

[4] Art. 105 TEC lists among the Eurosystem's functions: to hold and manage the official foreign exchange reserves of the Member States and to conduct foreign-exchange operations in accordance with Art. 111 TEC, while the latter mentions the possibilities of formal agreements on an exchange-rate system as well as of "formal orientations for exchange-rate policy"—to be formulated by finance ministers "without prejudice to the primary objective of the Eurosystem to maintain price stability." While some observers see in Art. 111 a threat to the Eurosystem's independence, it should be remembered that in countries like the U.S., Japan, U.K., and Sweden foreign exchange policy remains under government authority. In the relevant Bundesbank's case, an ambiguity existed due to an informal arrangement between the bank and the government (the famous "Emminger letter") signed at the time of the start of the European Monetary System which granted the Bundesbank to pull out of its obligation for unlimited foreign exchange interventions; as occurred at the end of that system in the early 1990s.

[5] In fact, Bofinger (2003) produced evidence that the Eurosystem's foreign exchange reserves—due to individual NCBs' conduct—declined during the period of January to April 2003, i.e. followed the trend.

finances, this is unlikely to boost central bankers' prestige and sympathies among national parliaments.[6]

The other key area in which central banks are most likely to incur potentially huge losses is in fulfilling their lender-of-last-resort function. In this regard, euro area arrangements remain special too though—related to the lack of a common fiscal authority that could provide the "deep pockets" in case of serious financial system problems and bank re-capitalizations. Essentially, the NCBs continue to be in charge within their respective national financial systems, as *national* lenders of last resort in case of *country-specific* problems, while it remains to be seen how cross-border systemic problems would play out and be responded to should they arise. Tomaso Padoa-Schioppa, the ECB Board member in charge of this area until very recently, may perhaps see this as a case of "constructive ambiguity." But others have regarded this as a serious threat from early on (see Prati and Schinasi 2000, for instance). It has to be said that the ECB proved itself capable of moving swiftly (and in collaboration with the U.S. Federal Reserve) following the events of September 11. Most recently, an "understanding" was reached to enhance the practical arrangements concerning cooperation in cross-border crisis situations that, in contrast to an earlier understanding between EU banking supervisors and central banks only, involved EU Finance Ministries too (see ECB Press Release, 18 May 2005).

These issues have to be seen in the context of the construction of the ECB Council, which, apart from being too large, also shows a clear overweight presentation of NCBs, currently 12 versus 6 ECB Board members.[7] Given the "one person, one vote" principle ruling at the ECB Council, some observers expressed concerns about the minority position of the ECB Board and the fact that any NCB president of a small country, say Luxembourg,[8] carries the same voting weight as the representative of a large county, say Germany. These arrangements reflect the idea that NCB presidents in their capacity as ECB Council members do not act as

[6] For instance, the Bundesbank's annual profits plunged from over 11 and 5 billion euros in 2001and 2002, respectively, to less than one billion in both 2003 and 2004, causing huge shortfalls in federal budget plans. In fact, the Bundesbank only avoided an outright loss for the year 2004 by—surprisingly—resorting to exceptional accounting measures. In this context, recurrent conflicts between the Bundesbank and the government/parliament on the potential use of gold sales to partly compensate these shortfalls featured a major clash in March 2004 when Bundesbank president Ernst Welteke walked over the German parliament. And it is not without interest to mention here Welteke's resignation in early April 2004, after being caught up in a hospitality affair (FT 16 April 2004). Another related issue here is the redistribution of seigniorage that arose as the euro replaced the deutschmark.
[7] As the problems of size and national overweight would have increased even further with potentially 25 (or even more) member states, an adjustment of voting modalities in the ECB Council (featuring a rotation system to come into effect once the 16th member enters Euroland) was agreed in 2003 (ECB 2003a).
[8] In fact, as (low public debt) Luxembourg was previously in a long-standing monetary union with (high public debt) Belgium, it only established its own NCB for this very purpose.

national representatives. Instead, the presumption is that they follow the script and aim at determining optimal monetary policy *for the euro area as a whole*. One sad fact is that outsiders are not in any position to judge what happens inside the ECB generally and whether individual central bankers live up to their responsibilities in particular; an issue that will continue to engage us in what follows. Another discouraging fact is that governments continue to focus on nationality rather than merit when it comes to selecting ECB Board members.[9]

CENTRAL BANK INDEPENDENCE AT ITS BEST—OR WORST?

Central bank independence (CBI) has been on the rise worldwide since the 1990s (Bibow 2004a, Forder 1998). In many cases, care has been taken in weaving the newly or more independent central bank into the democratic structures of the respective states involved. In Europe, the Bank of England and the Sveriges Riksbank are cases in point. In the Swiss National Bank's case too, guardian of Europe's hard currency par excellence, the finely balanced democratic attitudes of that country still shine through its monetary structure.

In Euroland's case, however, the opposite approach to CBI design was taken: the overarching principle was to shield central bankers from any possible political control. And the vision of a central bank perfectly outside any political control was actually achieved. There are no effective checks and no real accountability on performance in place whatever. Arguably, the ECB is the world's most independent central bank. Its designers even topped the Bundesbank model. For while the Bundesbank was only protected by a simple law that could have been changed at any time, the ECB's independence is engraved in the Treaty's marble; requiring unanimity for change. There is thus not even much of a threat to the ECB of becoming subjected to political control in case of too obstinate estrangement of Euroland's democratically-elected representatives.

I have for long argued that this is not just a politically absurd situation (more politely referred to as a "democratic deficit;" see also Begg and Green 1998). It is also an economic paradox: "Starting from an overriding principle of disciplining policymakers as the foundation

[9] This foolish procedure started in June 2004 when the Spaniard Eugenio Domingo Solans was replaced by the Spaniard José Manuel González-Páramo. Then the Italian Tomaso Padoa-Schioppa was replaced in June 2005 by the Italian Lorenzo Bini-Smaghi. Now Euroland is bracing itself for the prospect of another German replacing the ECB's influential chief economist Otmar Issing in June 2006. And Germany's Christian Democrats, likely to win the September 2005 general elections, already made it clear they want someone "just like Issing" (FTD 16 June 2005). Note here that in the following I will generally use ECB as a shorthand for the whole Eurosystem, as is common practice.

of stability, the ECB ended up as the 'benevolent dictator' in the scheme" (Bibow 2002b: 33), enjoying *unbounded discretion*.

The key stipulations concerning the Eurosystem's *institutional independence* are in Articles 108 and 109 TEC. The former states that "neither the ECB, nor a NCB, 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. The Community institutions and bodies and governments of member states undertake to respect this principle and not to seek to influence the members of decision-making bodies of the ECB or of the NCBs in the performance of their tasks," while the latter adds that: "each member state shall ensure … that its national legislation including the statutes of its NCB is compatible with Treaty and the Eurosystem's Statute."

Closely related to this obsession with shielding the supposed benevolent dictator, public relations in Euroland are characterized by the following curiosity: On the one hand, Euroland's central bankers are notorious for lecturing on matters relating to other actors' areas of responsibility while, on the other hand, any comment on monetary policy issues by any politician will be promptly declared as representing an attack on their sacred independence. In particular, any suggestion that the ECB might wish to consider an interest rate cut provides a welcome excuse for not doing so, as central bankers apparently have to prove their independence in this way. By contrast, central bankers' notorious calls for structural reform and budget consolidation are to be treated as sound advice—and any failure to heed the advice is providing yet another excuse for not easing interest rates. In all this the ECB is following its model's route to fame. In the past, the Bundesbank often successfully pulled off the same trick to stylize the government as the attacker on the currency, thereby raising its own profile as guardian of stability in the public's view. Interestingly, these showdowns were a key aspect of Germany's "stability culture," they—and the ECB's "public education campaigns" more generally too—have so far failed to impress Euroland's public opinion all that much. Obviously, such staged conflicts "are not on show" in countries with policymakers who ease policy stance in a timely fashion when changing circumstances so require (Bibow 2004b).

Other key aspects of CBI include the fact that members of the ECB Board serve long terms during which they cannot be fired unless they "rob the bank" (namely: non-renewable eight-year terms). In other words, central bankers are operating in an extraordinarily inflexible labor market. Only that in this particular labor market segment this rigidity is seen as a virtue that enhances performance (dubbed *personal independence*). In addition, the ECB's *financial independence* includes various safeguards of the "printing press" as well as the system's budgetary autonomy. Central bank loans to state bodies and privileged access of state bodies to credit from financial institutions are prohibited, while the ECB has the exclusive right to authorize the issue of banknotes.[10] As to budgetary authority, it is not without interest that the ECB enjoys much leeway in setting conditions for its own staff as well as regards the funding of "independent" research that it may have an interest in; apart from the discretion in determining its yearly bottom line (which affects public finances and taxpayers).

Even as today's conventional wisdom values independence highly, accountability is generally seen as the natural counterpart to it. Alas, the designers of the ECB were obsessed with the former, but forgot all about the latter. Admittedly, the ECB must report to the EU Parliament (EP). And it is also true that there is a quarterly "Monetary Dialogue" between the ECB's President and the EP's Committee on Economic and Monetary Affairs. The point is that this mechanism has no real bite and the ECB can always "get away with murder"—while Congress has the power to change the Fed's independence, for instance.[11]

In the end, it thus all depends on personalities and on whether the ECB chooses to be sufficiently transparent in its affairs, so as to at least allow public scrutiny to provide a surrogate for political control and effective accountability on performance. On the ECB's view, its publications and regular press conferences that follow Council meetings provide everything that is needed in this regard. Not everyone agrees though (Buiter 1999). In particular, the ECB refuses to publish minutes and voting records. It is thus impossible for outsiders to get any clear idea on the policy debates that underlie the bank's decisions or to assess the conduct and contributions of individual ECB Council members. I will return to this issue below, as there has been widespread criticism of a lack of transparency among both academics and market participants, in particular.

[10] In a broader sense, the Treaty's provisions on "excessive government deficits" (Art. 104 TEC) and the so-called Stability and Growth Pact also fall under this heading.
[11] In a recent incident, the EP rejected the ECB's tough interest rate policy (FT 5 July 2005), even after its monetary affairs committee praised that very policy the day before (FT 4 July 2005). The ECB's response to the EP's vote was "that it was a parliamentary matter" (FT 5 July 2005).

POLICY OBJECTIVES AND THE ECB'S INTERPRETATION OF ITS MANDATE AND ROLE

Before however it is important to emphasize that the ECB's independence includes both instrument as well as goal independence. The key Article 105 TEC reads: "The primary objective of the ESCB shall be to maintain price stability. Without prejudice to the objective of price stability, the ESCB shall support the general policies in the Community with a view to contribute to the achievement of the objectives of the Community as laid down in Article 2," including "a high level of employment … sustainable and non-inflationary growth, a high degree of competitiveness and convergence of economic performance." The proviso "without prejudice" is crucial. How and under what circumstances monetary policy might wish to support policy goals other than price stability appears to be left to the ECB alone.

The ECB's goal independence partly derives from the lack of a definition of "price stability." Whereas the U.K.'s monetary structure features the Government's prerogative to define the Bank of England's target (together with other safeguards), the ECB keenly grabbed the chance to fill the Treaty's vacuum itself when it interpreted price stability as: "a year-on-year increase in the Harmonized Index of Consumer Prices (HICP) for the euro area of [safely] below 2 percent," which was complemented by the proviso that this was to be maintained "over the medium term." Faced with the immediate criticism that its definition was asymmetric, the ECB argued that the word "increase" implied that deflation was considered undesirable. Yet, even after the strategy review outcome of May 2003 (see ECB 2003b, Press Release of 8 May), "confirming" and "clarifying" the aim of an inflation rate "close to but below two percent," the conspicuous lack of a clearly specified lower bound remains.

The other source of goal independence derives from the ranking of goals, which may seem paradoxical at first. Yet, rather than reducing central bankers' discretion, a hierarchical objective may actually enhance it. For the ranking of goals as such does neither render monetary policy a predominantly technical decision, nor does it make monetary policy any less political. Instead, it risks unnecessarily obfuscating important policy trade-offs and responsibilities involved.

In principle, the ideal of turning monetary policy into a technical affair could be achieved on either of the following two conditions: if monetary policy really only affected the primary (or sole) goal it is directed at, or if eminently political choices on trade-offs are laid down for the supposed central bank technicians. The first possibility is pure fiction as not even mainstream economists deny that monetary policy is non-neutral in the short run. While, ideally, this should be achieved in an explicit and public manner, the second possibility can at least be approximated in more informal ways too, namely, by transparency on the part of central bankers on the one hand, and public backing of their analyses and decisions by the political authorities on the other.

This kind of arrangement seems to have been established in the U.K. where public confrontations between the Chancellor of the Exchequer and his Monetary Policy Committee are conspicuous for their absence. Instead, Gordon Brown was seen backing the MPC's decisions on critical occasions, thereby underlining that the Bank of England is an integral part of overall economic policy for which the government of the day is responsible and accountable to Parliament.

In Euroland, by contrast, the roles of master and servant in economic policymaking are of reverse order. Shielding central bankers from any political control, the Treaty seems to grant the ECB unbounded discretion in framing the role of monetary policy to its own liking. In practice, Euroland's independent central bankers—apart from notoriously congratulating themselves on their own performance with regard to their "sole" price stability goal—have taken it upon themselves to lecture everyone else on what they should be doing in their respective fields of responsibility. Viewing policy coordination as conflicting with the ECB's independence (ECB 2000), there currently is no effective coordination of policies in place in Euroland. *Essentially, in Euroland, the macroeconomic policy-mix at any time is not a deliberate but random outcome.*

Mainstream economists would not necessarily see the absence of explicit policy coordination as a problem though. In particular, proponents of inflation targeting would argue that optimal outcomes can be achieved as long as monetary policymakers fully internalize fiscal stance. Regarding monetary policy as the more flexible and more effective stabilization tool anyway, on this view, it is best for fiscal policy to commit to a certain policy while leaving it to monetary policy to adapt to whatever that may be.

It is thus of vital importance that the ECB altogether denies its supposed role as primary stabilization instrument. In fact, the ECB asserts that through delivering on its primary price stability mandate monetary policy automatically also makes its best contribution to any other goal: "Maintaining price stability *in itself* contributes to the achievement of output and employment goals" (ECB 1999a, p. 40; emphasis added). Similarly, Mr. Duisenberg explained that "… we always maintain—and we still do—that the best contribution that monetary policy can give to fulfil that second task is to maintain price stability" (Duisenberg, Monetary Dialogue, March 2001). Mainstream economists have a hard time making sense of the ECB's price stability mantra though: "In this remarkable interpretation of the Treaty, the ECB fulfils its double mandate by reducing it to a single responsibility, a focus solely on price stability. All other objectives are then realized automatically. In this view the ECB cannot be held responsible for what happens in the real economy. We consider that this view is not just narrow, but mistaken" (CEPR 2002, p. 12).

THE "TWO-PILLAR POLICY FRAMEWORK" AND NO END TO OPACITY AND CONFUSION

Criticisms of the ECB's lack of transparency and confusing communications generally focus on its "two-pillar" policy strategy announced in October 1998. Some problems directly related to the chosen definition of price stability (to be maintained "in the medium term") were already noted above; as were some others related to the ECB's obscure and nonsensical proclamations on its secondary mandate, which it apparently fulfils automatically through delivering on its primary one. As to the two pillars featuring in the policy strategy, the monetary one is essentially a piece of Bundesbank nostalgia, whereas the other features a "broadly based assessment of the outlook for price stability in the medium term" that is widely confused as (implicit) inflation targeting.

Partly reflecting popular concerns about the time-inconsistency and credibility problems in monetary policy, the ECB has always emphasized that its lack of a track record and established reputation represented a problem that could best be alleviated by holding on to the policy wisdom of its "most successful" predecessors. With the Bundesbank's former chief economist Otmar Issing taking over the same position at the ECB in June 1998, this essentially meant implanting Bundesbank wisdom into Euroland's new guardian of monetary stability.

It must be stressed that the ECB's "monetary pillar" has nothing whatever to do with monetarism. Milton Friedman designed his monetary rule as a device to restrict central bankers' discretion (ideally to zero!) (Bibow 2002c). By contrast, the ECB, perverted "monetary targeting" as a device to maximize its discretion. Perhaps being a little less fuzzy about it than the Bundesbank, the ECB (1999a) declared that "the concept of the reference value does not entail a commitment on the part of the ECB to correct deviations of monetary growth from the reference value over the short term."

In practice, the reference value was set at the conspicuously low annual rate of 4.5 percent in October 1998, so as to provide a standing excuse for rate hikes. A drastic money growth slowdown and reference value undershot in 2000 was then bluntly ignored when the ECB was in tightening mood, whereas reference value overshoots have provided many a convenient excuse for not easing policy on other occasions. With the policy review of 2003, the two pillars swapped places and the monetary pillar is now justified as a "cross-checking" device that would signal longer-term risks to price stability which apparently are at risk of being overlooked in the economic analysis of short to medium-term risks to price stability under what is now the first pillar.

Under the price stability pillar, which many confuse as inflation targeting in disguise, the ECB uses a wide range of conventional short-term economic indicators meant to provide a comprehensive understanding of the prevailing and prospective economic situation to assess the outlook and risks to price stability. Among other things, the ECB publishes the inflation and GDP growth forecasts of external forecasters. In December 2000, the ECB also started to publish internal forecasts (first bi-annually, since 2004 on a quarterly basis). But these are not owned by the policymaking ECB Council. They are presented as *staff projections*.

This peculiarity is part of the ECB's endeavor to distance itself from inflation targeting. And, at least in my view, it is a mistake to describe the ECB as an inflation targeter—as many mainstream economists do. In fact, there is a widespread view that says that despite the ECB's confusing words and outright denial of such claims, its deeds closely correspond to inflation targeting. For instance, the CEPR (2001, p. 2) attested that "targeting inflation is very close to what the ECB has been doing—regardless of the rhetoric—and to what it should be doing." Importantly, it is not just that the ECB refrains from using internal inflation forecasts as the key ingredient to its policymaking and communication processes—as characterizes inflation *forecast* targeting proper (Svensson 1997). Its whole mindset and the actions this has inspired are not of a *symmetrically* forward-looking kind at all—when symmetry is key to the supposed employment-friendliness of inflation targeting. Perhaps the ECB may be compared to a driver who is quick at slamming the brakes, but notoriously abstains from using the accelerator.

The key issue here is that even today's mainstream views output stabilization as both as integral to inflation targeting as well as a foremost duty of monetary policy. The ECB, by contrast, has been at pains to stay clear from any such ideas and obligations. In many ways, the ECB's mindset is a product of the 1970s, when "fine-tuning" supposedly went seriously astray. Its "stability-oriented" monetary policy is all about avoiding fine-tuning. But at the same time, as I mentioned before, all this has got nothing to do with Milton Friedman's approach to the problem either, which was the design of a monetary autopilot regime. For quite clearly—by their very nature!—interest rate policies are anything but an autopilot regime. If a central bank deliberately sets interest rates, it also has to adjust rates when the economic environment changes. Otherwise monetary policy sets off, what Knut Wicksell (1898) described as, "cumulative processes" causing instability. Alas, and seriously conflicting with today's conventional wisdom, the ECB has not only obfuscated its policies through an ill-designed strategy and confusing words which provoked market opposition. Misguided by confused ideas and outdated doctrines, the ECB's deeds, that is its interest rate policies, have seriously destabilized Euroland. Before assessing its performance, the ECB's technique of making its interest rate polices effective in the market deserves a few comments too.

THE ECB'S OPERATING PROCEDURES

Like any other central bank, the ECB too conducts interest rate policies. Like any other central bank, it sets some key short-term interest rates, which thereby become the linchpin of interest rates and asset prices in the economy more generally. The ECB's operational target is the overnight rate (for which a "euro overnight index average" (EONIA) exists). Accordingly, liquidity ("reserves") is endogenously supplied to the system so as to make the target rate effective in the market. Largely inspired by the Bundesbank's past practices, the ECB uses open-market operations (mainly) in the form of repurchase agreements, standing facilities, and a reserve requirement (ECB 1999b).

Compared to state-of-the-art central bank practices in countries like the U.K. and Canada, for instance, the reserve requirement tool is of course something of a relic. While minimum reserves are fully remunerated and thus do not tax the banking system, the tool serves mainly two aims. First, it enlarges the structural liquidity deficit position of the market, thus allowing the ECB to operate as the marginal *provider* of liquidity on a larger scale. Due to the system's disproportionately large foreign reserve holdings the note issue alone initially provided only little leeway in this respect.[12] Second, the tool's averaging provision allows the ECB to be "lazy"—its regular repo tenders are only on a weekly basis; while more frequent fine-tuning operations would otherwise be necessary to stabilize interest rates at the desired target. Needless to say, if this is part of the overall pretence of providing a monetary order of price stability without apparently interfering all that much in the market process, it is an altogether foolish attempt given that it is interest rate policies that anchor the market process in the first place.

Another characteristic of the Eurosystem's decentralized liquidity policies is that it uses a very wide circle of counterparties, who also have access to the system's standing facilities. Together the demand-driven deposit facility and the marginal lending facility provide a corridor of usually 200 basis points for the overnight rate, a kind of market maker's spread that limits the maximum movement of the overnight rate and within which an EONIA target rate acts as attractor of the overnight rate. Since June 2000, the Eurosystem's main refinancing operation (MRO) has been carried out as variable rate tenders, with the "minimum bid rate" playing the key role of signaling the policy stance.

Unsurprisingly, apart from regular volatility spikes on the final day of the reserve maintenance period, the ECB was generally successful in making its overnight target rate effective in the market. In its liquidity management, however, the ECB repeatedly encountered "underbidding" problems related to market expectations of impending interest rate cuts. After punishing banks for such "misbehavior" on a number of occasions, revisions to the operating procedure took effect in March 2004 (ECB 2003d) to immunize bidding behavior against expectations of rate changes: the maturity of the MRO was shortened from two to one week, and the timing of the reserve maintenance periods were aligned with the settlement day of the MRO following the ECB Council meeting at which the monthly decision on the monetary policy stance is pre-scheduled. In addition, the ECB now provides forecasts of the autonomous factors affecting the liquidity position and carries out fine-tuning operations on the final day of the reserve maintenance period.

It is true that, except on a few occasions, short-term money market rates have generally predicted the ECB's next move correctly. This does neither mean that the markets properly understand nor appreciate the ECB's policies though. Dropping hints a few days ahead of council meetings is an easy thing to do. But this practice hardly qualifies as properly transparent

[12] Today's balance sheet proportions reflect the strong growth in the demand for banknotes in recent years and depreciated values of foreign exchange holdings.

policy conduct. Until today, the markets have not only had difficulties in deciphering the ECB's reaction function. To the extent that they got a grasp of what it might be, the markets have often not appreciated what is widely perceived as a notorious neglect of economic growth.

In fact, among academic researchers, the general public, and the body politic too, the seriousness of this problem is increasingly being recognized. Not for the first time since the global slowdown back in 2001, pressures on the ECB to easy policy were mounting from all around in the spring of 2005. Most recently, the OECD (2005) called on the bank to ease interest rates to address the problem of protracted domestic demand stagnation across the euro area. Not for the first time, if anything, this has provided yet another excuse for the ECB to dig in its heels and refuse to cut interest rates—when Euroland's independent central bankers showed no such reluctance back in 2000 when they hiked interest rates at a mind-boggling pace.

MONETARY POLICY PERFORMANCE, HYPE AND HYPOCRISY

Recall the metaphor I used above, of a driver who is quick at slamming the brakes, but notoriously abstains from using the accelerator. Between November 1999 and October 2000, the ECB hiked rates by 225 basis points, nearly doubling policy rates within less than a year. It then stood by as domestic demand, quite predictably, plunged after mid 2000. Ever since, the ECB has shown itself conspicuously reluctant to cut interest rates to boost domestic demand. It has routinely forecasted that—despite allegedly all-pervasive structural problems!—economic recovery is just around the corner, so that lower interest rates would not be necessary or even counterproductive. As the promised recovery has failed to materialize until today, there has been many an occasion to blame this failure on structural problems nonetheless (usually paired with the assertion that fiscal profligacy too was behind stagnation).

Recall also the hype about central bank independence and the supposed soundness of the Maastricht regime that characterized the 1990s EMU propaganda. It then seemed that maximizing central bank independence and disciplining spendthrift finance ministers offered a panacea to anything that had gone wrong in Europe in previous times. Actual outcomes have proved skeptics right in their worst fears: the ECB has made poor use of its unbounded discretion, inflicting an anti-growth bias on Euroland. More surprisingly, the ECB has thereby also contributed to keeping inflation *above* 2 percent since 1999. In fact, *the bank's* *performance since the start is best described as a series of policy blunders that pushed inflation up and GDP growth down.*

The first blunder consisted of a clash between the ECB and financial markets, which resulted in a marked depreciation of the euro. The second featured the bank's refusal to cut interest rates and boost growth, which resulted in a productivity slump that pushed up unit labor costs. And the third blunder witnessed a continued refusal to cut interest rates so as to stimulate a recovery, which saw fiscal policy, constrained by the Stability and Growth Pact, shifting into reverse gear. This series of policy blunders pushed inflation up and left Euroland in a very fragile shape when the dollar's depreciation prevented the world's second largest economy from free-riding on external demand yet again.

As to the euro's plunge, the ECB's role was one of acting as a two-fold propagation mechanism as the bank's words and deeds provoked market opposition. While Wim Duisenberg, the ECB's first president, was legendary for his gaffes, it was no less important that Otmar Issing's monotone "price stability above all else" anthem was way out of tune with the climate in financial markets at the time. The climate was one of growth enthusiasm, with inflation risks not seen as any serious threat. So when the ECB backed up its confusing words with all too clear actions, i.e. aggressive interest rate hikes, the markets simply took fright, preferring policymakers that were perceived as more growth friendly.

Interestingly, the risks and foreseeable consequences of *euro-weakening interest rate hikes*[13] were clearly spelled out by the European Commission. In its 2000 review of the EU economy, the EU's protagonist of structural reform no. 2 vigilantly observed: "To the extent that the depreciation in the euro is due to cyclical divergence between the euro area and the United States, a rise in interest rates in an attempt to support the currency could even backfire if it was perceived as stifling the euro-area recovery. The risk of creating an even more unbalanced growth pattern with weak domestic demand and higher export growth would be serious" (EC 2000: 71). It so happened that the ECB managed to push inflation up while choking domestic demand through its aggressive hikes.

It would be wrong to regard inflation *above* 2 percent as a justification of the subsequent refusal to cut rates as fast as it had hiked them.[14] For the ECB's "wait and see" attitude (when it

[13] See Bibow (2001b, 2002a) on the time-inconsistency hypothesis of the euro's plunge.

[14] The ECB's commentaries show that the bank was not just out of touch with financial markets, but also with developments in the economy. The January 2001 Bulletin's editorial discussed the U.S. Fed's first 50 basis points cut of 3 January 2001 with reference to increasing uncertainty surrounding the economic growth performance in the

comes to easing) provoked a severe productivity slowdown and a corresponding rise in unit-labor costs. While the euro's plunge pushed up headline inflation through magnifying the price effects of high oil prices and rising import prices more generally, blunder no. 2 saw to it that core inflation followed suit in 2001.

Of course protracted stagnation and rising unemployment are bound to cause budgetary troubles too. And this is where the ECB's blunder no. 3 comes in. A sound monetary policymaker *internalizes* fiscal policy. Given Euroland's fiscal regime, ill-named the Stability and Growth Pact, it was clear from the start that monetary policy had to shoulder the bulk of the stabilization burden—or else face the consequences of a destabilized economy.[15] The IMF even reminded the ECB of this textbook wisdom, referring to monetary policy as "the first line of defense." Mr. Duisenberg responded that he had never heard of that ("Duisenberg Defends Holding Rates Steady," *Wall Street Journal Europe,* 9 October 2002). Especially against the background of very low and stable wage inflation the ECB's record of keeping inflation above 2 percent for five years in a row represents something of a miracle. In fact, with wage inflation running at 2.5 percent since the mid-1990s, maintaining price stability would seem like a fool's job. It is thus crucial to appreciate that it was actually due to protracted stagnation that inflation has stayed stubbornly above 2 percent for so long.

In particular, a conspicuous gap has opened up since 2001 between "headline inflation"[16] and what may be seen as *market-determined* (as opposed to government-determined) inflation. Rises in indirect taxes and administered prices, reflecting finance ministers' desperate but vain attempts at keeping budget deficits below 3 percent, led to an upward distortion in headline inflation that reached 0.7 percentage points by the end of 2004. *Without "tax-push inflation" the ECB would not have failed on its price stability mandate in the last four years* (Bibow 2003, 2004c, 2005).

U.S., but in February the ECB declared: "While this deceleration will have some dampening effects on euro area net exports, the euro area is a large economy in which economic developments are determined mainly by domestic factors. Overall, the fundamentals in the euro area remain broadly favorable" (ECB Monthly Bulletin February 2001:, p5). As the euro's plunge extended the export boom, domestic demand tanked; seemingly unnoticed by those who had enacted stability-oriented monetary tightening in previous quarters.

[15] While some would argue that EMU implied the death of fiscal policy as a tool for macroeconomic stabilization, I use the notion of fiscal policy here to describe the macroeconomic effects (mainly) on aggregate demand that Euroland's huge public sector *inevitably* continues to have; even though one might perhaps better call it "anti-demand policy." On the fiscal policy issue see: Goodhart 1998, Bibow 2004d, and Seccareccia and Lequain (2005).

[16] While policymakers generally focus their attention on "underlying" inflation trends driven by the current and prospective state of the economy, it is often the overall CPI inflation that "catches the headline."

Similarly, it is hard to deny that with a more adequate monetary policy response to the *symmetric* shock that hit the euro area in 2000-01, which was itself at least partly monetary in nature, the failure of a rising number of member states to stay within the 3 percent budgetary threshold could have been avoided. Put in a nutshell, fiscal and monetary policies have prevented each other from achieving their respective primary (or sole) goals, deficits below 3 percent of GDP and inflation below 2 percent.

No doubt, then, Euroland has been plagued with a highly counterproductive interaction between fiscal and monetary policies in recent years, featuring a stability-oriented vicious circle with tax-push inflation as the key symptom in a macroeconomic policy blunder that has left the euro area stranded in stagnation—and with inflation persistently *above* the set limit of 2 percent. While fragility due to protracted domestic demand is one problem. Increasing divergence is another. This is mainly due to two factors. First, Euroland's fiscal regime imposes austerity especially on those who are crippled already, whereas stronger members may even have scope to cut taxes. Second, a process of competitive wage underbidding has meanwhile set in, with Germany as the key driver. Apart from pushing competitiveness trends within Euroland in a non-equilibrating way, there are also obvious deflationary risks involved with this approach.

It is thus something of an irony that the very beggar-thy-neighbour policies are observed today which EMU was supposed to ban forever. Moreover, these were kicked off by a symmetric rather than an asymmetric shock; which always used to be the key worry of mainstream economists. Blindly imposing policies that have crushed domestic demand, Germany has claimed the title of the world's exporter no. 1—only to pass on the buck of corresponding losses in competitiveness to other EU members. The world may soon come to regret the hypocrisy prevailing in this area of debate. Under the unchecked whims of a driver who is seriously lacking proper driving skills, but apparently keenly following its own dubious political agenda, Euroland hangs like an albatross around the global economy's neck.

THE FUTURE OF THE EURO: REFORM OR FAIL?

At the current juncture, if current trends in the behavior of key players persists and flaws in the institutional setup are not repaired, I thus agree with Milton Friedman (2003) that there is a serious risk of breakup of EMU in the medium term. EU politicians, including its independent central bank politicians, may continue to lament about the risks of external shocks (a dollar crisis, in particular), but the true causes of the ongoing EMU crisis are purely internal ones. In this regard, one risk is that labor market liberalization and competitive wage underbidding strategies will develop a deflationary force which the ECB may be too weak to counter. Already the ECB effectively argues that Euroland is in a liquidity trap when it asserts that cutting short rates would only undermine confidence and drive up bond yields. Another risk is that the Maastricht fiscal folly that has brought stagnation and budgetary disarray upon ever more EU countries continues unabated even as cuts in infrastructure investment *cause* structural problems and hikes in indirect taxes and administered prices drive *up* headline inflation.

The heart of the problem however lies in the area of monetary policy. As I argued before the fact (see Bibow 2001a), if the Maastricht regime might work at all, this will require *growth-oriented* monetary policies. And given that the ECB enjoys unbounded discretion, such a policy re-orientation is a clear option. Essentially, what is required is a change in mindset: leaders who are not trapped in flawed doctrines and misconceptions about previous times; even though personally I would much prefer appropriate institutional changes that make policy less dependent on personalities. With central banking gone seriously astray, Euroland has already wasted the last fifteen years or so. Alas, for the time being, hypocrisy is still protecting Euroland's key structural problem: ill-designed macroeconomic policies, the interaction of which is responsible for the ongoing EMU crisis.

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