

**“The European Central Bank:  
A View from Across the Ocean”**

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As I write the European Central Bank approaches its third anniversary of operational responsibility for the monetary policy of the Eurosystem.<sup>1</sup> The thousands of people involved in coaxing this new institution into existence have done an extraordinary job. Against formidable odds and the dire predictions of numerous observers, their insights and hard work have produced an extraordinary product. I am sit in awe of the job that has been done in Frankfurt by the Executive Board and the staff of the ECB itself, and by the Governors and staffs of what today are twelve National Central Banks (the NCBs) who have joined the European Monetary Union. The real measure of the success of the European System of Central Banks (ESCB) is how truly minor all of our criticisms are. I seriously doubt that any of us could have done better.

In this essay I will comment on a number of aspects of the ESCB. Throughout I will try to provide comparisons with the structure of other central banks, especially the Federal Reserve System. In the following section I begin with a discussion of institutional structure. This is followed by a critical examination of the Eurosystem's "two-pillar" policy strategy. In Section 3 I discuss issues of communication and transparency. This is followed by a very brief examination of policy performance and a conclusion that describes some future challenges.

## **1. Institutional Structure**

Economists often ignore one of the central precepts of other social science disciplines: Institutional structure is crucial for policy outcomes. The design of the ESCB embodies the received wisdom of a century of monetary policy making. The lessons of history are numerous, and they have all been absorbed. For example, operational policy of the Eurosystem is centrally controlled -- a lesson the Federal Reserve System did not learn until the 1930s. Care has been taken to insure that the ECB is independent from political influence, thereby avoiding problems that plagued the monetary policy of industrialized and emerging countries alike in the post-WWII period.

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<sup>1</sup> I have adopted the nomenclature described in the recently published European Central Bank, *The Monetary Policy of the ECB*, Frankfurt au Main: European Central Bank, 2001.

On its surface, the ESCB resembles the Federal Reserve System (FRS). There are twelve regional banks with a central board. But there are important differences. In the Federal Reserve System there is a sense in which the Board of Governors is in control. At the ECB, casual observation suggests that the reverse is true. While the Board of Governors supervises the regional Federal Reserve Banks, approving their budgets and overall management decisions, in the ESCB, it is the NCB governors who supervise the ECB.

The Governing Council of the ECB resembles the Federal Open Market Committee (FOMC) on the surface as well. The former is composed of the six members of the Executive Board and the governors of the euro area NCBs, and the latter includes the seven Governors of the Federal Reserve Board (the Governors) and the twelve regional Federal Reserve Bank Presidents. Both formulate monetary policy.

But again, appearances can be deceiving. While decisions in both bodies appear to be taken by consensus, as a technical matter only 5 of the Reserve Bank Presidents vote at any one time. This means that the Governors always comprise a substantial majority and can outvote the Presidents. The claim is that the Governing Council does not take formal votes, but even so the NCB Governors outnumber the Executive Board members by two to one.

In my view, the most important difference between the FRS and the Eurosystem policymaking procedures arises from the fact that all of the information provided to the FOMC comes from the staff of the Board of Governors. There is virtually no relevant information that either comes or is produced in consultation with the staffs of the regional Federal Reserve Banks that finds its way into the hands of all of the participants at an FOMC meeting. In my experience, the only information that is universally distributed was generated by at the Board of Governors in Washington D.C. The ESCB has an elaborate committee structure that was created to insure that information from the NCBs had a natural and straightforward way to enter into the policymaking process. This

means that the economic forecasts, for example, are constructed with explicit input from the staffs of all of the central banks in the Eurosystem.

Beyond the frequency of the policy meetings, with the Governing Council meeting three times as often as the FOMC, differ substantially in attendance. As I understand it the Governing Council meets alone (with the exception someone charged with recording minutes). By contrast, FOMC meetings include between 20 and 30 staff members, as well as the 19 principals.<sup>2</sup> Each Reserve Bank President has one staff member present, and a number of members of the Federal Reserve Board staff are in attendance as well.

Furthermore, at FOMC meetings the staff participates actively. But again, it is primarily the staff of the Federal Reserve Board that does the talking. With the exception of the System Open Market Account Manager, who is an employee of the Federal Reserve Bank of New York, in my two years attending FOMC meetings I never heard any staff member of a Reserve Bank speak. Only Federal Reserve Board staff spoke.<sup>3</sup> This, along with the fact that the Governors speak among themselves about policy, serves to further increase the influence of the Board members over the policy outcomes.

There is one more important difference between the FRS and the ESCB, and that is the fact that the ECB is a bank while the Board of Governors is not. As a consequence, the ECB itself is capable of operating in financial markets – and they have done so. Surely, the ESCB structure is set up to insure that the bulk of operations take place at the NCBs. In many ways, this is the remaining role of these satellites of the ESCB system. But how long can a system be maintained that has (currently) 13 separate operating locations, each with nearly the same capability?

The logic of having NCBs maintain regular financial operations is that these central banks have special knowledge of the mechanisms and participants in their local

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<sup>2</sup> For a description of the mechanics of FOMC meetings see Meyer (1998).

<sup>3</sup> Meyer (1998) confirms this.

national markets. But since one of the major goals of monetary union is to accelerate the development of a pan-European financial system, it is just a matter of time before things are centralized. There will be an inexorable pull toward the center, draining resources and power from the periphery.

A number of observers have noted the potential problems created by the fact that one country has one vote on the Governing Council.<sup>4</sup> This creates an inexorable pull toward the median country, and the objective of stabilizing euro-area prices would be compromised. Both von Hagen and Brückner (2001) and Alesina, Blanchard, Galí, Giavazzi and Uhlig (2001), suggest that if this were the outcome, the Executive Board would not be doing its job. The preponderance of the evidence clearly suggests that the Governing Council is following its mandate, and not behaving in a nationalistic way.

## 2. Policy Objectives and Policy Strategy

Turning to the policy strategy, there now exist numerous detailed descriptions of the strategy itself and the problems it has created.<sup>5</sup> As mandated in Article 105(1) of the Maastrich Treaty, "the primary objective of the ESCB shall be to maintain price stability" and that "without prejudice to the objective of price stability, the ESCB shall support the general economic policies in the Community with a view to contributing to the achievement of the objectives of the Community," including "a high level of employment..., substantial and non-inflationary growth, a high degree of competitiveness and convergence of economic performance." This is what Federal Reserve Board Governor Laurence Meyer has called a *hierarchical objective* -- price stability first, other things second.

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<sup>4</sup> Allowing for each EMU country to have a vote on the ECB Governing Council will eventually create an additional problem as the number of countries participating in monetary union grows. With twelve countries in EMU there are 18 voting members of the governing council. Without any change in the voting rules, and if countries joining the European Union become members of the Eurosystem, this number could potentially become much larger, thereby hampering the ability of the Council to arrive at consensus decisions.

<sup>5</sup> For a description of the strategy see European Central Bank (2001). The difficulties are discussed in von Hagen and Bruckner (2001), among others.

Implementation of monetary policy required that the Governing Council define what is meant by the term *price stability*, and that it formulate a policy strategy. An 18 October 1998 press release entitled “A stability-oriented monetary policy strategy for the ESCB” provide important operational details for how this objective would be addressed. That press release (which is available on the ECB’s web site at [www.ecb.int](http://www.ecb.int)) stated that the policy strategy would have the following three components:

1. The operational definition of price stability would be inflation in the Harmonised Index of Consumer Prices (HICP) of less than two percent per year, in the medium term.<sup>6</sup>
2. Money would be assigned a prominent role in the evaluation of financial market conditions, and that this role would be signaled by the announcement of a quantitative reference value for the growth rate of a broad monetary aggregate – they have chosen euro-area M3.
3. A broadly based assessment of the outlook for future price developments and the risks to price stability in the euro area would play a major role.

Let us take a look at each of these in turn. First, defining price stability in a clear quantitative manner is extremely difficult. Every inflation measure that we have available to us has its problems. They are all distorted by problems with weighting, with quality changes, with the introduction of new goods, with changes in expenditure patterns, and the like. The HICP has a particular problem in that it currently (June 2001) does not include owner-occupied housing. Given how high the ownership rate is in Europe, it is unfortunately that this is still not included in the index.

In looking at central bank strategies for achieving price stability objectives, the time horizon is often a subject of heated debate. Here, again, the ESCB has been criticized for its vague use of the terminology “medium term.” My view is that this is not

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<sup>6</sup> The ESCB was criticized from various quarters for not stating that the operational definition was inflation in the HICP of between zero and two percent. The suggestion was that somehow the current formulation left open the possibility of deflation. I view this criticism as inaccurate and generally unfair, as the term *inflation*, clearly implies a range of zero to two.

a serious issue. In the end, I agree with Mervyn King (1999) who argues that in the end, central banks with inflation objectives will be held accountable in such a way as to make the time horizon irrelevant. As King notes, if a central bank has a 2% target, then after 10 years the question will be whether inflation averaged less than 2% over the entire period. The overriding issue is that longer time horizons give somewhat more flexibility in responding to short run real factors. Here, I believe the ESCB has done the right thing.

Let me digress briefly to note that, by comparison, the objectives of Federal Reserve System monetary policy are extremely unclear. The language contained in the Full Employment and Balanced Growth Act of 1978 currently guides monetary policy in the United States. It states there that the Board of Governors and the FOMC are required 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 has been interpreted to mean that monetary policy should foster maximum sustainable growth and price stability.

Importantly, though, there are no numbers attached to what is meant by any of this. Federal Reserve Board Chairman Alan Greenspan has said that he believes "We will be at price stability when households and businesses need not factor expectations of changes in the average price level into their decisions."<sup>7</sup> But this statement seems very imprecise. What level of what price index constitutes price stability? Different people will have different interpretations.

The lack of clarity in the objectives of the FOMC creates an enormous problem for decision-making. How can a committee agree on policy actions if they do not agree on their objectives even privately among themselves? Surely it would be a step in the right direction to follow the course suggested by Governor Meyer (2001) if the FOMC would adopt an explicit definition of price stability and make it publicly known.

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<sup>7</sup> See Greenspan (1994)

We now move on to the second two components of the strategy, often referred to as the “two pillars.” These are the prominent role for money and the use of a range of indicators for future price developments. The first these has come under substantial attack, and I will now join the chorus. As Alesina, Blanchard, Galí, Giavazzi and Uhig (2001) write, the ultimate goal of the ESCB is to keep inflation low. In actual fact, they have been doing something that closely resembles inflation-forecast targeting. It is difficult to see in this context why M3 is special.

What is the logic of this first pillar?<sup>8</sup> I think that the best explanation is based on politics and sociology, not economics. When creating a new institution, constructive ambiguity is often essential. In the case of the ECB, no one really knew what was going to work, and so the Governing Council hedged by saying they would look at money on the one hand, and everything on the other. Beyond this, the difficulties of reaching consensus in a group of people with diverse backgrounds who have not worked together before was surely difficult, at least initially.

But we are now three years on, and the same arguments no longer apply. Instead, we can think of the ECB as just another central bank that controls interest rates in an effort to meet an inflation objective. Money is surely helpful in doing this, but then so are many other things. I agree with those who have said that this first pillar stands in the way of effective communication.

Beyond these conceptual issues, it is worth noting that the first pillar of the policy strategy has already caused some technical problems. The ECB defines M3 to include only currency, deposits and marketable financial instruments held by euro area residents. (See European Central Bank (2001) pg. 32-33.) Needless to say, it is difficult to discern the ultimate owner of deposit accounts or liquid financial instruments, and so estimating the size of euro-area M3 is not a trivial task. This difficulty created substantial problems in the spring of 2001. In his new conference on 10 May 2001 ECB President Duisenberg

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<sup>8</sup> In Chapter 5 of European Central Bank (2001) there is a lengthy attempt to justify the two-pillar strategy on economic grounds. I find the discussion unconvincing.

stated that “there have been indications that the monetary growth figures are distorted upwards by non-euro area residents' purchases of negotiable paper included in M3. This has now been confirmed by clear evidence, and the magnitudes involved are significant.”

All of this suggests to me that the ECB should discard the first pillar of its policy strategy. There is precedent for throwing central bank articulated ranges for money growth overboard. In the Federal Reserve Board's 20 July 2000 *Monetary Policy Report to Congress* there is a footnote that reads:<sup>9</sup>

“At its June meeting, the FOMC did not establish ranges for growth of money and debt in 2000 and 2001. The legal requirement to establish and to announce such ranges had expired, and owing to uncertainties about the behavior of the velocities of debt and money, these ranges for many years have not provided useful benchmarks for the conduct of monetary policy. Nevertheless, the FOMC believes that the behavior of money and credit will continue to have value for gauging economic and financial conditions, and this report discusses recent developments in money and credit in some detail.”

This statement concisely summarizes my own views, and leads me to the conclusion that the first pillar of the ESCB's monetary policy strategy should be jettisoned.<sup>10</sup>

Turning briefly to the second pillar, who can argue with the strategy of using broadly based assessment future price developments? Addressing uncertainties by bring all possible information to bear -- including that in broad monetary aggregates -- is the obvious thing to do. Importantly, though, it leads to inflation-forecast targeting, and it would be helpful if the ESCB were clear that this is what they are doing.

### **3. Communication and Transparency**

The next issue is communication and transparency. This is where the ESCB has, in my view, been at its worst. Let me give just one example from the spring of 2001.

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<sup>9</sup> This is footnote 2 in Section 1 of the report. It is available on the Federal Reserve Board's web site at <http://www.federalreserve.gov/boarddocs/hh/2000/July/ReportSection1.htm>.

<sup>10</sup> I would go even further and argue that the term “monetary policy” should be change to “central bank policy” so as to change the impression that it has anything directly do to with money.

During March and April 2001 there were numerous calls for policy easing. These came from places like the IMF, the OECB and the United States Treasury. Critics cited evidence of an impending slowdown in euro-area growth as the rationale for interest rate cuts. Initially, the ESCB responded that their objective was price stability, and inflation was in fact increasing. Their policy of maintaining relatively higher interest rates was consistent with this objective. As ECB President Wim Duisenberg famously said on 11 April 2001 “I hear but I do not listen.”

On 10 May 2001 the Governing Council reduced the target-refinancing rate by 25 basis points claiming that their long-term price stability objective was not in jeopardy. The stated reason for this policy reversal was that euro-area M3 had been mis-measured (see the previous quote). When the correction was made, and inflation forecasts were adjusted, the proper policy was to ease.

The ridicule was immediate and deafening. The *Financial Times* headline was the mildest: “European central bank rate cut trips up markets.” Things only got worse, as one week later there was a report of a sharp rise in the euro-area inflation measure to a five-month high of 2.9 per cent in April 2001, compared with 2.6 per cent in March. The general reaction was that this surely wasn’t consistent with HICP inflation of less than 2 per cent.

What is it about the ESCB’s communication strategy that has been such a failure? To understand, let us consider how an idealized central bank would communicate publicly. Blinder, Goodhart, Hildebrand, Lipton and Wyplosz (2001) argue that in creating transparent and clear communication a central bank must reveal

- What it is trying to achieve
- The methods, data and models used for analysis
- The substance of the policy deliberations, including which arguments have carried the day, how convincing they were and the degree of certainty surrounding

current conditions.

I believe that on the first two of these, the ESCB has done well. They have been clear about what they are trying to do, and they have provided substantial insights into their data, models and forecasts. It is the third point, transparency of the substance of policy deliberations that is the source of the problems. Here, the Governing Council speaks in many voices, and they are occasionally at odds.

There are several possible solutions to this communication problem. Blinder, Goodhart, Hildebrand, Lipton and Wyplosz suggest shrinking the size of the Governing Council to reduce chance that disgruntled members will air their disagreements in public. This is probably politically impossible. But why not issue minutes of meetings when they still matter?

#### **4. Performance**

Results are the real test of policy. Numerous people have examined the brief history of ECB policy in various ways. A decade ago John Taylor (1993) suggested the history of the U.S. Federal Funds Rate could be adequately explained by a simple rule in which the policy rate depended on a long-run equilibrium interest rate, the deviation of inflation from a target level and the output gap. It has become very fashionable for academic researchers to compare actual interest rate paths to those implied by various version what are commonly called “Taylor rules,” and analysis of the ECB is no different.<sup>11</sup>

Such exercises conclude that interest rates were initially too low, and later were too high. I would ask whether it is possible to actually evaluate policy using such an exercise. If the rule had been followed at the beginning of the period, then inflation and growth would have been different later. This is obvious, and what it means is that you

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<sup>11</sup> See, for example, Von Hagen and Brückner (2001)

cannot look at the actual policy relative to a Taylor-style rule without embedding the rule in a fully articulated dynamic structural model of the euro area.

Originally, Taylor viewed this as a way of summarizing policy history, not a proscription for future action. In recent years, researchers and policymakers have taken this rule and examined its properties for policymaking. Such exercises must be done with great care, however. In particular, evaluation of the rule can only be done if it is embedded into a dynamic model of the economy as changes in the interest-rate instrument that deviate from historical experience will drive inflation and output away from their historical paths as well.

Rather than build such a model (or borrow one) I will simply look at the performance of the ESCB since its inception. Figures 1 and 2 plot GDP growth and inflation in the Euro area. Growth data begin in 1992 and inflation data in 1996 – this is what is available from Eurostat and the ECB. It is surely difficult to tell from these data what the consequence of recent policy will be, but we can nevertheless make a preliminary evaluation. The results give the impression that policy has been more successful in fostering steady growth than in keeping inflation in check. The fact that HICP inflation has risen unabated since the ESCB started on 1 January 1999 is somewhat troubling, and provides support for the von Hagen and Brückner conclusion that policy was too loose early on. It is harder to argue that it became too concretionary, as inflation has continued its rise.

## **5. Future Challenges**

The report so far is of a new institution that has faced numerous challenges head on and come out only mildly bruised. It is difficult to see how things could have come out any better than they have. But this is not the end of the story. The future challenges of the ESCB are nearly as daunting as those that have past.

The biggest problem facing the ESCB is dealing with what is likely to be a constant conflict among national interests in policy setting. Recent new reports have suggested that the right policy for Germany is more stimulus, while France might be better off if policy were tighter.<sup>12</sup> Inflation and growth differentials across the euro area will continue and create the need for a delicately balanced policy.<sup>13</sup>

The problem of national inflation differentials is compounded by the fact that, as Alesina, Blanchard, Galí, Giavazzi and Uhig (2001) emphasize, not all inflation differentials are bad. During the early years of currency union and general economic harmonization one can expect that there will be substantial relative price adjustments among the various regions of the euro area and that these will show up as measured differences in national inflation indices. But in many cases these will be required real economic adjustments, not inflation differentials creating policy problems.

In writing this essay I have now joined the nearly continuous stream of observers commenting on the performance of European Monetary Union. But in the end, I am reminded of a story that is told about a meeting in 1972 between U.S. Secretary of State Henry Kissinger and Chinese Prime Minister Chou En Lai. According to the story, Kissinger asked Chou if he believed that when all its consequences were taken into account the 1789 French Revolution benefited humanity. Chou is reputed to have replied “It is too early to tell.”<sup>14</sup> So too for the early years of the European System of Central Banks – it is still too early to tell.

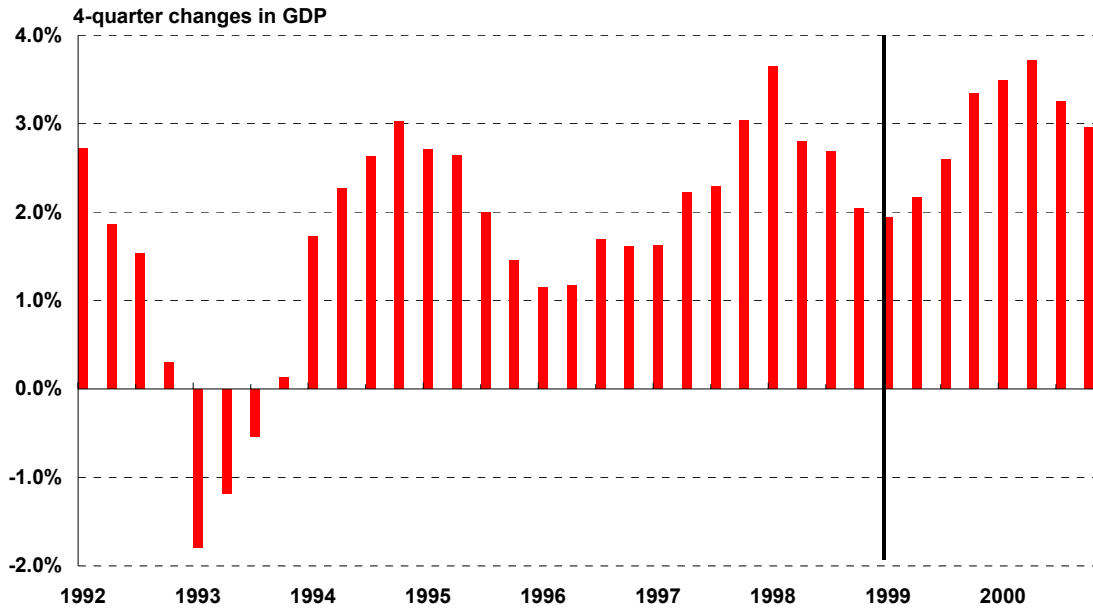
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<sup>12</sup> See the *Wall Street Journal* “The Right Rate for Europe?” 17 May 2001, pg. A18.

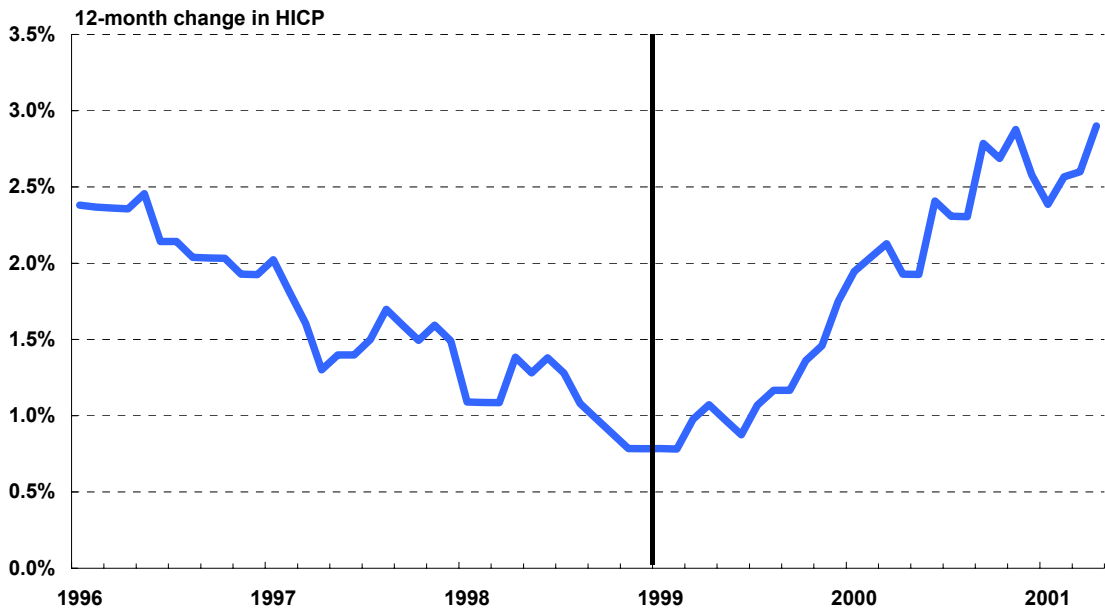
<sup>13</sup> See Cecchetti, Mark and Sonora (forthcoming) for a discussion how persistent inflation differentials are likely to be.

<sup>14</sup> Unfortunately, I have not been able to find any reliable source for this quotation, and do not believe that it is true. It is a good story.

**Figure 1: Real GDP growth in the Euro Area**



**Figure 2: Inflation in the Euro Area**



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