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OPINION

The terrible twos begin

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On new year's day the euro celebrated its second birthday and gained a new member, Greece. After a rocky start on the currency markets, it has also recently rebounded against the dollar. Yet even stiffer tests now lie ahead for the currency's guardian, the European Central Bank

YOU might think that life was at last getting easier for the infant European Central Bank. The twin threats that have hung over its goal of price stability, high oil prices and the weakness of the euro, are both subsiding. The euro's sharp recovery has stifled the gripes of Europe's politicians about both the ECB's policies and its president, Wim Duisenberg. Even the recent slowdown in most of the euro area's economies may prove to be good news, since most economists now expect the next move in interest rates to be downwards, following a climb of two-and-a-quarter percentage points between November 1999 and October 2000.

This week marked another seminal moment besides the currency's climb towards 95 cents against the dollar. On January 1st Greece became the euro's 12th member, shedding Europe's oldest currency, the drachma. Greece is the first country to join since the euro's birth. Its arrival somewhat makes up for the disappointment of the Danish vote against entry in a referendum held in September. The odds against either of the two other EU non-euro members, Britain and Sweden, joining soon have risen since the Danish vote.

Assimilating Greece should be fairly easy: its GDP is less than 2% of the euro area's. But its higher growth and inflation rates than those of the bigger members will continue to raise questions about the suitability of a one-size-fits-all monetary policy—just as they have done for Ireland, which has the highest inflation rate in the OECD. These questions will intensify as Central and Eastern European countries prepare to join both the EU and the euro.

Even before then, the ECB faces several daunting challenges over its next two years. Its monetary-policy task is likely to prove especially hard, as uncertainty over the path of the world

economy grows. So far, it has operated in a largely benign global climate in which any talk of recession was far-fetched. But it may this year have to act more vigorously to sustain growth and fend off deflation—especially if the euro keeps on rising. As a mere two-year-old, its record in adversity is largely untried.

Next January will see the introduction of euro notes and coins, a logistical and marketing operation of immense proportions. And Mr Duisenberg has promised to “retire” some time in 2002, to be replaced by the urbane governor of the Bank of France, Jean-Claude Trichet. This was the compromise agreed at the time of Mr Duisenberg’s appointment in May 1998; but it has no legal force, and a judicial investigation into Mr Trichet’s handling of *Crédit Lyonnais*, a French bank, may preclude his appointment to the ECB presidency in any case.

As if all this were not enough, there are at least three other difficulties that, sooner or later, will have to be resolved, either by the ECB itself or by the European Union’s politicians. The first is that the ECB has not yet learned how to communicate the way it executes monetary policy to financial markets and the media; or, put another way, outside commentators have not yet learned to “read” the ECB as clearly as they can America’s Federal Reserve.

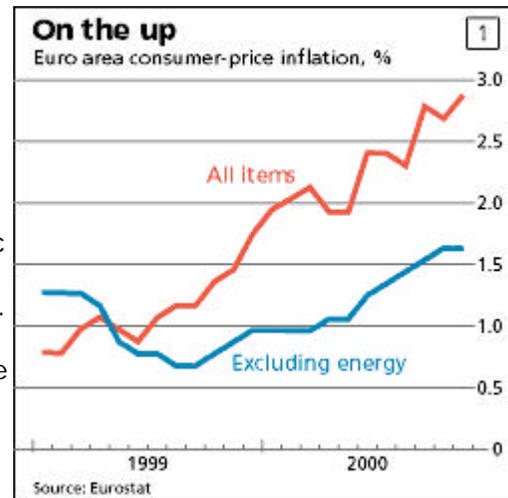
The second is that the division of responsibilities between the ECB and the national central banks (NCBs)—collectively known as the Eurosystem—needs to be reworked. Although monetary policy is now conducted in Frankfurt, NCBs retain many other central-banking tasks, including the prudential supervision of banks. There is a good case for shifting more to the euro-area level, and for doing it sooner rather than later. And the third is the prospective accession to the euro of Central and Eastern European countries. Although this is several years away, it is already stirring debate.

Read my lips, every month

The most immediate of these three issues is the ECB’s communication problem. This was neatly summarised last June by Otmar Issing, its chief economist and a member of its six-strong executive board, when he said that “the verdict among most, if not all, our ‘watchers’ seems to be that—broadly speaking—the ECB has done a good job but has not been very effective in presenting and explaining itself.” As Mr Issing also said, this is a matter of more than public relations.

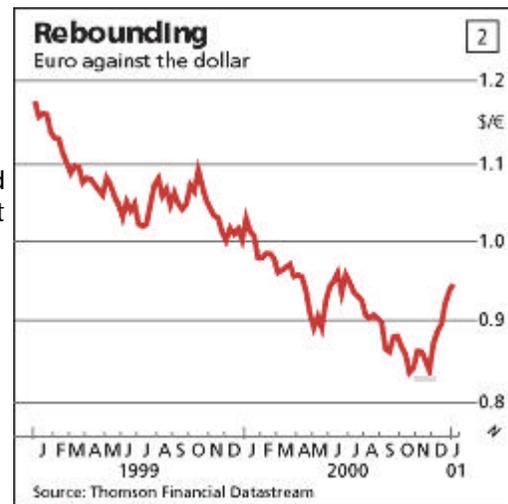
The ECB’s task is to maintain stable prices, which it defines as an annual inflation rate of no more than 2%. In November inflation was well above this target, at 2.9%; but it is hard to criticise the bank, because a lot of the excess was caused by high oil prices and the falling currency. Moreover, since monetary policy works with lags of up to two years, the full impact of the ECB’s first interest-rate decisions has only just worked through. The ECB’s real job is to stop inflation taking a grip, by feeding through from oil prices to wages and consumer prices. Stripped of energy prices, inflation has stayed within bounds (see chart 1).

Nor does it make much sense to bash the ECB for the pasting that the euro took in the currency markets for its first 22 months. Mr Duisenberg may have helped to put the skids under it with some incautious remarks, notably in an ill-judged newspaper interview in October. But for most of 2000 market sentiment was against the currency anyway, thanks to the perceived weakness of the euro area relative to the United States. Once the news from across the Atlantic worsened, the euro began to recover, rising by almost 15% between its late-October trough and this week (see chart 2). In any case, the ECB is charged with maintaining the internal value of the euro, not the exchange rate—and, since trade now accounts for only some 10% of euro-area GDP, the inflationary impact of any depreciation is smaller than it was for, say, the D-mark.



Yet the fact remains that financial markets have found the ECB's actions hard to understand. In a way, this is curious, because the bank has gone to great lengths to try to make its thinking plain. America's Federal Reserve has no inflation target. Unlike the ECB, it has never written down its monetary-policy strategy. Nor does Alan Greenspan, the Fed chairman, hold on-the-record press briefings to explain what the Fed is up to. Mr Duisenberg, in contrast, gives one a month.

Thomas Mayer, an economist at Goldman Sachs in Frankfurt, likes to differentiate the ECB's approach from what he calls the "Greenspan model" of central banking. In Mr Greenspan, the Fed has a strong leader who has managed to steer markets' expectations skilfully. Mr Duisenberg is more a "moderator" of the ECB's 18-strong governing council (the six executive board members, plus the 12 NCB governors), which meets to set rates every fortnight.



Unable to rely on a strong individual, the ECB has set out a monetary-policy strategy with two "pillars", designed by Mr Issing. The first pillar is the money supply, reflecting the fact that inflation in the long run is a monetary phenomenon. The second consists of other, short-run influences on the price level. Nothing wrong with that, says Mr Mayer: the problem is that it is not clear to ECB-watchers such as himself whether the governing council is using this framework in a consistent way.

For example, economists point to the way the ECB reacted to the euro's plunge. At first, says Mr Mayer, "Duisenberg gave the impression that they would neglect the currency." But last autumn the ECB intervened to support it. Michael Schubert of Commerzbank, a German bank, says that the ECB estimated that the devaluation of the euro in 1999 would add only 0.2 percentage points to inflation; so, he comments, "I expected that in the coming months there'd be no increase in interest rates. But they did it."

Worse, the more the ECB tries to explain, the more confusion it sows. Just before Christmas it published projections of GDP growth and inflation for the next couple of years. These, stresses the bank, are not forecasts, nor do they reflect the view of the governing council. They are instead an "input" to the rate-setting process, supplied by the bank's staff. However, quite a few economists are not sure what the new information is worth. The range of projections is pretty broad: GDP growth in 2001, for instance, is set to lie somewhere between 2.6% and 3.6%. Moreover, points out Mr Schubert, the mid-point of the inflation projection for 2002 is 1.9%, within the definition of price stability. Yet the forecast assumes no change in exchange rates. Why, he asks, has the ECB

been complaining about the undervaluation of the euro if, according to its own staff, it presents no threat to the bank's objective?

It is hard to see what might solve this problem, except for more experience on both sides. "Transparency," said Mr Issing last year, "is a rather subjective notion and may have a lot to do with familiarity." Publishing the minutes of the ECB meetings, as happens with the Fed and the Bank of England, would clarify the arguments put forward in the governing council; but, on the other hand, the exposure of 18 different arguments might confuse ECB-watchers even more. And it is hard to claim that the ECB's problem is a lack of openness.

The doubts about the presidency of the ECB will also continue to cast a cloud. Mr Duisenberg is still expected to stick to his bargain and quit next year. But because Mr Trichet can no longer be considered a certainty as his successor, others are already said to be manoeuvring behind the scenes. The French are unlikely to surrender the post without a fight, so if Mr Trichet is ruled out they might have to look for an alternative. But since they have no other obvious figure with central-banking clout, other countries might wish to offer candidates of their own. It took over 12 hours of heated argument at a Brussels summit to settle the presidency of the ECB last time round.

A case for centralisation?

The second difficulty is the relationship between the ECB and the national central banks. Although the NCBs are no longer responsible for national policy, they have kept several other important jobs. Bank supervision and financial stability are still under their eyes. NCBs still maintain their own payment systems, even though the Eurosystem has its own, TARGET. In all, according to an estimate by Lorenzo Bini Smaghi of the Italian treasury and Daniel Gros of the Centre for European Policy Studies in Brussels, in "Open Issues in European Central Banking" (published by Macmillan in 2000), over 50% of the Eurosystem balance sheet is outside the ECB's direct control because it is supposedly unrelated to monetary policy.

Does this arrangement make sense in a monetary union? Suppose that a fair-sized bank in a large euro-area country ran into difficulty. The national central bank alone, looking at the domestic market, would not be able to judge whether the failure of the bank would pose a systemic risk to the euro-area's banking system. If there is a systemic risk across the euro area, it is arguable that a national central bank ought not to have to recapitalise the bank by itself. And national bank supervision might even increase the risk of bank failure, if NCBs worried only about the banks' domestic liabilities rather than their exposure across the euro area.

There is a case for leaving things as they are. There are, after all, no signs of instability in the euro area yet. And banking markets are mostly still national, rather than cross-border. But this misses the point, say Messrs Bini Smaghi and Gros. It is better to act while things are quiet than to try to cobble together a new structure in a crisis. It is also a mistake to suppose that, just because most bank lending takes place in domestic markets, euro-area banks are not exposed to other euro-area risks. There is a single money market; euro-area government bonds are virtually perfect substitutes; and there is a single foreign-exchange market.

The answer is surely not to have every bank supervised in Frankfurt. Perhaps only a few dozen of the euro area's 9,000 banks will need any supranational supervision. In the first instance, closer co-operation between NCBs is the easiest and most likely way forward. And even if supervision across the euro-area does develop, it is not certain that the ECB should do everything. In Germany, for instance, a "liquidity consortium", not the Bundesbank, appraises the solvency of stricken banks and lends them funds if they look salvageable. But it is better to start doing something now, rather than wait for a crisis to blow up.

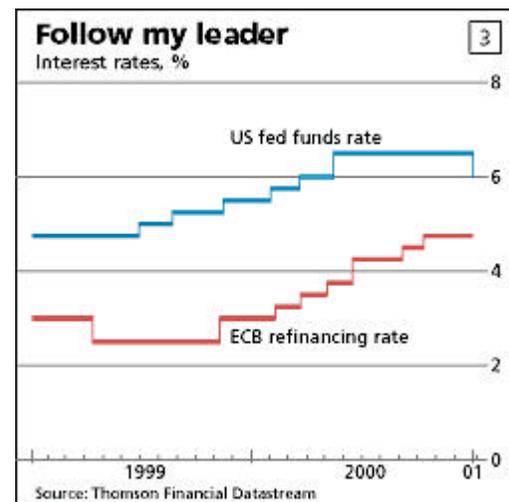
Eastern approaches

The third problem ahead is the queue of Central and Eastern European countries wanting to join both the EU and the single currency. Their accession to the euro, even on the most optimistic timetable, looks far away (although several are already linking their currencies to the euro, and some may yet toy with "euroisation" ahead of entry). None will join the EU before 2004. They will then have to be members of the exchange-rate mechanism, limiting fluctuations against the euro, for at least two years. After that (ie, in 2006 at the earliest), they will be admitted to the euro area if they satisfy the Maastricht treaty criteria on inflation, interest rates, budget deficits and government debt. Unlike Britain and Denmark, the new countries cannot formally opt out of the euro. If they pass the Maastricht tests, they are supposed to join—though Sweden has stayed out even without a treaty-sanctioned opt-out.

Long before the Central and Eastern Europeans join, the way in which the ECB takes interest-rate decisions will have to be reformed. The current rules give every NCB governor a seat on the governing council, alongside the executive board. All members have equal weight. So far, decisions have been taken by consensus rather than majority vote (at any rate, no vote has ever been admitted to). This system is hard enough to manage even with 18 members. With perhaps 30-odd, it will become all but impossible. It will be harder to forge a consensus on interest rates, or to pretend that one exists. And with more use of votes, it seems highly improbable that the big euro-area countries will accept having the same voting power as, say, Estonia or Slovenia.

There is another argument pushing for change: that the relative weight of NCB governors, as a group, on the governing council will otherwise grow at the expense of the centre. The Fed gives its regional presidents a minority of votes on its open-market committee. In an enlarged ECB, the NCB governors could control as many as four-fifths of the votes. That risks giving too much weight to regional concerns, and not enough to the centre.

Europe's political leaders have already spotted that the system needs adjustment. In the treaty negotiated at the Nice summit last month, they agreed that the Council of Ministers should be able to amend the ECB's decision-making procedures, acting on a recommendation from either the European Commission or the ECB. But how the rules might change is far from decided.



One model is to take a leaf out of the Fed's book, and rotate the right to vote: only five of the presidents of the 12 district Federal Reserve banks have a vote in any year, plus the seven Fed governors. In Europe, this might have to be amended to give permanent voting rights to NCBs from big countries: in America, the president of the New York Fed is the only regional boss with perpetual voting rights. But as the abortive Nice summit discussions on limiting the size of the European Commission to less than one per member country showed, getting such a change agreed may prove extremely hard.

How long EU governments have to do it depends largely on how soon the acceding countries will be ready to join. In theory, preparations are already taken care of by the Maastricht criteria. Indeed, several countries are already well on course, and look in better shape than did Italy, Spain or Portugal in the early 1990s or Greece did even more recently. As happened with the southern Europeans, the goal of joining the single currency, enshrined in these criteria, should give the easterners the incentive to put their macroeconomic houses in order.

For the markets, the Maastricht criteria may be essential. It could help to allay fears that letting in "soft" countries such as Greece, and later others from Central and Eastern Europe, when such "hard" countries as Britain, Denmark and Sweden still stand aside, could somehow undermine the euro. But from a broader economic point of view, Maastricht may be as much a hindrance as a help. It is too soon to measure the Central and Eastern Europeans against the Maastricht

yardsticks—and not only because they are not yet members of the EU. The reason? Their GDP per head is far below the European average. Joining the EU, or the prospect of it, ought to help them catch up. However, as they catch up, their price levels as well as average incomes should in theory converge on the European average. That implies a higher inflation rate.

Get moving now

How much time do the ECB and EU governments have to sort out the ECB's various challenges? If economics were the sole guide, the politicians and bankers ought to be able to put the institutional implications of the admission of the Central and Eastern Europeans on hold for several years. But politics may force them to decide on a new system within, say, three or four years, ahead of the possible admission to the euro of some countries in 2006.

The division of labour between the ECB and the NCBs, and the communication problem, are more pressing. Certainly, there is little virtue in waiting for the euro area's first financial crisis to prompt action. And markets will have to have a clearer understanding of ECB policies before eastward expansion forces institutional reform. As for the presidency of the ECB, this too will also need to be sorted out quite soon. One way and another, this year and next look likely to be every bit as controversial and difficult as have the bank's—and the euro's—first two years.

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