European Monetary Policy: The Ongoing Debate on Conceptual Issues

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1. INTRODUCTION

INCE January 1999, European monetary policy has been centralised in the form of the European System of Central Banks (ESCB) with the European Central Bank (ECB) at its core. This new monetary authority is quite unique in many aspects: It is supranational and has the sole responsibility for monetary policy in the entire euro area, which now includes twelve member countries of the European Union. It has a clear mandate by the Treaty on European Union to ensure price stability in the whole currency zone; other objectives, in particular those more related to output and employment in the euro economy, should only be addressed if price stability is maintained. The EU Treaty also guarantees the ECB’s operational independence as well as its independence from political interference. The presidents of the national central banks of the Eurosystem as members of the ECB Governing Council (together with the six members of the Executive Board) are supposed to pursue the goals of the monetary union as a whole; they should not act as delegates of their country of origin and should not base their decisions on national considerations.

At the outset and for the sake of transparency and accountability, the ECB shaped and announced its stability-oriented monetary policy strategy (the ‘two pillar strategy’) and provided a quantitative definition of price stability. The transition from national monetary policies to a common European monetary policy took place without major technical problems. The public in the member countries has learned that the ECB must conduct its policy in a way which cannot take regional differences in price developments and stages in the business cycle into consideration. This implies that decisions which the ECB makes concerning
interest rates may not be necessarily regarded favourably or unfavourably by all member countries. The conventional monetary policy instrument for strengthening or constraining demand is no longer available for the use of individual countries.

From the beginning there was a heated debate on whether the strategy for which the ECB opted is the adequate strategy for achieving price stability in the euro area. In the course of this paper, we will analyse some of the controversial issues in this debate. To put it bluntly: One group of analysts suggests to abolish the ‘first pillar’ and to focus on inflation (forecast) targeting (thereby building upon the ‘second pillar’).\(^1\) The other faction, diametrically opposed, advocates to emphasise the ‘first pillar’ (conduct monetary targeting) and to suppress the second one.\(^2\) Related to this controversy is the question as to whether or not the ECB has pursued an appropriate communication policy which stabilises the expectations of economic agents.

The paper is structured as follows: In Section 2, we discuss the decisions the ECB made concerning its strategy. The role of money and its leading indicator properties are then analysed in Section 3, followed in Section 4 by a short description of the ECB’s interest rate policy, the development of monetary aggregates and inflation in the euro area. Section 5 deals with the issue of transparency and credibility. In Section 6 the paper briefly discusses issues related to the macroeconomic adjustment process within the euro area, before closing with some final remarks. As it is, in our view, too early to establish a thorough track-record of the ECB’s actual interest rate policy, we will rather focus throughout the article on the conceptual issues concerning the monetary policy strategy.

2. STRATEGIC DECISIONS

In the original discussion on the appropriate strategy for the Eurosystem two factions developed: One faction favouring ‘inflation targeting’ (for instance Begg, 1997), the other advocating monetary growth as an intermediate target (for instance von Hagen and Neumann, 1996). In the end of 1998, the ECB finally came up with a ‘two pillar strategy’.\(^3\)

The ECB (1999, p. 39; emphasis added) defines its strategy as follows:

The stability-oriented strategy of the Eurosystem consists of three main elements: a quantitative definition of the Eurosystem’s primary objective, namely price stability, and the ‘two pillars’ of the strategy used to achieve this objective. These pillars are a prominent role for money, as

\(^1\) To this group belong inter alia: Alesina et al. (2001), Svensson (1999 and 2000), Gros et al. (2001).

\(^2\) See, for instance, Artus et al. (2001), Scheide (1998).

\(^3\) For an in-depth description of the ECB’s strategy see Issing et al. (2001).
signalled by the announcement of a quantitative reference value for the growth rate of a broad monetary aggregate, and a *broadly based assessment* of the outlook for price developments and risks to price stability in the euro area as a whole.

The ECB itself classifies its strategy as unique, meaning that it neither constitutes a monetary targeting regime nor an inflation targeting regime (Issing, 1999b).

The definition of price stability has been specified to be ‘a year-on-year increase in the Harmonised Index of Consumer Prices (HICP) for the euro area’ between 0 and 2 per cent, which is ‘to be maintained over the medium term’. We will not enter the theoretical discussion whether the definition of price stability established by the ECB is adequate or not.4 But it is important to note that by quantifying its stability goal the ECB has manifested a clear commitment towards a euro area-wide price development which avoids both inflationary and deflationary processes. We think that this is the most valuable contribution to economic growth and job creation in the euro area as a whole which can be expected from monetary policy.

However, price stability is not a sufficient condition to foster economic growth and employment. National macro- and microeconomic policies, which remain the responsibility of member countries, play an important role, too. This points to the need of fiscal consolidation, lower tax rates, moderation in collective wage agreements, a greater social effectiveness and allocative efficiency in the social security system, the deregulation of product and factor markets, the privatisation of public enterprises and so on. All these are elements of a supply-sided policy approach at the level of individual countries which, adequately shaped and applied, avoid conflicts with the price stability-oriented policy of the ECB.

Regarding the first pillar, M3 has been chosen as the monetary aggregate for which a ‘reference value’ is announced each year, on the grounds that this aggregate is a good indicator for future price developments. The ECB has emphasised that the announcement of a reference value does not constitute a commitment to mechanistically correct deviations of monetary growth from the reference value. The ECB (2000, p. 41; emphasis added) further specified:

> ... the reference value for M3 is *not* an intermediate monetary target. The ECB does not attempt to control monetary growth so as to reach the reference value at a specific point in time. Rather, the reference value acts as an analytical and presentational tool which constitutes an *important benchmark* for assessing risks to price stability.

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4 See the conference volume edited by Herrero et al. (2001) and therein the contribution by Wyplosz (2001), see also Galí (2001) for a discussion of the ECB’s definition of price stability. Svensson (2001c) calls for a ‘symmetric point target of 1.5%, with or without a tolerance interval of +/-1%.’ The lower this benchmark is, the stronger the signal to economic agents that the central bank is serious about its goal. Another big question is whether and how ‘hedonic methods’ for product quality adjustment should be used when calculating the HICP; though this would be desirable in periods marked by rapid and broad product innovations, in order to know the ‘true’ price development, the hedonic method is complicated and not immune from statistical arbitrariness.
The reference value is derived using the quantity equation and assuming a trend of real potential output growth (currently between 2 per cent and 2.5 per cent per annum), a trend decline in M3 income velocity (currently 0.5 per cent to 1 per cent per annum), and an acceptable rate for the increase in prices in the medium term (less than 2 per cent). The reference value was first derived in December 1998 and set at 4.5 per cent; it has been confirmed since in December 1999 and 2000.

Concerning the second pillar, the broad-based analysis of the outlook for inflation includes model-based forecasts and a variety of other indicators. The basket of indicators includes the exchange rate, bond prices, the yield curve, unit labour costs, oil prices, and the degree of capacity utilisation in the economy. The ECB emphasised that the second pillar is not synonymous with an inflation forecast. It published in December 2000 its first internal forecast for HICP growth and real GDP growth (using ranges) for a two-year horizon, after having been exposed to considerable pressure. These forecasts constitute conditional forecasts as they are conducted on the assumption of unchanged short term interest rates and, inter alia, constant exchange rates.

To the dismay of the advocates of inflation forecast targeting the ECB downgraded them to ‘staff projections’ and emphasised repeatedly in advance and afterwards that the publication of conditional forecasts did not mean that it would change its monetary strategy or react mechanistically in cases in which the projected rate of inflation deviated from the target range. An advantage of publishing forecasts is that the ECB comes under pressure to explain in a coherent and credible manner why it does or does not act immediately, and whether it is going to take any monetary policy measures at all. Such a pressure is useful; it helps the ECB to strengthen its reputation.

There are suggestions to replace the conditional forecasts with unconditional ones (in other words: forecasts conditional on an optimal interest rate path) or to publish forecasts conditional on market expectations. The former alternative meant that the ECB had to forecast its own behaviour. The latter possibility has

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5 Duisenberg (1999) stated in October 1999 when presenting the Annual Report to the European Parliament, that ‘I am confident that we can achieve this [the publication of forecasts] in the course of next year.’ Issing’s (1999a, p. 516) article in September of 1999 already indicated that it was only a question of time when the ECB would publish its internal forecasts: ‘...the balance of costs and benefits of making forecasts available to the public can be expected to change.’

6 See ECB (2000) for its views on the problems associated with the publication of forecasts. For more details on how the forecasts are arrived at see ECB (2001) which constitutes ‘A Guide to Eurosystem Staff Macroeconomic Projection Exercises’.

7 Svensson (2001b), who had earlier demanded a forecast conditional on unchanged interest rates, is now suggesting along with Alesina et al. (2001) an unconditional forecast. See Bernanke and Mishkin (1997) for an introduction to the concept of inflation (forecast) targeting, Bernanke et al. (1999) for country studies, and Svensson (1997) for the theoretical background of this monetary policy strategy.
the drawback that market participants can have low inflation expectations in spite of dangerous inflationary pressures, simply because they incorporate an adequate reaction by the central bank to counter the inflationary development. If a central bank based its behaviour on this kind of forecast, it would not act because the market expectations did not portray a risk to price stability. By not raising interest rates it would thereby allow higher inflation rates to materialise simply because of its reputation of pursuing a strategy compatible with price stability.

In short: Despite the wish in some circles to abolish the first pillar (see Alesina et al., 2001; Galí, 2001; Gros et al., 2001; and Svensson, 2001b), we concur with the ECB that it should definitely keep it because of the reasons explained in the following section.

3. THE ROLE OF MONEY AND ITS LEADING INDICATOR PROPERTIES

Inflation is, in the long run, a monetary phenomenon, as numerous empirical studies have shown. Due to this simple finding, central banks should pay close attention to the development of the money supply.

The relationship between money and output, however, belongs to one of the most disputed questions in macroeconomics (see Issing, 2000). There is only one consensus: In the long run no trade-off between inflation and unemployment exists (see Parkin, 1998). However, the direction of the causal relationship between money and output is controversial – to put it mildly.

Let us assume, as it is often argued, that, firstly, the central bank does not control broad monetary aggregates, secondly, that changes in output or expectations of changes in output induce changes in monetary aggregates (therefore, output causing money). Even if this were the case, it would still make a lot of sense for a central bank to closely monitor the development of money aggregates as they would still be an indicator for inflation in the medium term and certainly in the long run. On the other hand, if a central bank targeted and controlled the growth rate of the money supply, money became an exogenous variable and one could argue that excessive money growth caused inflation.

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8 The standard reference is McCandless and Weber (1995). They provide results based on data for 110 countries over a 30-year period, using different definitions of money. McCandless and Weber find that the correlation between inflation and the growth rate of the money supply varies between 0.89 and 0.99, depending on the definition of money and on the subsample. Other studies such as Lucas (1980) or Rolnick and Weber (1994) come to similar results.
9 See as an example Mervyn King’s (2001, p. 105) view on the general role of money in monetary policy: ‘... it is difficult to talk about inflation or monetary policy without according a special role for money.’ and ‘So it is extremely important that a central bank sees as one of its first responsibilities the need to explain movements in money and why it thinks that its policy stance is consistent with the likely behaviour of money.’
10 Pill (2000) shares this view, see Svensson (2001a) for a different opinion.
vast amount of literature examining the question of causality yields mixed results.\textsuperscript{11}

In the following, we will abstract from the question whether money is exogenous or endogenous. Instead the focus will narrow on the question if money plays an ‘active’ or a ‘passive’ role when monetary policy decisions are translated into effects on the ‘real’ economy.\textsuperscript{12} It is important to note that ‘active’ and ‘passive’ do not substitute the terms ‘endogenous’ and ‘exogenous’. Money can play, for instance, an active role, but be endogenous at the same time (see for an in-depth explanation Laidler, 1999). Engert and Selody (1998) define those roles as follows: The passive-money paradigm attributes the most influential role in the monetary transmission process (MTP) to interest rates and exchange rates. Money and credit simply ‘follow’ aggregate demand and inflation, while inflation is solely the result of excess demand or cost pressures.\textsuperscript{13} The alternative, presented by the active-money view, is that excess money and credit influence demand and cause inflation, therefore playing an active part in the MTP.\textsuperscript{14}

Economists are still uncertain about the MTP (see McCallum, 1999). Furthermore, the MTP might also be changing during the business cycle. If more than one mechanism is part of the MTP, there is no clear evidence which MTP is dominating.\textsuperscript{15} Nevertheless, money can even be a useful leading indicator when one holds the passive-money view (Engert and Selody, 1998, as well as Pill, 2000, emphasise this point). The active-money view gives, from a political economy point of view, a monetary policy strategy, which includes a highlighted role for monetary aggregates, an advantage over a strategy which does not. A discussion about excess liquidity or the level of the money supply is not as easily subject of political pressure as is the discussion about the level of employment and output (Laidler, 1999). Therefore, if a central bank displays an active-money view, it can more easily fend off political demands on monetary policy to follow a policy not compatible with price level stability (see also von Hagen, 1999). Masuch et al. (2000) make the case for the euro area that, as money is a variable with area-wide

\textsuperscript{11} See as examples for some recent research: Hayo (1999), Serletis and Molik (1999) and Trecroci and Vega (2000).

\textsuperscript{12} We use this wording as Engert and Selody (1998), Fung and Kasumovich (1998) and Laidler (1999) do.

\textsuperscript{13} One could attribute this passive-money characteristic for example to the model in Svensson (1999).

\textsuperscript{14} For more details see Laidler (1988 and 1997), as well as Brunner and Meltzer (1993). Nicoletti Altimari (2001, p. 29) finds some tentative support for an ‘independent, active role of money in the transmission process’ for the euro area. Fung and Kasumovich’s (1998, p. 575) study, based on data from Canada, France, Germany, Japan, the UK, and the United States, suggests ‘that the stock of money has an active role in the transmission mechanism.’

\textsuperscript{15} For an overview about the different theoretical and empirical issues concerning the MTP, see Mishkin (1995) and Norrbin (2001). See also a conference volume edited by the Deutsche Bundesbank (2001a) and herein contributions by Meltzer (2001) and McCallum (2001).
focus, in contrast to GDP which is seen more nationally, a communication strategy relying on money can shift the public focus away from the national level to an area-wide perspective.

The major part of the literature analysing the empirical properties of monetary aggregates in the euro area comes to the conclusion that money, mostly in the definition of M3, has the property of being a leading indicator for inflation. Therefore, as monetary aggregates include information for monetary policy, they should obviously play a role in the ECB’s strategy.

Two crucial points arise in this context: One refers to the stability of money demand in the medium run, the other to the controllability of the money stock by the ECB. For Europe numerous studies estimating money demand functions have found that the medium term money demand in the euro area is stable. Nevertheless, this should not conceal that there are still noteworthy uncertainties about fundamental monetary relationships in the euro area. This may reduce the information conveyed by money, but does not make monetary developments superfluous when discussing monetary policy decisions and explaining them to the public.

Besides a stable money demand function, the money stock should be controllable by the instruments available to the central bank. The Deutsche Bundesbank (2001b) expresses the view that the instruments employed by the ECB exert a sufficiently strong influence on the money stock, which is M3 in the euro area context. A forthcoming econometric study by the German Council of Economic Experts raises serious doubts in this respect; while for Germany, if considered as a monetary area of its own, the controllability of the development of M3 can be taken as granted, for the euro area (of the eleven founding countries, i.e. Greece excluded) it cannot. Again, there are still some methodological and statistical problems which further research will – hopefully – solve in a not too distant future. For the time being, the setting of a ‘reference value’ for monetary growth rather than establishing an intermediate monetary target allows the ECB to circumvent the uncertainty about the controllability of M3.

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16 Studies supporting this indicator property are Trecroci and Vega (2000), Nicoletti Altimari (2001), and Gerlach and Svensson (2001). They not only find that monetary indicators have a predictive content for inflation, their results also suggest that they perform better than non-monetary indicators such as the output gap, especially at horizons between one and two years.

17 It should be mentioned that there are studies not supporting the link between money and prices. Estrella and Mishkin (1997) find for Germany and the United States that there is no information content in monetary aggregates. Stock and Watson (1999) come to the same results for the United States. See for criticism on their method Atkeson and Ohanian (2001).

18 See Coenen and Vega (1999), Fagan and Hendry (1999), Brand and Cassola (2000) and Deutsche Bundesbank (2001b). Nevertheless, the aggregated ‘artificial’ national money demand functions prior to EMU are probably different from the ‘real’ aggregate money demand in the euro area because of problems with aggregated data and a possible change in the behaviour of market participants caused by the introduction of EMU (Lucas-critique).
euro area M3 – and still make use of the information content embodied in monetary expansion for price-level developments in the future. A stability-oriented monetary policy surely needs a nominal anchor, and money displays the necessary characteristics.

A further advantage of closely monitoring monetary aggregates lies in the answer to the question what a central bank can do and what it cannot. Following Friedman (1968), a central bank’s core objective should be to prevent itself from causing output volatility. It should insert enough money into the economy without inducing inflationary pressures or output instability. This is best achieved, in our view, if a central bank does not neglect the information incorporated under the first pillar. By using the growth rate of potential output when deriving the reference value, the ECB ensures a medium-term oriented policy and contributes automatically to a smoothing of the business cycle. As the growth rate of real potential output is incorporated, the central bank provides ample money in a period of a general economic slowdown. If the economy is in danger of overheating and real economic growth exceeds real potential output, the central bank automatically tightens the expansion of the money stock. The ECB should, therefore, monitor monetary aggregates closely in the internal analysis as well as in its external communication.

4. INTEREST RATE MEASURES AND INFLATION

Any monetary policy strategy must be measured against the degree of price stability it achieves. Taking into account that the ECB took charge in the beginning of 1999, it is not easy to provide an assessment because of the long lags of monetary policy.

Figure 1 shows the development of the annual inflation rate based upon changes in the HICP. In contrast to May 2001, when the euro area witnessed an inflation rate of 3.4 per cent, inflation was very low in the outset of EMU (0.8 per cent in January 1999). The average inflation rate in 1999 was 1.1 per cent, in 2000 the average was 2.3 per cent. Increases in oil and food prices and the depreciation of the euro certainly played a role in this process (see the Monthly Bulletins for an in-depth explanation). Figure 1 shows that the inflation rate substantially increased. The ECB Governing Council reacted by raising its main refinancing rate seven times from 2.5 per cent in November 1999 to 4.75 per cent in October 2000 where it stayed until May 2001 when the ECB reduced it by 25 basis points (see Figure 2). 19

19 Since 28 June, 2000, the main refinancing operations of the Eurosystem are conducted as variable rate tenders. The Governing Council decides on a minimum bid rate for these operations. Under the fixed rate tender regime the Eurosystem had been confronted with an overbidding problem. Nautz and Oechssler (2001) provide an analysis on the overbidding problem and conclude that the variable rate tenders solved this problem.
FIGURE 1
HICP Inflation in the Euro Area

Note:
Annual percentage changes; monthly data; 1996:01 till 2001:05.
Source: ECB.

FIGURE 2
The ECB’s Main Refinancing/Minimum Bid Rate

Note:
Percentage per annum; daily data; 1 January, 1999–30 June, 2001; since 28 June, 2000, the main refinancing rate refers to the minimum bid rate, see footnote 19.
Source: ECB.

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As of space restrictions and because the focus of this paper lies on the conceptual level of monetary policy, we will not interpret the money market’s behaviour or go into the ECB’s operational procedure, although these factors do certainly matter a lot for monetary policy. Whether a central bank’s credibility and predictability are correlated factors in this context is a question beyond the scope of this article.  

Since the start of EMU in January 1999, M3 growth had been above the reference value of 4.5 per cent (as portrayed in Figure 3). During 1999 and 2000 M3 (unadjusted) grew on average by about 5.7 per cent. Its increase, measured by a three-month centred moving average (annual growth rate), peaked with 6.5 per cent in March and April 2000. Since then, interest rate increases have slowed monetary growth substantially (see Figure 3). There is, however, some evidence that M3 has been distorted upwards, among other things by holdings of money market fund shares/units, money market paper and short term debt securities by residents outside the euro area. Figure 3 shows the unadjusted series for M3 and M3 adjusted constitutes the series which is adjusted for non-euro area residents’ holdings of money market fund shares/units.

Note:
Annual percentage changes; three-month centred moving average; monthly data; 1998:10 till 2001:03/04 for M3 unadjusted and M3 adjusted respectively; M3 adjusted constitutes the series which is adjusted for non-euro area residents’ holdings of money market fund shares/units.

Source: ECB.

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Source: ECB.

20 Gaspar et al. (2001) provide an in-depth analysis of the behaviour of money markets within the Eurosystem’s operational framework.
the series adjusted only for holdings of money market fund shares/units by non-euro area residents. The impact of this distortion was small until the summer of 2000. In March 2001 it amounted to about 0.5 percentage points. Once all these distortions are accounted for in the monetary statistics (probably by the end of 2001) it may turn out that the more recent monetary growth was quite in line with the first pillar’s reference value. This would improve the medium term outlook for price stability. 21

Independent of the revision, the growth rate of M3 is consistent with the rise of inflation. Figure 4 portrays the development of M3 (adjusted) and the HICP with the latter lagging 12 months. Superficially looked at, this graph suggests that the monetary development was a leading indicator for inflation. In 1999 a considerable ‘price gap’ (or ‘real money gap’ as expressed by the ECB) developed which signalled inflationary pressures. 22 Monetary growth was too high to be compatible

21 See, for an analysis of the monetary development in the euro area, von Hagen (2001).
22 The ‘price gap’ constitutes the difference between the ‘equilibrium price level’ and the actual price level. It originates within the P-Star (P*) model, which links ‘excess liquidity’ with inflationary pressures by drawing on the quantity theory. Economic agents will influence aggregate demand by eliminating their excess money holdings which will eventually lead to changes in prices. The P-Star model plays a major role in the empirical studies examining the information content of money. For an introduction to the P-Star model and its historical roots see Humphrey (1989).
with price stability. The gap closed considerably in the middle of 2001 because excess money growth was absorbed in higher prices. The ECB cannot be held responsible for the immediate development of M3 in the beginning of 1999. But one could argue ex post that the growth of M3 and later prices was spurred by the relatively low level of interest rates in 1999.

5. TRANSPARENCY AND CREDIBILITY

The debate on transparency has been at the centre of the discussion on European monetary policy. Does the transparency of a central bank correlate with the amount of information it publishes? Can it only be considered transparent if it publishes minutes and voting records? The answer will depend on the observer’s perspective. We think the last question can be answered with a no. The public is not really interested in knowing after some time how each member of the Governing Council voted on a particular issue, i.e. change of interest rates, and what kind of reasons were put forward on that occasion. Instead, the public is concerned with the degree of price stability which the ECB achieves and maintains. This task might be unnecessarily rendered more difficult if the publication of minutes and voting records provokes external (political) pressure upon members of the Governing Council.

The ECB risks, however, to convey the impression that it follows a ‘look-at-everything’ strategy, which is probably what most central banks do, but it should emphasise where it looks more and where less. The ECB (2000, p. 46) argues that ‘some trade-off between simplicity and openness may exist’. We think that this is true. How complex can a strategy be and at the same time be understood by the general public?

We regard it as superior not to convey the impression that monetary policy is an easy business because otherwise it will raise expectations it cannot fulfil. Therefore, a strategy à la Eurosystem, complicated and not very easy to communicate, is better than a strategy à la Greenspan or an inflation forecasting targeting regime. We regard as an advantage that the strategy chosen by the ECB as well as the communication clearly show that it knows what it can do and what it cannot do.

23 See the controversy between Buiter (1999) and Issing (1999a), and the perspectives provided by Randzio-Plath and Padoa-Schioppa (2000). See Svensson (1999, p. 129) for a critical view. He blames the ECB for pursuing a strategy which sets ‘lower standards with regard to intellectual coherence, analysis, and transparency than the best practice of current inflation-targeting central banks.’

24 Gersbach and Hahn (2001) balance the costs and benefits of voting transparency. In their model the negative effects of publishing voting records outweigh the benefits.

The ECB has tried its best to achieve the minimum requirements to be regarded as transparent: an announced quantitative ultimate goal, a definition of its monetary policy strategy and the intention and good will to provide a detailed description of its policy decisions with comments on all factors contributing to it.\textsuperscript{26}

To which degree the ECB has achieved to fulfil these criteria is disputed. We think that there is still room for improvement in one area or the other, which is not unusual for a young institution. One has to concede that the ECB is faced with the problem that it has to address economic agents with a much more diverse experience and background than most if not all other central banks in the world.

An example for a major communication problem is the ECB’s policy towards the evolution of the euro exchange rate. The exchange rate should only concern policy-makers to the degree that its movement endangers price stability. But even if that is the case, it is difficult to establish whether a central bank should react, and how. Consistency seems to be one of the most important factors for achieving credibility with financial markets; although not necessarily with academic circles.

The ECB’s communication was, however, everything but consistent in transporting a clear message on its policy towards the euro exchange rate. It should try to convey to the public that the main goal attributed to the euro is its degree of price stability \textit{within} the euro area. The interventions may have included useful signals to the financial markets such that the ECB has the technical ability and knowledge to implement these measures, but the ECB’s experience supports the view that interventions (especially if conducted unilaterally) simply do not work against market tendencies.

Simply put, we regard capital flows as the decisive determinant of the exchange rate. International portfolio and investment decisions do exert major influences on the exchange rate, they are probably more influential than trade flows. Under the conditions of globalised markets, capital movements are mainly driven by a region’s economic attractiveness. Part of that attractiveness is determined by the central bank. This part is price stability, not more, not less. Therefore, it is \textit{not} true to argue that the exchange rate is a central bank’s share price, it is more a share price representing the position of a country/region in the process of locational competition. If internationally mobile capital prefers the dollar area to the euro area, as has been the case, it may be so because investors consider Europe to be at a disadvantage with regard to important structural aspects such as taxes, labour costs, and market regulations. The European monetary policy simply cannot offset drawbacks of this type and thereby attract capital or prevent it from choosing an exit option. Other fields of economic policy, situated in the individual member countries themselves, have the responsibility to deal with this.

\textsuperscript{26} Winkler (2000) provides an analysis of the wording used in this argument. The Deutsche Bundesbank (2000) discusses which degree of transparency can be attributed to different central banks.
6. MACROECONOMIC ADJUSTMENT AND MONETARY POLICY

The increasing focus on stock markets and the behaviour of the Federal Reserve are indicators that asset prices will also in the euro area play a more influential role in the formulation of monetary policy in the future. In our view, this development underlines the case for the significance of the first pillar. The experience shows that the development of monetary and credit aggregates are more closely related to asset price bubbles than the change in consumer price inflation (see Gros et al., 2000). Although there is no clear recipe how to deal with asset price bubbles, the growing relevance of asset prices remains a strong argument in favour of closely monitoring monetary aggregates.

Inflation differentials are a further issue arising when weighing the arguments for or against a strategy. These differentials have increased in the euro area since the introduction of EMU. With reference to the Balassa-Samuelson effect, Sinn and Reuter (2000), for instance, argue that the ECB’s definition of price stability is too low, if taking into account that the more dynamic countries portray high inflation rates correlated with higher growth.

We do not see the necessity to revise the ECB’s definition of price stability. There will always be sub-regions within regions, regions within countries, and countries within the euro area who portray higher growth rates and sometimes also higher inflation rates than the average. The reference value within the first pillar of the ECB’s monetary policy strategy should automatically be revised upwards in the medium term, if and when potential output rises. This makes sure that sufficient liquidity will be made available in the medium or long term. In the short term, market forces will ensure that the regions in necessity of higher liquidity will get their ‘slice’.

One should also not forget that it is possible for a region to grow without experiencing inflation, namely, if potential output is rising along actual output and if there is no excess liquidity. Important to note, deregulation and reforms on goods, labour and financial markets will spur growth within the medium and long term horizon and will also help keep regional inflation under control.

7. FINAL REMARKS

The ECB is still halfway on its road to ultimately earn the reputation as guarantor of price stability in the euro area. This path is anything but easy. There are many conflicting approaches to the shaping of the single monetary policy. The statistical information systems still portray important weaknesses. The monetary transmission process contains a high degree of uncertainty with regard

27 See for a more detailed analysis of this subject Alesina et al. (2001) and Canzoneri et al. (2000).
to every participating country. Policy makers are tempted, once and again, to urge the ECB Governing Council to make monetary policy decisions which are not consistent with the goal of price stability. The ECB is also faced with the challenge to improve its communication strategy as its watchers, as well as the broad public have difficulties to fully understand the two-pillar strategy and the policy decisions which have been made with reference to developments in the two pillars.

However, European monetary policy had to start from scratch. There was no model in the real world which could have worked as an example. The ECB could not afford an attitude to wait until economic research yielded clear-cut solutions for the adequate monetary policy stance. Imperfections are therefore unavoidable for some time in the future. After all, the real test concerning the ECB’s stability-oriented credibility is still to come, that is when external circumstances become extremely unfavourable.

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