The Conduct of Monetary Policy in the Main Areas

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Abstract. The euro area, like the United Kingdom and unlike the United States, has provided its central bank with the clear and appropriate sole task of pursuing low inflation. Unlike the United Kingdom, the euro area has failed to provide its central bank with an appropriate institutional structure for carrying out this role. The ECB's strategy for attaining a reputation for inflation aversion has thus been two fold. First, it has followed the United States and the United Kingdom in pursuing low inflation. Second, unlike the United States, it has attempted to provide itself with an appropriate institutional structure. Unfortunately, the ECB has been less successful at this than the United Kingdom. As a result, policy makers at the ECB share US policy makers reputation for inflationary toughness, but the ECB – as an institution – may not share the UK MPC's credibility.

1. Goals and Strategy

There is a near consensus among academics and policy makers that low and stable inflation is desirable and that monetary policy cannot be used to systemmatically increase output or employment. Long and variable lags between the implementation and effects of monetary policy limit its usefulness in offsetting transitory shocks. As a consequence, it is now widely accepted that the proper role for a central bank is to provide price stability. Thus, the European Central Bank (ECB) and the Bank of England, along with the Bank of Japan, the Banco Central do Brazil, the Bank of Korea, the Bank of Canada, the South African Reserve Bank and many others, have low inflation as their legislated primary goal. In contrast, the anachronistic Federal Reserve Act of 1913 asks the Federal Reserve's FOMC to pursue the impossible and poorly defined task of increasing production, promoting maximum employment and maintaining both moderate long-term interest rates and stable prices.

Given policy makers' incentives to use monetary policy opportunistically, specifying price stability as the central bank's primary goal is not enough; the institutional structure of the central bank ought to be conducive to low inflation. Probably the best way to ensure low inflation is to make the central bank operationally independent, and so relatively free of the influence of politicians, and to give the central bank a simple, visible, verifiable, easily understood, rarely changing goal. This was done in the United Kingdom, and in other countries such as Brazil and Canada, by mandating an inflation target. Somewhat less appealing arrangements are South African Reserve Bank's requirement to keep inflation within a specified band and the Bank of Korea's requirement to both set and meet an target inflation. Unfortunately, neither the ECB nor the Federal Reserve were given the benefit of such a structure; while enjoined to keep inflation low they are neither given nor required to set explicit goals.

Since its inception the ECB has managed to keep inflation low; inflation has hovered just above two percent most of the time. This favourable outcome is similar to what has

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been achieved by the FOMC under the chairmanship of Paul Volcker and Allen Greenspan and by the Monetary Policy Committee of the Bank of England since its beginning in 1997. As a result, policy makers at the ECB share the reputation of Paul Volcker, Allen Greenspan and the UK monetary policy committee for being tough on inflation. Unfortunately, in the euro area, as in the United States, there is a danger that simply pursuing low inflation leads to a reputation that is attached to the specific people who have been responsible for policy and not to the central banks.

The ECB has differed from the FOMC in attempting to improve upon this outcome and to attain an institutional reputation for inflation aversion by setting its own monetary policy goals. Unfortunately, the goals it has chosen have not been as simple and easy to understand as those of the UK's MPC. And, unlike the MPC, the ECB has not been able to meet its stated aim. Worse, after failing to meet its initial goal, it revised its aims and then has failed to meet the new goal.

The ECB initially defined price stability as a year-on-year increase in the Harmonised Index of Consumer Prices (HICP) for the euro area of less than two percent in the medium term.[1] While vague, an obvious interpretation of this definition was that the ECB was aiming for an inflation rate between zero and two percent. A new institution, such as the ECB would have enhanced its reputation by sticking to and achieving its announced target. As Willem Duisenberg said, "Don't change the rules of the game when you have only just begun playing."[2] On at least two occasions, Duisenberg reassured the public that no change in the target was envisioned.[3] Unfortunately, the inflation goal was not attained; average inflation was 2.3 percent in both 2001 and 2002 and under the guise of a "clarification", on 8 May 2003 the inflation target was loosened to below but close to two percent. In addition to not enhancing the ECB's reputation for inflationary toughness, the move was confusing. Rather unhelpfully, Otmar Issing further clarified that the goal was, "inflationary expectations remaining in a narrow range of between roughly 1.7 percent and 1.9 percent... ." A befuddled journalist may have spoken for many when he said, "I have to communicate it, I have to write it, and I have not understood it."[4]

To summarise the above discussion, the early record of the ECB has left little doubt that Willem Duisenberg and Jean-Claude Trichet are committed to low inflation. However, the result of the ECB's imperfect attempt at institution building is that it may be that the ECB, as an institution, does not share the MPC's credibility.

2. Communicating Decisions

If a central bank is to gain credibility for a commitment to low inflation, it must be able to convincingly communicate the reason for its decisions. For example, consider a sharp rise in the price of oil. If the central bank perceives this rise as temporary then it may sensibly choose not to offset it; as previously argued monetary policy has limited usefulness in offsetting transitory shocks. It is then important that the central bank quickly and clearly explains to the public the reasons for its failure to respond so that the lack of response is not perceived as resulting from insufficient determination to meet the central bank's inflation goals.

Compared to other central banks, the ECB has done an admirable job in justifying its actions. Most modern central banks, including the ECB, the Federal Reserve and the

[1] Willem F. Duisenberg, ECB Press conference: Introductory statement, 13 Oct. 1998.
[2] Duisenberg, ECB press conference 12 Sept. 2002.
[3] Duisenberg, ECB press conferences 19 Oct. 2000, 1 Mar 2001.
[4] Press seminar on the evalutaion of of the ECB's monetary policy strategy, 8 May 2003.

Bank of England immediately and publicly announce the results of their policy-making meetings. However, the FOMC provides only a couple of paragraphs of explanation and the MPC provides no justification whatsoever. In contrast, the ECB immediately provides several pages of detailed analysis and holds a press conference. It is only much later that other central banks publish a more detailed discussion of their actions. The MPC publishes the minutes of its monthly meetings on the Wednesday of the second week after the meetings take place, leaving a more detailed analysis for its quarterly *Inflation Report*; since January 2005 the FOMC has released its minutes three weeks after the date of the policy decision. The ECB also provides a more detailed analysis, publishing is comprehensive monthly bulletin only one week after the press conference. In addition to written information, Executive Board members give regular speeches. This is similar to the situtation in the United States, where Federal Reserve Board members give regular presentations, but contrasts with the United Kingdom; Jean-Claude Trichet has given more speeches this year than all of the members of the MPC combined.

The ECB regards what they refer to as the *real time* analysis of monetary policy as the cornerstone of what think of as transparency.[5] Certainly in the rapid and comprehensive transmission of analysis they have

3. Opacity

The ECB is widely viewed as more opaque in its decision making than the either the Bank of England or the Federal Reserve. This is a result of its refusal to say how the Governing Council has reached a decision. No minutes or transcripts are published. Individual votes and the size of the majority are not revealed. Probing journalists are rebuked at the post-decision making meeting press conference with, "I do not answer questions on voting" and "As regards voting, you know I never say anything".[6] This secretive attitude is in contrast to many central banks; the FOMC, the MPC and the Bank of Japan all publish the votes of individual members. Indeed, it is not clear that votes are *ever* even taken by the Governing Council or how a decision is reached if they are not. At press conference after press conference the President has emphasised that there is little dissent saying, "it became clear that taking a vote was not necessary", "there was – again – as usual, consensus", and "today's decision was, as so often, a consensus decision". [7]

Opacity may hurt the ECB in another way. If attaining inflation near to two percent is the overriding goal of the ECB, then this suggests that making monetary policy is primarily a technical activity best undertaken by technocrats who must decide, given current and expected future fundamentals, what path of short-term interest rates will produce the desired inflation. This suggests that the structure and practices of the Governing Council ought to be such that its members have an incentive to exert effort in the acquisition and analysis of information. Unfortunately appears that ECB's mandated structure and the practices that it has chosen to adopt seem designed to minimise the incentives of its Council members. In this matter the ECB is similar to the FOMC and in sharp contrast to the MPC.

The ECB's Governing Council currently has 18 members, with the possibility of an even larger group when the accession countries adopt the euro. This contrasts with the FOMC's 12 members and the nine-member MPC. Both the academic economics and

[5] See, for example, Jean-Claude Trichet, "Communication, transparency and the ECB's monetary policy," speech for the International Club of Frankfurt Economic Journalists, 24 Jan 2005.

[6] Duisenberg, 30 Aug. 2001, 7 Nov. 2002.

[7] Duisenberg, 11 Apr 2001, 5 Dec. 2002, 12 Dec. 2002.

pyschology literature suggest that increased committee size can lower individuals' incentives to exert costly effort and ability to interact.[8] In addition to having an excessively large Governing Council, the ECB has chosen not to publish invidual votes. This is in constrast to both the FOMC and the MPC and may be especially injurous to effort given the Governing Council's size. The psychology literature provides evidence that effort in large groups is diminished even further when individual contributions cannot be evalutated.[9]

References

[1] Mukhopadhaya, K., 1999. "Jury Size and the Free Rider Problem," *Journal of Law, Economics and Organization, 19.*

[2] Napier, R. and M. Gershenfeld, 1999. *Groups: Theory and Experience*, 6th. ed., New York, Houghton Mifflin Co.

[3] Parks, C. and L. Sanna, 1999. *Group Performance and Interaction*, Boulder, CO, Westview Press.

[8] See Mukhopadhaya (1999) and Napier and Gershenfeld (1999), for example.
[9] See Parks and Sanna (1999) for a discussion.