

ECOMENTARY™

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The ECB Searches for Adaptability While Staying True To Its Task

An intense controversy over ECB policies, presentation style and the effectiveness of its policies arose after the ECB caught the market off guard with its 25 basis point reduction on May 10th. Unfortunately, the initial presentation on the day of the change left a broad feeling of discomfort, because the policy change was preceded by statements of some of the ECB policy makers that led to a diametrically opposite conclusion. Many of us, therefore were ‘wrong footed.’

Fortunately, we were able recently to meet with some senior staff at the Bank and those meetings, together with the ECB’s own published views have helped to develop a more rounded picture of policy making at the ECB. Overall, we have been struck with the gravity with which members of the staff of the ECB and its member NCB (national central banks) approach their task, but the task is one that goes beyond traditional Central Bank policy-making. The key for non-Europeans is to understand that task. This means that we ought to view the ECB in light of how their own practitioners see their task. To analyze the ECB’s policy in any other terms is to be tricked by one’s own starting points---in terms of monetary theory and observed Central Banking practice elsewhere. Why?

The overriding impression one gets of the ECB as well as its constituent National Central Bank is the vastness of the institution-building that its proponents and staff take for granted in their policy approach. They see the activity as the most important historical event in European history. One can smirk at such an inflated posture, or one can take it seriously and try to gain understanding into the policy process. Seen in that light, the ECB is not merely a Central Bank, it is a major instrumentality in the process of building EUROPE as an integrated political-economic entity. This is not a new insight, but sometimes in the process of evaluating monetary policy, we forget it. If one loses sight of that task, however, then much of the ECB day- to-day policy apparatus makes little sense.

Since, Americans are a rather a pragmatic bunch, we tend to disregard this nation-building aspect of the ECB.. We usually only want to know, did they make the right policy decision on the day? Unfortunately, as very often happens in a meeting involving individuals speaking different languages, the two sides wind up being misunderstood because in fact they do not share a common agenda.

On the whole, many American economists look at the functioning of a Central Bank in terms of its performance in achieving a smoothing out of the business cycle and to the very occasional lender of last resort function that may be exercised by a Central Bank. Yet, very confirmed monetarists might well argue that a Central Bank cannot affect the growth rate as monetary policy primarily affects the price level. Europeans, particularly those involved on a day to day basis with the

operation and policy making of the ECB, would agree with that definition.¹ However, the ECB is hitched to the task of institution building, as part of the larger task of building Europe as a modern political-economic entity. This has to put a strain on the policy making process, because it has the appearance of rigidity. The process has to be consistent with the explicit mandate (price stability), but it cannot be consistently at the expense of political realities that could create too much strain within the monetary union. That is where we are now...and it is evident that the ECB is stretching to cover both bases! With such divergent criteria, it is not hard to understand why the ECB is regarded as exhibiting consistent ineptitude in getting across the reasoning behind its policy determination, particularly when it imposes the requirement on its Governing Council that it speak with a single voice!

If you step off the Continent, and you look at the essence of the political campaign now being waged by the Conservative Party over the question of 'going into Europe,' it becomes a bit more clear. The Conservatives are horrified by that very vastness of building a new national entity. The symbolic representation of that new entity is of course the Euro. To them, giving up Sterling for the Euro, is to give up the very essence of sovereignty, which is how Lady Thatcher recently put the case. Labor, on the other hand, is mightily intrigued by what is going on. If Labor wins big in next month's election, sooner or later, the issue of European Nation-Building is going to be on the agenda. It will come in the form of whether Britain joins EMU and the Bank of England becomes just another one of the National Central Banks that make up the ECB. In such context, there will be no independent policy action by the Bank of England except as a constituent NCB in the regulatory process and as a single member of the Governing Council of the ECB. For the world's first central bank to be 'acquired,' is for some an intolerable thought. At a more practical level, the very governance procedure of the ECB may cause a problem. The ECB appears to think it needs to speak with only a single voice. As one commentator put it, getting two people to agreement is hard. Getting 18 to agree and speak in agreement is an impossibility. But, if one's ultimate goal is trans-national institution building, a 'variety' of views on display each moment is a sticky wicket indeed.

Institution building might seem to us an inappropriate activity for a Central Bank. But, unless one visualizes the ECB in that context, much of what it says and does makes little sense. Seen in the context of that enlarged mission, ECB monetary policy presentation may appear a bit less incomprehensible. It is almost foreordained that the stretching of doctrine to meet unforeseen circumstance is bound to arise. The Fed gets around this problem by varying attention to multiple goals. The ECB has not felt it had that latitude. It really has only a single target..

The post mortem of the recent decision revealed just that. If there is one consensus opinion that is heard by financial analysts who cover the ECB, it is that they found the ECB decision very hard to understand. A great deal of labor in order to make one small easing. The ECB behaves as if it seems to require of itself to make decisions that only fit within its announced criteria, and the first of those criteria was price stability. Prices, however, have not behaved so stably in recent months and

¹ "The primary objective of the ECB's monetary policy is the maintenance of price stability. The ECB organizes its analysis of the assessment of risks to price stability under two pillars. Under the first pillar, money plays a prominent role, implying that monetary aggregates are thoroughly analyzed for their information content relevant for monetary policy. This role is signaled (sic) by the announcement of the reference value for the growth of the broad monetary aggregate M3. Under the second pillar, a range of other economic and financial indicators relevant for future price developments is analyzed. The two pillars complement each other and allow for a broadly based and robust assessment of risks to future price stability." ECB Monthly Bulletin, May 2001, "Framework and tools of monetary analysis," p.41.

weeks, but the macro economy of Europe is definitely weaker. The latter causes political pressures of various kinds and it must cause some discomfort for ECB governing members who will be asked discomfiting questions if the decline persists. Making a change when your primary indicator does not signal you to make such a change is then a very difficult hurdle.

Such was the case in the recent “surprise” when the ECB let the rate down by 25 basis points, when scarcely days before, senior officials in Europe openly spoke of the risks of inflation. To go around that obstacle, emphasis is now on “risks to medium term,” and a reinterpretation of the primary indicator of future price stability problems, M3.

A new mantra is developing at the ECB, which revolves around understanding when growth of M3 does not signal a future inflation problem. The ECB now contends that growth rates of M3 – properly defined--have been overstated. Yesterday, further evidence of this was presented by the ECB first by publication on the ECB website of another analysis of M3 behavior as between Euro residents and non-Euro residents,² and second, by a speech, originally not for public distribution, by Otmar Issinger.³ One should ask, while all this attention to what is happening to the internals of M3? The easy answer is that the ECB is uneasy with its public persona and how it has been perceived in making the policy change of May 10th. The harder answer is that it is clear that economic conditions are deteriorating more rapidly in Europe than the ECB’s earlier forecasts have suggested. If the new trends continue, the ECB will be in great discomfort because its signaling apparatus will have failed.

The ECB now appears to be in process of finding a suitable justification for what may become a significant change in its policy stance. It may be doubly uncomfortable because it deeply wishes to be taken seriously, true to its own task. The issue is whether the data and the interpretation placed upon them actually make the case for easing. We are not sure, but we are sure that monetary policy has been shifted. We also think that it is highly likely to be moved once again in the not too distant future even if M3 continues to grow. The ECB will now wrestle with how to present its case and appear once again an august institution worthy of serious regard in the nation-building process.

What is now evident to almost everyone in Europe who wishes to speak openly about it, is that economic activity in the EMU countries has taken a more negative turn. The so-called second pillar is giving off uncomfortable signals---while at the same time---the first pillar could easily be interpreted to render a “no change” decision. The ECB is not only a Central Bank. It is a political institution---as all Central Banks ultimately recognize that they are---and it must render a decision that is not completely indifferent to the perceived needs of its constituents. It is clear that the effort to portray M3 growth in a different light is not altogether an exercise in pure science. A way must be found to make the transition, and we believe they are now doing just that.

From the effort, it seems wrong to interpret this as ‘much ado about nothing.’ It is much ado about making a shift, yet finding a language that is both consistent with earlier ECB policy formulation while not distancing the ECB so terribly from emerging economic realities. If you are building a serious institution—designed for the most serious trans-national experience in European history---the institution has to be ‘adaptable.’ Adaptability is, after all, what makes survival under new conditions possible!

² “Monetary Developments in the Euro Area: April 2001,” May 30,2001 ECB, <http://www.ecb.int/>

³ Otmar Issing, "The Euro and the ECB - Successful Start - Challenges Ahead," delivered in Milan May 30, 2001.