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IS THE EUROPEAN CENTRAL BANK WORKING?

WITH EVIDENCE

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(Q) refers to a question in oral evidence
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FORTY-SECOND REPORT

30 OCTOBER 2003

By the Select Committee appointed to consider European Union documents and other matters relating to the European Union.

ORDERED TO REPORT

IS THE EUROPEAN CENTRAL BANK WORKING?

PART 1: EXECUTIVE SUMMARY

Box 1

Executive Summary

The European Central Bank is one of the most influential financial institutions in the world economy. Endowed with an extraordinary degree of independence, the European Central Bank (ECB) sets interest rates for the countries that have adopted the euro.

This report reviews the operations of the ECB so far, assessing its monetary policy decisions. It goes on to examine the central bank's monetary policy strategy and considers issues around the structure and governance of the bank, as well as the broader question of the institutional arrangements for the economic governance of the EU as a whole and the euro area in particular.

The Committee concludes that the ECB has performed well so far given its mandate. The ECB is still a young institution, but it has rapidly built up a high level of credibility by delivering the desired objective of price stability. There are, however, a number of significant challenges that the bank is facing: disputes over the Stability and Growth Pact, calls for greater transparency, and enlargement of the EU.

The Committee recommends:

• The ECB should adopt a symmetrical inflation target.

• The ECB should publish records of meetings of the Governing Council in which the reasoning and various arguments behind monetary policy decisions would be spelled out clearly but not attributed.

It is within the power of the ECB itself to implement these two changes. The Committee's other key recommendations require changes to the draft Constitutional Treaty and so call for the urgent attention of Member States at the current Inter-Governmental Conference:

• In due course the monetary-policy decisions of the ECB should be taken by a small Monetary Policy Council, composed of the Executive Board and external experts, which would operate under the oversight of the current Governing Council, where all the Member States of the euro area are represented.

• The arrangements for communication between the ECB and the Eurogroup need to be strengthened. There should be an enhanced policy dialogue and exchange of information between the ECB and the Member States of the euro area.

PART 2: BACKGROUND

Introduction

1. The European Central Bank is one of the most influential financial institutions in the world economy. Endowed with an extraordinary degree of independence, the European Central Bank (ECB) sets interest rates for the countries that have adopted the euro. A few months before the ECB was established on 1 June 1998, we conducted an inquiry that examined how and whether the bank would work.[1] Five years have elapsed since the bank announced its monetary policy strategy, and so we consider that it is an opportune time to review and evaluate the ECB's strategic framework.

2. The current Inter-Governmental Conference (IGC), which is discussing the draft Constitution prepared by the Convention on the Future of Europe, offers Member States an opportunity to review the institutional framework of the European Union (EU). In this context, we decided that our inquiry should not only look at the ECB's monetary policy strategy but should also consider issues around the structure and governance of the bank, as well as the broader question of the institutional arrangements for the economic governance of the EU as a whole and the euro area in particular.

The contents of this report

3. As well as following up our previous report on the ECB, this report, looking at how monetary policy is conducted in the euro area, complements the report we produced earlier this year on the Stability and Growth Pact.[2] This report does not consider whether, when and in what circumstances the United Kingdom should adopt the euro; it is intended rather as a contribution to the debate on the ECB itself, irrespective of whether the UK and other Member States outside the euro area decide to adopt the single currency. Our dual aim was to review the workings of the bank since it was established in 1998 and to look forward and ask whether any changes should be implemented ahead of enlargement of the EU and the euro area. The report looks at these issues from a European perspective, focusing on the wide European interest. In preparing the report, we heard from witnesses from 9 different Member States, as well as from the United States of America (US).

4. The rest of this section provides an introduction to how the ECB works and concludes with an assessment of the bank's record of monetary policy decisions so far. Part Three of this report analyses the ECB's monetary policy strategy as a framework for making those decisions and as a means of communicating them to the public. In Part Four we examine the governance of the ECB, and in particular the issue of reform of the Governing Council, asking what would be the optimal solution to the problems posed to the workings of the Governing Council by enlargement of the euro area. In Part Five we consider the issues of transparency and accountability. Part Six looks at the broader question of economic governance of the EU and the euro area in particular. Part Seven provides a summary of our conclusions. A glossary is provided in Appendix 3.

The inquiry

5. The inquiry was carried out by Sub-Committee A of the European Union Committee. The Membership of the Sub-Committee is listed in Appendix 1. Our witnesses are listed in Appendix 2; we are grateful to all of them and all those who assisted us in the course of the inquiry, particularly those who gave oral evidence.[3]

6. As well as taking evidence in the House, the Sub-Committee visited the ECB at its headquarters in Frankfurt. The Sub-Committee met the President of the ECB, Wim Duisenberg, and the other members of the ECB's executive board, all of who were most open and helpful. The frankness of their

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[1] The subsequent report was published in June 1998 and called *The European Central Bank: Will It Work?* (Session 1997–98, 24th Report, HL 112). The report was debated in the House on 13 October 1998.

[2] *The Stability and Growth Pact* (Session 2002–03, 13th report, HL 72). The report was debated in the House on 4 June 2003.

[3] We would also like to thank all those who, although unable to supply us with new evidence in response to our questions, sent us copies of articles or reports that they had already produced on the ECB: Professor Dr Ansgar Belke, Universität Hohenheim; Professor Guillermo de la Dehesa, Chairman of the Centre for Economic Policy Research (CEPR) and Chairman of the Observatorio del Banco Central Europeo (OBCE—Spanish ECB Watcher); Dr Ellen Meade, Senior Research Fellow, Centre for Economic Performance, London School of Economics & Political Science; Professor Hans-Werner Sinn, President of the Ifo Institute for Economic Research; Professor Lars E.O. Svensson, Professor of Economics, Princeton University; and Professor Charles Wyplosz, Professor of Economics, Graduate Institute of International Studies, Geneva, Director of the International Center for Monetary and Banking studies (ICMB) and co-director of international macroeconomics at the CEPR. We also thank our Specialist Adviser, Professor Richard Portes, Professor of Economics at the London Business School and President of the CEPR, who provided valuable advice to the Sub-Committee at the start of its inquiry.

responses to questions greatly assisted the Sub-Committee as it pursued its inquiry and prepared this report. During its visit to Frankfurt, the Sub-Committee also held an informal meeting with the President of the Deutsche Bundesbank, Ernst Welteke, and we are also most grateful for his time and constructive contribution to our work.

The Structure and Governance of the ECB and ESCB

7. The European Central Bank took over monetary policy decision-making for those Member States participating in the euro area on 1 January 1999, when the euro was formally created at the start of Stage Three of Economic and Monetary Union (EMU)—see Box 2.[4]

8. The EC Treaty established three levels of governance within the ECB in connection with the single currency. These levels can be conceived of as a set of concentric circles. First, at the centre, forming the inner circle, there is the full-time Executive Board of the ECB, which is comprised of the President, the Vice-President and four other members (Article 112(2)(a)). Second, moving outwards away from the centre, there is the Governing Council of the ECB, which normally meets twice a month and comprises the Executive Board members and the governors of the national central banks of the countries in the euro area (Article 112(1)). Finally, representing the outside circle, is the General Council of the ECB, which meets four times a year; its membership comprises the President and Vice President of the ECB plus the governors of the national central banks of all EU Member States.

Box 2

Economic and Monetary Union (EMU)

The Delors Report in 1989 envisaged a three-stage transition to full Economic and Monetary Union (EMU). The EC Treaty, as revised in Maastricht, set out a timetable for the transition to a single currency in the final stage – Stage Three –of EMU.

The first stage of EMU began on 1 January 1990; Stage Two began on 1 January 1994. On 3 May 1998 11 Member States were judged to meet the conditions for adopting the single currency, the euro; and the third stage of EMU started on 1 January 1999, with the launch of the euro.

In Stage Three of EMU the exchange rates of participating currencies were locked together and these currencies became denominations of the single currency, the euro. Euro notes and coins followed three years later, on 1 January 2002, and gradually replaced participating national currencies.

The original 11 countries were later joined by Greece, which it was agreed could join the euro area in 2000 and which adopted the euro on 1 January 2001.

Responsibility for determining monetary policy for those countries participating in Stage Three passed to the Governing Council of the ECB, which consists of members of the Executive Board of the European Central Bank, plus governors of participating Member States' national central banks.

9. The Executive Board implements the monetary policy of the ECB, prepares the meetings of the Governing Council and deals with the day-to-day business of the ECB. The Governing Council represents the Eurosystem, the central banking system of the euro area, which is constituted of the ECB and the national central banks of the Member States that have adopted the euro. President Duisenberg, the first President of the ECB, compares the Eurosystem to a wheel, with the ECB in Frankfurt as its hub, and the national central banks as its spokes.

10. The General Council represents the European System of Central Banks (ESCB), which consists of the ECB and the national central banks of all the Member States of the EU. The General Council has oversight of the advisory and reporting activities of the ECB, the collection of statistical information, the conditions of employment of the staff of the ECB and certain other matters. The governors of the national central banks of the acceding countries participated as observers in a meeting of the General Council of the ECB for the first time on 26 June 2003, giving a foretaste of the enlarged ESCB.

[4] On 3 May 1998 the European Council unanimously decided that 11 Member States fulfilled the necessary conditions for the adoption of the single currency on 1 January 1999. The 11 countries were Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, the Netherlands, Portugal, and Spain.

11. Because the UK has so far chosen not to adopt the euro, the Bank of England is not represented in the Governing Council. However, the Governor of the Bank of England does sit on the General Council of the ECB, which has certain responsibilities under the Statutes[5] and which also holds general discussions about progress within the euro area. The Bank of England is also represented on a number of technical working groups and committees of the ESCB.

Independence

12. The ESCB is governed by the decision-making bodies of the ECB (Article 107(3) TEC). The independence of the Executive Board and the Governing Council in the performance of their tasks is protected by the terms of Article 108 of the EC Treaty: the members of the ECB's governing bodies shall neither seek nor take "instructions from Community institutions or bodies, from any government of a Member State or from any other body. The Community institutions and bodies and the governments of the Member States undertake to respect this principle and not to seek to influence the members of the decision-making bodies of the ECB or of the national central banks in the performance of their tasks." It is an important reflection of this provision that the national central bank governors of the euro area participate in the work of the Governing Council, not as representatives of the Member States from which they come but as independent experts.

The ECB's monetary policy strategy

13. The Treaty assigns the ESCB the principal objective of maintaining price stability. Article 105(1) TEC states that:

> "The primary objective of the ESCB shall be to maintain price stability. 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".

This formulation leaves the ECB with a very substantial measure of discretion as to the way it achieves these objectives: the Treaty neither defines the concept of price stability, nor lays down a method by which the bank is to take into account the Community's other specified objectives, which are laid down in Article 2 of the EC Treaty and include "a high level of employment" and "sustainable non-inflationary growth".

14. In October 1998, the Governing Council of the ECB announced its quantitative definition of "price stability" as being a "year-on-year increase in the Harmonised Index of Consumer Prices (HICP) for the euro area of below 2%". As well as declaring that it was to use Eurostat's headline HICP (the consumer price index that has been harmonised across the EU), the bank also specified that it would aim to maintain price stability "over the medium term".[6] Accordingly, the Governing Council would set short-term interest rates with a view to keeping inflation for the euro area below 2%. In reaching its decisions on interest rates, the ECB declared that it would use a two-pillar approach. Under the first pillar, the bank attributed a prominent role to monetary indicators; under the second pillar, the bank would make a broadly-based assessment of non-monetary indicators of price developments.[7] The role to be attributed to monetary indicators would be signalled by a quantitative reference value for the growth of the broad monetary aggregate M3.[8] In December 1998, the Governing Council set the first reference value for monetary growth at 4.5%, explained the derivation of the reference value and said that they would review this figure annually.[9] The ECB reviewed its monetary policy strategy in the first half of 2003. The outcome of that review is presented and discussed below (see Part Three).

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5 The Treaty contains the provisions which establish these three bodies. A protocol annexed to the Treaty, Protocol (No 18) on the Statute of the European System of Central Banks and of the European Central Bank (1992), contains more detailed provisions. The responsibilities of the General Council are defined in Article 47; they are basically advisory and do not relate to monetary policy.

6 'A stability-orientated monetary policy strategy for the ESCB', ECB Press Release, 13 October 1998.

7 cf. 'The stability-orientated monetary policy strategy of the Eurosystem', *ECB Monthly Bulletin*, January 1999; and 'The two pillars of the ECB's monetary policy strategy', *ECB Monthly Bulletin*, November 2000.

8 See the glossary in Annex 3 for a definition of technical terms.

9 'The quantitative reference value for monetary growth', ECB Press Release, 1 December 1998.

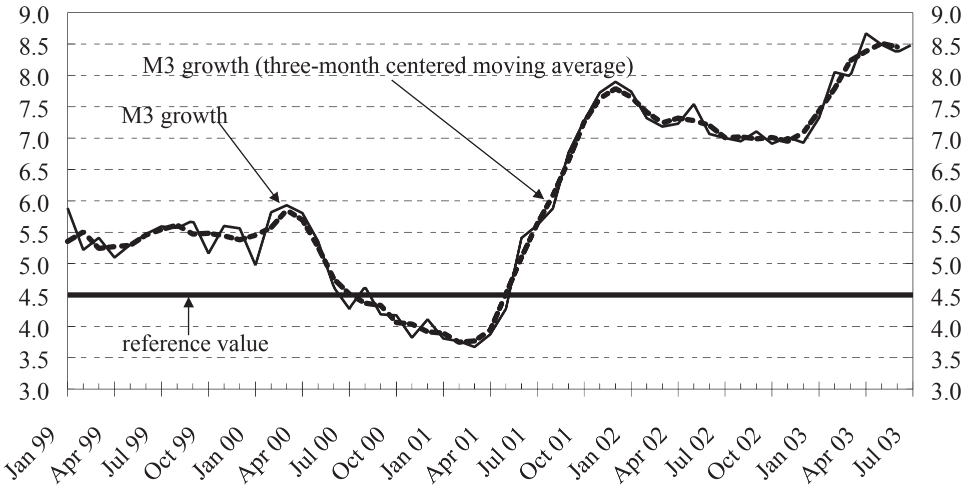
The monetary policy record of the ECB

The facts

15. The charts below show money growth, inflation and interest rates in the euro area since the ECB started operating on 1 January 1999.

Box 3

M3 annual growth rate

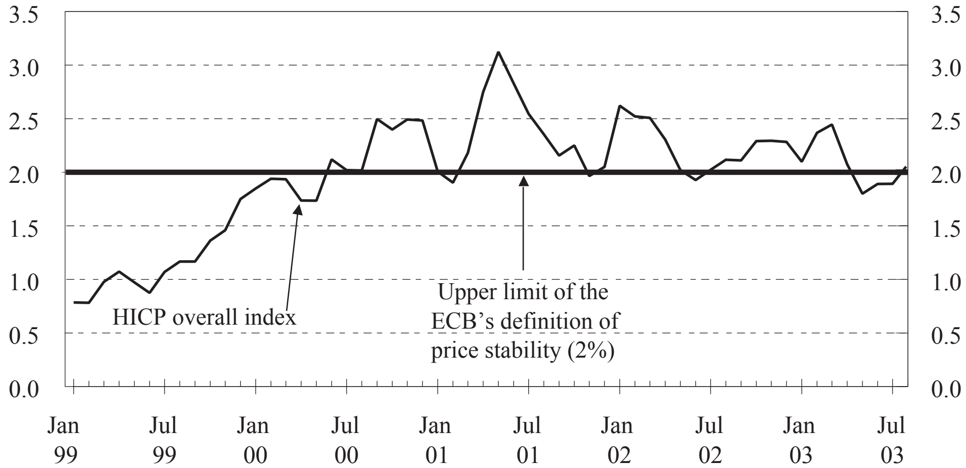


Source: ECB, Monthly Bulletin. Last observation: July 2003.

16. On average in 1999 M3 grew by 5.7%, substantially above the ECB's reference value of 4.5%. After a slowdown between spring 2000 and early 2001, M3 growth increased significantly in the course of 2001. Following this marked increase in M3 growth, the average annual growth rate of M3 remained well above the ECB's reference value of 4.5%. (see Box 3). The annual growth rate of the broad money aggregate M3 averaged 4.9% in 2000 and rose to 5.5% in 2001. The average annual growth rate of the broad money aggregate M3 increased further in 2002 to 7.4%. This upward trend in M3 growth continued during the first half of 2003.

Box 4

Euro area inflation (HICP)

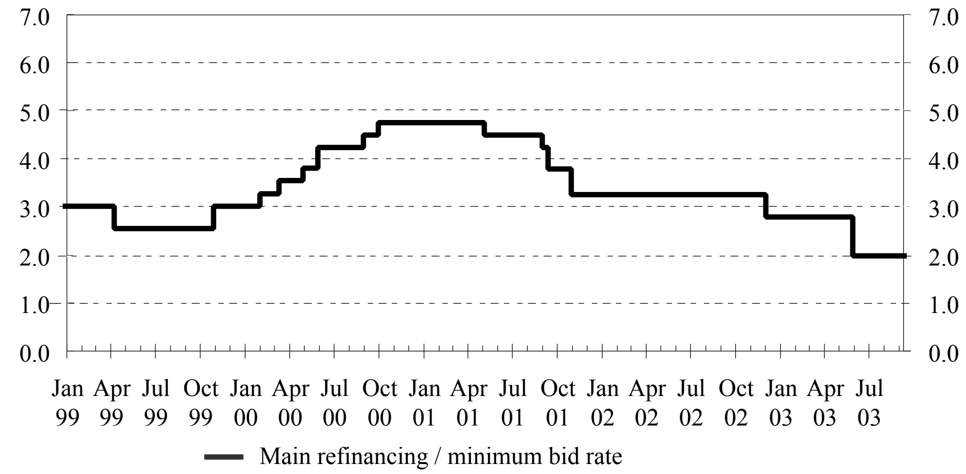


Source: Eurostat. Last observation: August 2003.

17. According to the latest set of data, average headline inflation (measured in terms of the HICP) was 1.1% in 1999, 2.1% in 2000, 2.3% 2001, and 2.3% in 2002. Since June 2000 inflation has been consistently slightly above the ECB's definition of price stability (see Box 4).

Box 5

Key ECB (main refinancing) interest rates



Source: ECB, Monthly Bulletin.

18. In December 1998 the Governing Council set the interest rate[10] for the euro area at 3%. In April 1999 the bank cut the interest rate by 0.5% to 2.5%, and it remained unchanged at that rate until November 1999, when it was raised by 0.5% back to 3% (see Box 5). The Governing Council then successively raised rates until October 2000, when they reached their highest level so far of 4.75%. The interest rate stayed at that level until May 2001. The bank then successively reduced rates until June 2003, when rates reached their historical low of 2%.[11]

19. The Governing Council normally meets twice a month, and it usually takes its decisions on interest rates at the first meeting of the month. Following the terrorist attacks on the US, however, an extraordinary meeting of the Governing Council was held on 17 September 2001 by means of teleconferencing. "In concert" with the decision that day of the Federal Open Market Committee in the US to lower its target for the federal funds rate, the Governing Council reduced interest rates for the euro area by 0.5% from 4.25% to 3.75%.[12]

The views of our witnesses

20. A number of witnesses drew our attention to the fact that the ECB was a relatively young institution. They also pointed out that the bank had had to deal with a number of challenges during its first few years. For example, Mr Paul Volcker, who was Chairman of the Board of Governors of the US Federal Reserve System from 1979–87, considered that, despite the difficulty of getting cohesion among the 12 countries of the euro area, the bank had gone "a long way in establishing the legitimacy and the authority of the institution". On balance, it had done "a good job." (QQ 85, 123–24). The ECB had also had to oversee the replacement of national currencies by the euro. This euro cash changeover, which started with the introduction of euro banknotes and coins on 1 January 2002, went far more smoothly than expected (p.25). Sir Samuel Brittan, commentator for the *Financial Times*, said:

> "we should pay tribute to the ECB for the efficiency with which it introduced the euro. It was not really very easy to substitute a new currency for about 12 national currencies, and it was a

[10] That is, the "repo" rate, the main rate used in the ECB's interventions in financial markets.

[11] The chronology of monetary policy measures of the Eurosystem taken in 1999 can be found on pp. 176–79 of the *ECB Annual Report 1999*; those for 2000 on pp. 205–08 of the *ECB Annual Report 2000*; those from January 2001 to October 2003 on pp. 97*–100* of the *ECB Monthly Bulletin* of October 2003.

[12] 'Monetary policy decisions', ECB Press Release, 17 September 2001.

much more successful operation in terms of the general public than either decimalisation in Britain, or the move to the new franc in France some decades ago. It went over extremely smoothly but, above all, the ECB negotiated the difficult transitional period when exchange rates were locked together but there was no actual currency in circulation." (Q 148)

21. Professor Thygesen, Professor of International Economics at the University of Copenhagen and a Member of the Delors Committee on EMU 1988-89, also gave a positive assessment of the ECB's monetary policy, in particular because the bank had delivered inflation at around 2%, which was a commendable outcome given the disturbances the euro area had experienced over the few years of the bank's operation. The ECB had to deal with the economic effects in the euro area of a number of significant shocks, including the financial crises in Asia and Russia, a strong increase in oil prices, an increase in food prices due to animal diseases and bad weather, the terrorist attacks in the US, and other geopolitical tensions. But inflationary surges which came largely from such uncontrollable factors were subsequently dampened by the cautious policy of the ECB (Q 62).

22. The Federation of German Industries (BDI) considered that the ECB's monetary policy strategy had "proved effective" (p.85). The Union of Industrial and Employers' Confederations of Europe (UNICE) agreed that the bank could take credit for the inflation record of the euro area (p.90). Likewise, Mr Klaus Regling, Director General of the Directorate-General for Economic & Financial Affairs at the European Commission, considered that "all in all" the ECB's monetary policy decisions had been successful (p.88). Professor George S. Tavlas, Bank of Greece, also concluded that the ECB had "delivered price stability."[13] Professor Jacques Mélitz, Professor of Economics at the University of Strathclyde, went further to argue that this situation could be expected to continue:

"The European Central Bank quickly convinced the markets that it is a worthy successor of the Bundesbank.[14] From the beginning, it has acted in a responsible manner. There is every reason to expect the ECB to continue to pursue moderate inflation in the future while paying reasonable attention to the business cycle."[15]

23. Mr Bootle, Managing Director of Capital Economics Ltd, said that in the UK the ECB had come in for "a lot of criticism for all sorts of things." But, he argued, a lot of the criticism had been "ill judged." The facts belied the rhetoric, and the ECB did not warrant the criticism that had been made of it (QQ 85, 89). Sir Samuel Brittan was particularly concerned that the ECB should not be made the scapegoat for the sluggish growth of the euro area, pointing out that the bank had "not moved very differently from the Fed or the Bank of England." He added that the ECB had simply moved "a bit more slowly and a bit more cautiously" (QQ 148, 165 and p.54). Sir Samuel was not alone in adding this caveat to his support for the ECB. For example, Professor Charles Goodhart, who had been a member of the Monetary Policy Committee of the Bank of England, said: "There has been a lot of criticism of the ECB, but in practical terms what they have actually done, in my view, they have done really extremely well, with one minor qualification which is that they have frequently been a month or two slow". Professor Willem Buiter, who had also been a member of the Monetary Policy Committee of the Bank of England, agreed that the bank had done "an effective job", but he concurred that the ECB had been "systematically slightly behind the curve, but only at the most a couple of months or so" (QQ 41, 44, 67). Professor Draghi, Managing Director and Vice-Chairman of Goldman Sachs, however, questioned whether this was so and if it was, what effect it had had:

"the ECB was widely criticised, especially in the United States by our American colleagues, for being too cautious and for reacting to events much more slowly than the US Fed had done […]. Have they been too cautious? With the benefit of hindsight now, we would not say so. We would say they were just on the mark. Could they have lowered interest rates more when the Fed was much more aggressive? They refused to do so, because they were afraid of inflation. Inflation did not materialise, but at the same time the case for lower interest rates in the year 2000 and beginning of 2001 is, with the benefit of hindsight, now much less strong than it looked at that time." (Q 193)

24. Professor Draghi argued that during its first four and half years the ECB's monetary framework had been "constantly reviewed, more in practice and in substance than in its formal wording". The ECB had shown itself willing and able to change its methods when weaknesses in them become apparent. It was this capacity the bank had to review and learn from its own actions that made

13 'Monetary Union in Europe', taken from HM Treasury's EMU study *Submissions on EMU from leading academics*, p.215.

14 A study published in 2002 by the Centre for European Reform concluded that ECB monetary policy had been broadly adequate for the euro area economy and appeared "as effective as, if not more so than, the monetary policies of the EU's national central banks that preceded it." *How to reform the European Central Bank*, Jean-Paul Fitoussi and Jérôme Creel, October 2002, p.19.

15 Taken from HM Treasury's EMU study *Submissions on EMU from leading academics*, p.172.

Professor Draghi say that all in all the experience of the first few years had been positive. The Government agreed that it was "very encouraging" that the ECB that had demonstrated that it was "a learning institution" that was interested in ongoing policy debates and had "shown a willingness to evolve" (QQ 191, 213, 217, 224).

The Committee's conclusions on the ECB's monetary policy decisions so far

25. **Our overall assessment of the ECB's monetary policy since its started operating on 1 January 1999 is positive. We commend the ECB for the fact that its monetary policy is achieving the desired objective of price stability. The consensus in the evidence we received was that the ECB had performed well so far given its mandate, and this is a view that we share. The ECB is still a young institution, but it has rapidly built up a high level of credibility. It is in the context of this positive assessment that our criticisms and recommendations that follow are to be understood.**

Financial Stability and Prudential Supervision

26. There is an on-going debate on the adequacy of the current EU institutional arrangements for financial stability. There is no institution at EMU or EU level which has responsibility for prudential supervision. Supervisory responsibilities remain at the national level. In the UK, for example, the Treasury, the Bank of England and the Financial Services Authority each have different responsibilities for ensuring financial stability. When the Treaties were formulated, financial supervision was explicitly considered to fall under the remit of the national authorities. The ECB consequently has no powers in the area of financial supervision; the Treaty simply calls on the ESCB to "contribute to the smooth conduct of policies pursued by the competent authorities relating to the prudential supervision of credit institutions and the stability of the financial system" (Article 105(5) TEC). As President Duisenberg put it, the only task that falls to the ECB is "to foster the smooth operation of banking supervision in the various countries and to try to harmonise at a distance."[16] In the US in contrast, Professor Thygesen pointed out, the Federal Reserve is very closely involved in banking supervision (Q 83).

27. The Economic and Financial Committee, which contributes to the preparation of the work of Ecofin, the Council of Ministers of the EU responsible for Economic and Financial Affairs, keeps under review the economic and financial situation of the Member States and makes regular reports thereon to Ecofin and the Commission. In addition, a Financial Services Committee was established in 2002 to advise Ecofin on issues to do with financial markets. Also in 2002, the ECB established a Directorate for Financial Stability and Supervision. The bank also operates a Banking Supervision Committee (BSC), which provides structural and macroprudential analyses. The ECB also sits on the Financial Stability Forum, a global body. The ECB has published parts of its output in the field of financial stability in its *Monthly Bulletin*. The February 2003 edition also contained a report entitled "EU Banking Sector Stability", which summarised analyses conducted by the BSC.

28. While the BSC appears to be a useful forum for exchanges between banking supervisors and central banks, there is still currently no framework which brings together all interested parties in the financial stability of the EU: finance ministries, financial sector supervisors, the ECB and national central banks. As the ECB itself said:

> "EMU has changed the nature and scope of systemic risk, increasing the likelihood that disturbances originating in or channelled through wholesale and capital markets or market infrastructures will extend beyond national borders. […] In addition, the trend towards internationalisation and conglomeration of financial activities raises important issues as to the systemic concerns created by large and complex multinational institutions."[17]

29. Professor Buiter argued that the ECB should be charged explicitly with responsibility for systemic financial stability in the euro area. He said that the ECB should be "the guarantor of the integrity of the financial system, especially the banking sector, but also any financial market of significant import for the economy as a whole in which liquidity problems could possibly arise. They have to be there as the lenders of last resort, ready and willing to create liquidity instantly in any amount required to preserve the integrity of the financial system." Because of its mandate under the Treaty, the ECB did not have the long-term ability to recapitalise a sizeable chunk of the European

[16] Monetary Dialogue with the Economic and Monetary Affairs Committee of the European Parliament, Brussels, 12 June 2003.

[17] *ECB Annual Report 2001*, p. 136.

banking system, which Professor Buiter saw as "a problem". This was an issue which needed to be cleared up and clarified: "ambiguity is never constructive in monetary policy", he argued. Sir Samuel Brittan shared these concerns about the current EU institutional arrangements for financial stability. Mr Volcker also agreed that the issues around who in the EU was the lender of last resort and in what circumstances were "a cloudy area" that needed "clarification". The Government also wanted the issue of how and when liquidity would be provided in the event of a banking crisis to be made more explicit (QQ 43, 143, 158–59, 226).[18]

The Committee's conclusions on financial stability and prudential supervision in the EU

30. **In this inquiry, we did not examine the EU's institutional arrangements for prudential supervision, but we are aware of the debate on the adequacy of the current institutions arrangements for financial stability in the EU. We recognise that the Government considers that "official support operations remain a national responsibility for euro area members",[19] yet the Financial Secretary also called for "more clarity in the arrangements" as to who the lender of last resort should be in the euro area. We would like the Government to explain how it would like the system of prudential supervision in the EU to develop over time, whether it considers that the ECB should be given any powers in the area of financial supervision, and what it considers to be the ideal institutional set up for prudential supervision in the EU.**

31. **As part of its contribution to the smooth conduct of supervisory policies in the EU, we would encourage the ECB to publish regular broad reports on financial stability in the EU.**

[18] For a succinct discussion of banking supervision under EMU, see Professor Christian de Boissieu's Briefing paper for the Economic and Monetary Affair Committee of the European Parliament 'Financial Stability, Banking Supervision and the ECB', May 2003 (available on that committee's website).

[19] *UK Membership of the single currency: An assessment of the five economic tests* (Cm 5776), p. 193.

PART 3: THE ECB'S MONETARY POLICY STRATEGY

Introduction

32. In this section we examine the monetary policy strategy of the ECB. We analyse the remit that the EC Treaty gives the central bank, and we ask who should define price stability for the euro area. We then appraise the outcome of the ECB's internal review of its monetary policy strategy, focusing on the ECB's definition of price stability and the 'two-pillar structure' of the ECB's monetary policy strategy. Finally, we look at the question of whether the ECB should have an exchange rate target.

Does the EC Treaty give the ECB the right remit?

A comparison of the mandates of three central banks

33. The EC Treaty establishes a clear hierarchy of objectives for the ECB that enforces the primacy of price stability. Article 105(1) states that the "primary objective" of the ECB is "to maintain price stability." The ECB is also "to support the general economic policies in the Community with a view to contributing to the achievement of the objectives of the Community," which include "a high level of employment" and "sustainable and non-inflationary growth". However, the central bank is only to do so "without prejudice to the objective of price stability." In so far as the Treaty sets out an unambiguous hierarchy of objectives for the ECB, it is very similar to the Bank of England Act 1998, which states (in Section 11):

"In relation to monetary policy, the objectives of the Bank of England shall be—

(a) to maintain price stability, and

(b) subject to that, to support the economic policy of Her Majesty's Government, including its objectives for growth and employment."

34. This type of hierarchical mandate (based around the clause "without prejudice to" or "subject to") differs from the remit given to the Federal Reserve, the central bank of the United States, which is also required to keep prices stable, but also, and at the same time, to seek full employment and moderate long-term interest rates, which are formally seen as having equal importance. The Federal Reserve Act of 1913 (Section 2A) states that the monetary policy objectives of the Board of Governors of the Federal Reserve System and the Federal Open Market Committee are "to promote effectively the goals of maximum employment, stable prices and moderate long-term interest rates". President Duisenberg testified to the European Parliament that he preferred the ECB's "unambiguously stated mandate". He said: "it gives more clarity to the people and to the markets as to what we are supposed to do and what we are actually doing."[20]

Does the ECB actually aim at a single objective?

35. Although the EC Treaty gives the ECB a dual, hierarchical mandate, it was suggested to us that the bank fulfilled this remit by, in effect, reducing it to a single mandate: to provide price stability. The ECB considered that it could best contribute to supporting sustainable non-inflationary growth and a high level of employment in the euro area by fulfilling its primary objective of maintaining price stability. President Duisenberg explained this position:

> "By being strictly geared towards maintaining price stability in a credible and lasting manner, monetary policy makes an important contribution to achieving a high level of output and employment, and to sustaining growth. Confidence in lasting price stability removes the inflation risk premium on interest rates, ensuring low real interest rates, which in turn foster investment, growth and employment. Theoretical and empirical evidence clearly confirm that there is no long-term trade off between price stability and economic growth. Trying to use monetary policy to fine-tune economic activity or to gear it above a sustainable level will, in the long run, simply lead to rising inflation – not to faster economic growth."[21]

36. This was also the position of Professor Thygesen (p.24) and of the UK Government:

[20] Monetary Dialogue with the Economic and Monetary Affairs Committee of the European Parliament, Brussels, 10 September 2003

[21] 'Changing Fortunes: Financing World Growth', Speech by President Duisenberg at the 2003 Spruce Meadows Round Table, Calgary, Friday 5 September 2003. (All the key speeches of the members of the Executive Board are available on the ECB's website.)

"Stability helps individuals and businesses to plan for the long term, improving the quality and quantity of investment in the economy and helping to raise productivity and the sustainable rates of growth and employment. Macroeconomic stability is also a prerequisite of successful economic reform, since a framework of stability permits the rapid achievement of the full benefits of structural reform policies."[22]

37. The ECB forcibly denied that monetary policy faced a long-term trade-off between inflation and economic growth. Rather, "maintaining a low and stable rate of inflation" was "the best contribution" that monetary policy could make to economic welfare.[23] Furthermore, the bank pointed out that under the Treaty while it alone had responsibility for delivering its primary objective of price stability, its secondary objectives – a high level of employment and sustainable and non-inflationary growth – were also shared with all the other economic actors of the EU. Miss Silvia Pepino, Vice-President, Economic and Policy Research at JPMorgan, maintained, however, that it is "not appropriate for the ECB to argue that the second part of its mandate is met by simply sticking to the first half of the mandate" (p.86). The bank has received a lot of criticism in the press for not doing enough to promote growth in the euro area. We therefore examined whether, in an ideal world, the ECB's mandate should be changed to give more prominence to employment and growth.

How does the Fed interpret its broad mandate?

38. Almost all of our witnesses opposed changing the mandate that the EC Treaty gives the ECB. Professor Buiter said that he would "quite strongly" oppose any extension of the ECB's mandate. He declared that the Federal Reserve was lucky that its three-legged mandate had "basically been forgotten in practice"; in reality, he argued, the Federal Reserve basically followed an inflation target (Q 41). Professor Von Hagen, Professor of Economics at the University of Bonn, also considered that that was the case:

"the Fed actually cares most about price stability *de facto*, and the reason why that can happen despite the legal mandate is that there is a broad agreement, both among monetary policy makers and among members of Congress in the United States today, that monetary policy is not an appropriate tool to promote full employment. It can support full employment but to use monetary policy systematically to reach full employment will always undermine price stability. Thus that is the consensus that makes it possible for the Fed to act very much like the ECB or Bank of England do today although the legal mandate is different" (Q 181).

39. Mr Volcker, who was Chairman of the Board of Governors of the Federal Reserve System from 1979–87, confirmed that in practice the Federal Reserve interpreted its mandate in a narrow, hierarchical way that gave primacy to price stability: "the principal function of the Central Bank has to be concerned about stability." The Federal Reserve interpreted that in a way which did not give it "all that much leeway." It always kept clearly in mind "the primacy of stability." The UK Government also considered that in practice the ECB, the Federal Reserve and the Bank of England all operated in a similar way despite the differences in the wording of their mandates (QQ 144, 214).

There is a limit to what monetary policy can achieve

40. One of the main reasons why our witnesses were against changing the ECB's remit was that they did not want to see a situation where the central bank was set several objectives that could not possibly be met by using monetary policy alone. Mr David Walton, the Chief European Economist at Goldman Sachs, for example, argued that it was necessary to be careful about how much central banks were asked to do: "At the end of the day, central banks have one instrument, which is interest rates, and really they can only achieve one target" (Q 15). Professor Buiter argued this point forcibly:

"Having an explicitly symmetric inflation target, I think, meets most of the substance of the desire of those who want the central bank to pay more attention to real economic activity. To go beyond that I think creates a danger of illusions being reinforced about what monetary policy can deliver. Monetary policy cannot increase the long-term growth of the economy and has no lasting effect on the equilibrium rate of employment. It has important effects at cyclical frequencies but that is it. The best way to formulate policy is to have a single nominal objective, preferably, in the case of the euro area, a symmetric inflation objective, but definitely not a growth objective on top of that. It is idle talk; it is like making church attendance an objective of monetary policy; there is no way of influencing it significantly in the long-run." (Q 41)

[22] *UK Membership of the single currency: An assessment of the five economic tests* (Cm 5776), p. 183.

[23] 'The first lustrum of the ECB', Speech by the President of the ECB at the International Frankfurt Banking Evening, Frankfurt, 16 June 2003.

41. Mr Andrew Smith, Chief Economist at KPMG, agreed that the ECB could not be expected to get over "the logical problem, that if you have one instrument, you cannot target two things simultaneously" (Q 15). Dr Schmieding, the Chief European Economist at the Bank of America, contended that it could be "politically dangerous" to change the ECB's mandate:

> "It might nourish a popular illusion that indeed the Central Bank can do more than influence the short-term fluctuations of the growth rate but that the Central Bank may be responsible for the longer term trend rate of growth. Coming from this angle, that it might be politically dangerous to nourish such an illusion, I would come out clearly on the side of those saying there should not be an explicit growth objective in the remit of the Central Bank" (Q 69).

42. Professor Von Hagen agreed that "changing the Treaty and actually giving the ECB an explicit mandate for full employment or economic growth could be dangerous because it could undermine the credibility of a very young institution because it would be a very visible action for the European governments to take" (Q 181). The Union of Industrial and Employers' Confederations of Europe (UNICE) reasoned that the current weak activity of the euro area had other causes that monetary policy could not solve (p.91). Professor Draghi and Professor Thygesen agreed that something beyond the monetary policy was needed to restore growth in the euro area (QQ 70, 200).

In practice the ECB has paid attention to growth

43. A number of our witnesses suggested that one reason why there was no need to change the ECB's mandate was because the criticisms that the bank ignored its secondary objectives and concentrated on delivering price stability to the exclusion of growth were not well founded. It was unreasonable to say that the ECB was unconcerned with the underlying performance of the economy. In practice, they argued, the central bank did pay some attention to its secondary objectives of growth and employment. Mr Martin Weale, the Director of the National Institute of Economic & Social Research, said that the European Central Bank was "somewhat maligned", explaining that there was a tendency to blame it for the slow growth that the euro area was experiencing.[24] He and many other witnesses pointed out though that, in fact, the bank had been consistently tolerant of inflation in the euro area above its definition of price stability (QQ 1, 4). Professor Buiter bluntly summed up this position: "The fact that inflation has been above target in the euro area for years now is not consistent with the view that monetary policy has been too tight" (Q 44). Professor Goodhart said:

> "the ECB has actually in practice run a rather careful and successful tightrope, because almost all the public argument has been that they have been too tight, and growth in the euro zone has been too slow. If you look at what has been achieved on the inflation side, they have allowed the inflation rate continuously to be marginally over their upper limit. Inflation in the euro zone has not been running at or below two per cent, it has running marginally above two per cent. They have actually nicely managed the balance between political pressure for maintaining growth and maintaining expansion in the euro zone, and what they themselves set out to do." (Q 41)

44. Professor Thygesen drew attention to the actions of the ECB in cutting interest rates as providing some evidence that the ECB was not unconcerned with poor growth performance in the euro area. (QQ 62, 65, 70). For example, the ECB cut interest rates in April 1999 by 0.5% and, in explaining this decision, cited "a slowdown in economic activity" indicated by "downward revisions in the growth forecasts" while "the progress in reducing unemployment" had "continued to be very gradual".[25] The ECB acted again to stimulate activity after September 11, 2001, at a time when inflation was running well above the bank's upper limit for price stability. The ECB also cut rates in December 2002 and in March 2003 when inflation was above 2% because it was concerned about the weakness of economic activity. Mr Walton argued that the facts demonstrated that the ECB had become more prepared to cut rates and more tolerant of inflation: when the bank cut interest rates in the euro area down to 2.5% was in April 1999, inflation was at 1%; in June 2003 the bank once again cut rates down to 2.5%, but at this time inflation was above 2%. The bank explained that the latter decision was due to "the subdued pace of economic growth".[26] Mr Walton took this as evidence that the Governing Council was prepared to move more aggressively than when the bank was first

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[24] Professor Alberto Alesina (Professor of Political Economy at Harvard University) and Professor Guido Tabellini (Professor of Economics at Bocconi University) explained that politicians were particularly to blame for the perception that the ECB did not pay enough regard to growth: "Often bureaucrats are used by politicians as scapegoats. For instance, 'excessive' monetary tightening is often invoked by politicians to justify poor economic conditions even when monetary policy has nothing to do with it." According to Professor Alesina et al., this was precisely what had happened in Europe since the creation of the ECB (*Designing Macroeconomic Policy for Europe*, CEPR London, 2001).

[25] 'Editorial', *ECB Monthly Bulletin*, April 1999, p.5.

[26] 'Editorial', *ECB Monthly Bulletin*, March 2003, p.5.

established. They now appreciated the fact that they needed to ease monetary conditions when activity was weak.[27] The UK Government said that recent work suggested that monetary policy for the euro area had been “a little bit looser” under the ECB than it would have been under the Bundesbank. The ECB accepted inflation temporarily in excess of its 2% ceiling as unavoidable at times and not necessarily inconsistent with price stability over the medium term. Professor Von Hagen agreed that the ECB was now “showing its readiness to care for promoting real economic growth” when price stability was not a problem. He concluded that “in terms of actual economic policies or monetary policies” there was “virtually no difference today between the three major central banks – the ECB, the Bank of England and the Fed”. Mr Weale said that it was right that at first the ECB had focused on controlling inflation: “independent central banks, whose job is to control inflation, need to show that they are taking that job seriously.” Mr Volcker agreed that this position was justified. (QQ 1, 5, 12–13, 123, 181, 225)

The Committee’s conclusions on the mandate that the EC Treaty gives to the ECB

45. **We regard the strength of the ECB’s mandate to be its unambiguous nature. The EC Treaty makes it clear that the primary objective of the bank is to achieve price stability. Price stability is desirable because it is conducive to, and a pre-requisite for, long-term stable growth and employment. It is right therefore that price stability is the primary objective of the ECB; we would not seek to change that.**

46. **Without prejudice to that objective, the ECB must also support growth and employment. For citizens of the EU, economic success must go beyond a narrow definition of price stability; EMU will be judged by its ability to deliver what the EC Treaty terms sustainable and non-inflationary growth and a high level of employment. As the EU’s most visible financial institution, how people judge the ECB will inevitably be influenced by the level of growth and employment in the euro area; it is right therefore that the Treaty places these as key but subsidiary elements of the bank’s mandate. It should be recognised, however, that there are limits as to what monetary policy alone can achieve.**

[27] In their CER study, Fitoussi and Creel went even further, coming to the following conclusion: “If anything, the ECB’s policy has stimulated economic growth, since real interest rates have been much lower than during the low-growth period of 1991–97” (*op.cit.*, p.19).

Who should define price stability for the euro area?

47. Whilst the EC Treaty sets the ECB the primary objective of achieving price stability, it gives the bank no instructions as to how it is to interpret this aspect of its mandate. The Treaty does not give a definition of price stability or establish by whom this concept is to be defined. The ECB is therefore free to define what constitutes price stability. In October 1998, the Governing Council of the ECB announced a quantitative definition of "price stability": it was to aim for a "year-on-year increase in the Harmonised Index of Consumer Prices (HICP) for the euro area of below 2%".[28] The Committee examined the question of whether it was right that the ECB should continue to define price stability for the euro area. The alternative would be for another body outside the central bank to define price stability, while the ECB would continue to control the means by which it would seek to achieve this goal.

'Goal independence' and 'operational independence'

48. In relation to central banks, commentators distinguish between 'goal independence' and 'operational independence' (which is sometimes called 'instrument independence'). If a central bank has goal independence, it is free to change its objectives. If a central bank has operational independence, it is free to change the level of its designated policy instrument (that is, interest rates), which are the means by which a central bank operates to achieve its goals. Both the Bank of England and the ECB have operational independence. The Bank of England, however, is not goal independent. The objective the Monetary Policy Committee (MPC) is asked to meet is set by the Chancellor of the Exchequer. The Chancellor defines price stability and specifies the rate of inflation that the MPC is to target, so there is no goal independence. The ECB in contrast has a high degree of goal independence: it is in command of the definition of what is meant by price stability and the time horizon over which it should achieve this objective.[29] It is not completely goal independent, however, because it does not set the ultimate objectives of policy, which are enshrined in the EC Treaty. Nonetheless, critics of the ECB say that because the bank can define price stability it can decide the parameters within which it operates and so in effect is free to set its own targets. They argue that the definition of price stability is a political target (see, for example, Q 9); hence, it should be decided by a political body.

Should a political body define price stability for the euro area?

49. Some witnesses argued that decisions on the target level of inflation, and on the balance to be struck between price stability and other objectives, should be made by a political body rather than the ECB. Professor Goodhart argued that giving the right to define price stability to a political body could help to address the so-called 'democratic deficit' in the EU. Dr Schmieding agreed that it would ultimately be preferable for the legitimacy of EMU for a political body to define price stability. Such a change would reduce the independence of the ECB and ensure that the goals of the ECB and the governments in Europe were more closely aligned. Mr Bootle claimed that continuing to allow the ECB its high degree of goal independence was "potentially very dangerous", as its aims might be out of step with those of the citizens. Some body outside the central bank should define price stability; otherwise there was a risk that "a substantial part of the eurozone" could go into deflation (QQ 42, 47, 66, 96–99).

50. When considering which political body should define price stability, Professor Buiter cautioned against following the UK model:

> "The British system puts the power to change the target in the hands of one man or one woman, the Chancellor and, in principle, he could change it every day before and after lunch. That has not happened, but the framework carries that risk. I would want a system that has greater safeguards than the current British one, which only has self-control as the safeguard to refrain the body politick from changing the target arbitrarily and too frequently."

51. To overcome this "shortcoming", which was also of concern to Dr Schmieding, Professor Buiter proposed giving the power to the Eurogroup, the group of finance ministers of participating Member States[30] (QQ 47, 58, 66). Miss Pepino suggested that Ecofin would be the most appropriate

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[28] This shows a greater degree of openness and transparency than some other central banks. The US Federal Reserve System and the Bank of Japan do not specify a quantitative definition of their price stability objectives. The Bundesbank operated without a public numerical definition of price stability.

[29] This situation is not unique: in Sweden, for example, the Riksbank sets the value of its inflation target.

[30] Known previously as euro-X, and then as euro-11, the Eurogroup is an informal body that was formed following a French initiative. Since the group was established, the Council has repeatedly reemphasised the fact that Ecofin, the meeting of the Finance Ministers of all the Member States, is the sole decision-making body at Council level on the economic matters

body (p.87). The ECB normally jealously protects its independence, but when the European Parliament asked President Duisenberg if it might not be more appropriate to allow a political body to define price stability, he replied rather curiously:

> "I am almost inclined to say: if the political authorities want to define it, let them do it. Let me leave it at that."[31]

The problem with giving the power to define price stability to a political body

52. A number of witnesses warned that it could be potentially dangerous for governments to set the ECB's inflation target. Greater political influence might increase the danger that the ECB would be forced to aim at an inappropriately high level of inflation or would be unduly swayed by the situation in one Member State.[32] Professor Draghi agreed with the criticisms of the current set up and argued that, ideally, there was a case for changing the EC Treaty. But, he cautioned, it was important to consider what the practical alternatives could be:

> "Let us imagine for instance that the new euroland inflation rate were to be fixed by the Eurogroup. There you have 12 finance ministers, each one strongly convinced that their own country's interests are to become the European interests; each one, because of his national interest, is less keen to give in to other countries' views. A European inflation rate set by a body made up of 12 finance ministers seems to be, to me at least, a fairly complex, possibly cumbersome process. If the inflation rate were to be set by other bodies like the Commission, it would be even less accountable than the ECB, because the Commission is made up of non-elected officials. Even though I share this criticism [of the current set up], especially when we compare this framework with other countries' monetary policy frameworks, both the objective difficulties of amending the Treaty and the practical difficulties of having a process working to produce a reasonable outcome make me think that it is hard to change the present framework into something which is more accountable." (Q 194)

53. Professor Giavazzi, Professor of Economics at Bocconi University, Milan, was against asking the Council to define price stability; he was worried about the difficulty of finding agreement between 15 or 25 finance ministers and the political bargaining that that might involve. Mr Volcker argued very strongly against giving the power to define price stability to politicians, because he was extremely concerned that they might not agree on the most appropriate definition. Professor Goodhart on the other hand disputed the assertion that politicians would choose to set an inappropriate and excessive target for inflation (QQ 47, 88, 139–40).

Certain witnesses argued that the ECB was the best placed institution to define price stability

54. Mr Klaus Regling, Director General of the Directorate-General for Economic & Financial Affairs at the European Commission, put the decision to allow the ECB to define price stability in its historical context and argued that this institutional balance should not be changed:

> "As price stability had been decided to be the primary goal of the Economic and Monetary Union, it was reasonable to look closely to those central banks that had performed well. These central banks had never worked with a specific inflation target imposed on them from the outside world […] In order to make use of the better parts of the European monetary heritage it was decided to keep the tradition of letting the central bank determine its operational value. The experience of the euro area in the first years confirms the advantages of such a set-up" (p.90).

55. UNICE was adamant that the ECB's independence, which it described as a "key pillar" of EMU, "must be preserved and the ECB must continue to set the operational definition of price stability". Mr Volcker agreed that if the ECB were to be "a truly independent Central Bank," it ought to be the one to determine the "technical matter" of defining price stability. Mr Lorenzo Codogno, Managing Director, Co-Head of European Economics at the Bank of America, agreed that the ECB was "best equipped" and "most qualified" to define price stability, especially if its ability were compared "to European governments, the EU Parliament, the EU Commission or the EU Council." The fact that the ECB set its inflation objective and at the same time was judged against this

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which fall within its remit. The Eurogroup can currently only operate as a consultative grouping and normally meets informally before the formal meetings of Ecofin. It is possible that new Constitutional Treaty may ascribe formal status to the Eurogroup for the first time.

31 Monetary Dialogue with the Economic and Monetary Affairs Committee of the European Parliament, Brussels, 12 June 2003.

32 The ECB is not completely independent from political influence; it is open to Ecofin to ask the ECB to pay more attention to the exchange rate. On the ECB and the exchange rate of the euro, see below (paragraphs 115–23).

benchmark was "not an aberration": there was "no doubt" that the ECB could be held accountable for this self-imposed target. Professor Thygesen agreed that it was "natural" to let the bank define price stability itself, and, as the public and political debate had consistently demonstrated, the bank was held to account for its definition (pp.25, 91; QQ 20, 132).

The Committee's conclusions on who should define price stability for the euro area

56. **The ECB enjoys a high degree of independence. The question arises whether greater political involvement could and should be introduced to the process by which price stability is defined for the euro area without seriously prejudicing that independence. Giving the right to define price stability for the euro area to a political body could arguably help to address perceptions that the process currently lacks sufficient political accountability. We believe, however, that for the time being the ECB should continue to define price stability for the euro area. If at some later date a political body outside the ECB were to define price stability for the euro area, that body could perhaps best be the Heads of State or Government of those Member States that have adopted the euro, acting on a recommendation from the Eurogroup.**

The ECB's Internal Review of its Monetary Policy Strategy

57. In December 2002, President Duisenberg announced that in the course of the first half of 2003 the Governing Council of the ECB would undertake a thorough evaluation of the ECB's monetary policy strategy, which was originally announced in October 1998.[33] The ECB announced the outcome of its review in a press seminar on 8 May 2003.[34] We do not discuss here all elements of the ECB's review. Instead, we focus on the two most-debated aspects: the ECB's definition of price stability and the 'two-pillar structure' of the ECB's monetary policy strategy.

THE ECB'S DEFINITION OF PRICE STABILITY

58. Having reviewed its definition of price stability, the ECB announced that:

> "the Governing Council confirmed that it defines price stability as announced in 1998, namely as a year-on-year increase in the HICP for the euro area of below 2%. At the same time, it clarified that in the pursuit of price stability it aims to maintain inflation rates at levels close to 2% over the medium term."

59. The bank announced that this clarification aimed to underline "the ECB's general commitment to provide a sufficient safety margin to guard against potential risks of deflation." The safety margin also addressed "the issue of the possible presence of a [positive] measurement bias in the HICP and the implications of inflation differentials within the euro area."[35]

A safety margin against deflation

60. Definitions of price stability or targets for inflation that are 'asymmetrical' – such as that of the ECB, which originally said it aimed for inflation of below 2% – were criticised for having a perceived deflationary bias. As HM Treasury put it, "policy makers could have an incentive to drive inflation as low as possible to ensure they meet their target comfortably".[36] The fact that inflation in the euro area has averaged above 2% since the beginning of 2000 demonstrates to us that in practice the ECB has ignored this temptation. The Financial Secretary agreed, saying that the ECB had shown itself to be "sensitive to risks of deflation" (QQ 217, 222, 225).

61. Announcing the outcome of its monetary policy strategy review, the ECB stressed that it had always been vigilant in preventing deflationary and inflationary dynamics alike from emerging in the euro area. The bank argued that the use of the word "increase" in its original announcement of its strategy in 1998 excluded deflation from its definition of price stability.[37] The bank would never want to expose the euro area to the risk of deflation. By adding that it would not only try to achieve inflation "below 2%" but also "close to 2%", the bank aimed to clarify this aspect of its policy by making it clear that the bank considered it to be desirable to maintain a small safety margin against deflationary spirals in the form of a positive rate of inflation. President Duisenberg said that this 'clarification' of the ECB's definition of price stability was given "specifically to do away with this eternal debate about our being less vigilant in fighting deflation than inflation. This means we have a significant and adequate margin above 0% such that we need not be concerned with deflation at all."[38] Professor Issing was insistent, however, that the clarification of the bank's definition of price stability did not represent any change of policy:

> "this 'close to 2%' is not a change, it is a clarification of what we have done so far, what we have achieved – namely inflation expectations remaining in a narrow range of between roughly 1.7% and 1.9% – and what we intend to do in our forward-looking monetary policy."[39]

62. During the first half of 2003, the President of the ECB frequently stressed that the bank watched, and was prepared to act against, deflationary as well as inflationary developments. Countering accusations of a deflationary bias to the ECB's monetary policy, the President told the

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33 ECB Press Conference, Frankfurt, 5 December 2002.

34 Press seminar on the evaluation of the ECB's monetary policy strategy, Frankfurt, 8 May 2003.

35 'Editorial', *ECB Monthly Bulletin*, May 2003, p.5.

36 *Reforming Britain's Economic and Financial Policy: Towards Greater Economic Stability*, HM Treasury, Edited by Ed Balls and Gus O'Donnell (Palgrave, 2002), page 47.

37 Economists generally use the term deflation to refer to an extended period of continuous fall in the general price level. Disinflation is a lowering of the rate of inflation (but not necessarily to or below zero).

38 Monetary Dialogue with the Economic and Monetary Affairs Committee of the European Parliament, Brussels, 12 June 2003.

39 Press seminar on the evaluation of the ECB's monetary policy strategy, Frankfurt, 8 May 2003.

European Parliament, for example, that the bank was committed to acting to avoid "both inflation and deflation."[40]

A positive measurement bias in the HICP

63. One reason why the ECB wanted to clarify that its definition of price stability provided a sufficient safety margin to guard against potential risks of deflation was that there was a measurement bias in the HICP. This bias might cause the HICP as published to overstate systematically the true rate of inflation in the euro area. Research had shown that not enough was known "to estimate with any degree of precision the magnitude of measurement biases in European consumer price indices."[41] Furthermore, the measurement bias possibly varied over time. The bank concluded, however, that the bias was "likely to be small and to further decline in the future."[42]

Inflation differentials in the euro area

64. Another reason why the ECB announced a safety margin to guard against deflation was to address "the implications of inflation differentials within the euro area". Since 1999 there had been some divergence in inflation rates between Member States, which had made the ECB's job in setting interest rates for the euro area more difficult. Witnesses stressed to us that it was natural that different regions or countries in the euro area – a large currency area with a market of more than 300 million people – would experience different rates of inflation. Critics of the bank feared, however, that if the euro area as a whole experienced a low level of inflation, then, as a consequence of these inflation differentials, some countries might be pushed into an extended and costly period of deflation. The bank's clarification of its strategy seemed, in part, to have been an attempt to counter such a fear.

65. The bank emphasized that in setting a single monetary policy for the euro area, it could not address inflation differentials between countries. They were a normal feature of any currency area: in a single country, monetary policy could not reduce inflation differentials across regions or cities.[43] Professor Goodhart confirmed this: "there are asymmetries within any European country; so that the monetary policy which is suitable for the tradeable goods sector in the UK, (before sterling started to decline) is not necessarily the monetary policy best adapted to the housing sector. You can get asymmetries within a country as well as between countries". Such differentials should correct themselves almost automatically over time (and new ones would appear); they were, in the bank's terms, "an integral part of the adjustment mechanism resulting from demand and supply shocks in the economies". Dr Schmieding explained that those countries with a level of inflation below the average for the euro area, such as Germany, would, over time, benefit from the competitive advantage that that difference brought, thus rectifying the situation. In the meantime, however, the ECB's clarification of its definition of price stability could be seen as an attempt to show that it would aim to achieve over the medium term an inflation rate for the euro area as a whole that was high enough to prevent regions with lower inflation rates from facing significant costs of deflation. The ECB itself stressed that "a period of falling prices in a country within a monetary union should be mainly seen as an adjustment of relative prices within the currency union" and so the concern for the conduct of its monetary policy would continue to be avoiding situations where there were risks of deflation in the euro area as a whole.[44] Professor Thygesen and the Federation of German Industries (BDI) both mentioned the potential problem of inflation differentials in the euro area. If the definition of price stability was too low that "could lead to a deflationary trend in EMU states with below-average price increases"; both witnesses concluded, however, that this was not the case for the euro area and that the ECB's definition provided "an adequate safety margin against deflationary risks" (pp. 24, 85; QQ 37, 68).

[40] Monetary Dialogue with the Economic and Monetary Affairs Committee of the European Parliament, Brussels, 17 February 2003. The incoming President, Mr Trichet, has even said that the ECB "could legitimately make use of unorthodox monetary weapons" (in an answer to the questionnaire drawn up by the Economic and Monetary Affairs Committee of the European Parliament for its hearing on 11 September 2003 on the appointment of Mr Trichet as President of the ECB).

[41] 'The definition of price stability: choosing a price measure', by G. Camba-Mendez, Background study for the ECB's review of its monetary policy strategy, 2003, p.4 (available on the ECB's website).

[42] 'Overview of the Background Studies for the Reflections on the ECB's Monetary Policy Strategy', ECB, 8 May 2003, p.5.

[43] 'Overview of the Background Studies for the Reflections on the ECB's Monetary Policy Strategy', ECB, 8 May 2003, p.7.

[44] 'The outcome of the ECB's evaluation of its monetary policy strategy', *ECB Monthly Bulletin*, June 2003, pp.85–86. See also the ECB report "Inflation differentials in the euro area: potential causes and policy implications", published 30 September 2003 (available on the ECB website).

SHOULD THE ECB'S DEFINITION OF PRICE STABILITY BE CHANGED TO A SYMMETRICAL INFLATION TARGET?

What is a 'symmetrical' inflation target?

66. The Bank of England is an example of a central bank that operates with a 'symmetrical' inflation target. The bank's primary monetary policy objective is to deliver price stability, which is defined by the Government's inflation target. The target specifies that the bank is to aim for underlying inflation (measured by the 12-month increase in the Retail Price Index excluding mortgage interest rates) of 2.5%. This target is symmetrical because inflation would be allowed to move away from the target by 1% in either direction, which means that "deviations below the target are treated in the same way as deviations above the target".[45]

67. Many of our witnesses argued that, in contrast to clearly-framed monetary policy objectives such as that of the Bank of England, the ECB's definition of price stability did not provide the clearest guide for inflationary expectations. They criticised the bank's definition for being imprecise and asymmetric. These criticisms were not alleviated by the bank's 'clarification' of its definition; witnesses still complained that the bank specified the upper limit for price developments but did not define a lower limit;[46] as Mr Bootle said, there was "an awful lot of confusion" following the revision. Some people thought that there had been a change; others thought that there had not been (Q 86). As Professor Goodhart said:

> "there is a fair way to go to get real clarity and transparency. I do not know what the central point for the target is. I do not know whether there is a lower bound. I do not know, if there are bounds, whether they are symmetric." (Q 45)

68. Our witnesses said that it was essential to know what margin of fluctuation around the target figure the central bank would tolerate. "We need to know this margin to be able to understand and anticipate the central bank's actions."[47] Our witnesses therefore argued that the ECB's price stability objective should be more precise and ideally should be changed to a symmetrical inflation target. Almost all of our witnesses made a point of explicitly calling for such a change. A symmetrical inflation target would be entirely transparent as to what level of inflation the bank was aiming for and what range of inflation it would tolerate; as such, it would help the ECB to communicate its monetary policy objective in a clear and unambiguous way and should anchor more effectively inflation expectations. The increased transparency of objective would mean that the bank's monetary policy decisions should become more predictable, which would help to smooth interest rates fluctuation by leading markets to anticipate and prepare for the decisions. A symmetrical inflation target would also provide a clearer benchmark against which the bank could be held to account (QQ 1, 4–5, 41, 49, 69, 71–72, 86, 88, 96).

A further benefit of a symmetrical inflation target

69. In regarding an undershooting of the target as being as important as an overshooting, the Government said that its symmetrical approach clearly and explicitly guarded against deflation as well as inflation. The Government also stressed that its target was aimed at ensuring that monetary policy not only delivered price stability but also supported growth and employment, because monetary policy would be "neither unnecessarily loose nor unnecessarily tight."[48] Dr Schmieding agreed that in an explicit symmetrical inflation objective, there was "an implicit assumption on the need or the objective for the Central Bank to try to keep the real economy close to its natural rate", which would ensure that the central bank maintained a satisfactory growth rate for the euro area. As Professor Buiter put it, having an explicitly symmetric inflation target would meet "most of the substance of the desire of those who want the central bank to pay more attention to real economic activity." (QQ 41, 69; p.87)

A question of semantics?

70. The UK Government, Professor Buiter and Professor Goodhart all suggested that the outcome of the ECB's review of its monetary policy strategy meant that the ECB was gradually moving

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[45] *Reforming Britain's Economic and Financial Policy: Towards Greater Economic Stability*, HM Treasury, Edited by Ed Balls and Gus O'Donnell (Palgrave, 2002), p. 47.

[46] Most recently President Duisenberg added some further clarification to the definition. He said that "close to but below 2% implies a rate which is close to below 2%, but higher than 1.3%, I can assure you." ECB Press Conference, Lisbon, 2 October 2003.

[47] Professor Wyplosz, 'The Strategy Review', Briefing paper for the Economic and Monetary Affairs Committee of the European Parliament, second quarter 2003, p.4 (available on that committee's website).

[48] *Reforming Britain's Economic and Financial Policy: Towards Greater Economic Stability*, op.cit., p.47.

towards a symmetrical inflation target (albeit one which dare not speak its name). Professor Thygesen said that completing the move would not make much difference to the way in which the ECB conducted its monetary policy. President Duisenberg even complained that the matter was "almost a question of semantics."[49] Indeed, as we have seen above (paragraphs 43–44), many of our witnesses already judged that the ECB did keep one eye on the growth rate of the economy and expected the bank to be vigilant in fighting deflation. Dr Schmieding shared the view that "it would not have made any difference to the actual decisions by the ECB" if the bank had had a symmetrical inflation target. Nonetheless, he considered that such a change would be "preferable on grounds of rhetoric – preferable in terms of making it easier to communicate with the public." (QQ 35, 71–72, 223–24)

71. For example, in its review of its monetary policy, the ECB confirmed that it viewed 2% as the upper limit for inflation. Yet the bank had in practice consistently allowed inflation of above 2%. This discrepancy lent some support to the view that the bank's definition of price stability was more symmetrical than it seemed. If this were the case, the ECB should go further in 'clarifying' or redefining its definition of price stability, in order to, as Mr Walton put it, "realign its words with its actual actions" (Q 1). The view of Professor Wyplosz, who criticised the ECB for being "unnecessarily cryptic", summarised the disappointment of our witnesses: "No central bank with a price stability objective can operate without some inflation target. The new posture hurts both the bank's transparency and its ability to anchor expectations, a key requirement for policy effectiveness."[50]

Why does the ECB reject adopting an explicit inflation target?

72. The ECB, however, remained hostile to the idea of an explicit inflation target. President Duisenberg said:

> "I protest against the word 'target'. We do not have a target, as you know, and […] we won't have a target."[51]

73. This refusal to consider the notion of the ECB adopting an explicit inflation target was reinforced by the ECB's Chief Economist, Professor Issing, when he announced the outcome of the bank's review of its monetary policy strategy. He was asked whether the clarification of the bank's definition of price stability meant that the ECB had adopted an inflation target; he replied curtly:

> "Certainly not. We have confirmed our two-pillar approach. This is totally different from what is normally seen as inflation targeting."[52]

Quite clearly the ECB has rejected inflation targeting. Yet, as we will argue below, adopting an inflation target need not automatically imply the abandonment of the bank's two pillars or the adoption of an inflation-targeting strategy.

74. One of the main reasons why the bank refused publicly to countenance adopting a symmetrical inflation target was that it believed that such a target would cause the public to focus too narrowly on whether inflation was just inside or outside the range. President Duisenberg explained that monetary policy was a much more complex process:

> "We specifically did not define a range, although we considered it, because we want to avoid being seen as targeting inflation towards a precisely defined range. We recognise that monetary policy in the short-term cannot fine-tune the inflation performance of the euro area economy as a whole to an extent which would make a precise quantitative definition of a range sensible or viable."[53]

75. President Duisenberg said that trying to reduce the complexity of monetary policy to a single inflation target would be a mistake:

> "Experience suggests that it can be very misleading to summarise the assessment of medium-term inflationary pressures in one single figure, even when a measure of statistical error is

[49] Monetary Dialogue with the Economic and Monetary Affairs Committee of the European Parliament, Brussels, 12 June 2003.

[50] 'The Strategy Review', *op. cit.*, p.1.

[51] ECB Press Conference, Frankfurt, 8 May 2003.

[52] Press seminar on the evaluation of the ECB's monetary policy strategy, Frankfurt, 8 May 2003.

[53] Monetary Dialogue with the Economic and Monetary Affairs Committee of the European Parliament, Brussels, 12 June 2003.

attached to it. Unfortunately, monetary policy is not so simple and the repeated significant forecast errors by all major institutions over the last few years provide evidence of this."[54]

76. The ECB's incoming president, Mr Trichet, also wanted the ECB to avoid implying that it took a limiting, mechanistic and over-simplistic approach to monetary policy:

> "the main disadvantage of applying direct inflation targeting to a vast and complex economy is the mechanical aspect of monetary policy instrumentation. A system of equations and the calculation of a law of probability are supposed to indicate the appropriate conduct to be adopted by Monetary Policy Councils […] the extraordinary complexity of reality cannot be reduced to an equation or a system of equations."[55]

77. A second major reason why the ECB did not want to change its definition of price stability to a symmetrical inflation target was that the bank was concerned that announcing any change to its definition of price stability would be perceived in the public as such a shift of policy that it would risk the bank's hard-won credibility. President Duisenberg explained that, during its review of the ECB's monetary policy strategy, the Governing Council had not always immediately agreed on everything, particularly on whether to change the definition of price stability:

> "There were those who pleaded for an even tighter interpretation. There were others who pleaded for a looser interpretation. In the end we all agreed that we would have a big credibility problem and would even create our own credibility problem if we were to change the definition. And so we quickly reached consensus that there was no need, and that it would even be dangerous, to change the definition."[56]

78. A final reason why the ECB rejected any change to its definition of price stability was that it considered it unnecessary. As we have seen, one of the major arguments in favour of a clear and symmetrical inflation target is that it should anchor more effectively inflation expectations. The ECB announced, however, that "its performance in maintaining low volatility of long-term inflation expectations in the euro area [was] comparable to that of the best-performing countries."[57] The ECB, the Commission and the UK Government all highlighted the fact that "longer-term inflation expectations" for the euro area had been "firmly anchored at levels in line with the definition of price stability since January 1999, remaining in a range between 1.7% and 1.9%." (Q 225; p.88) The ECB did acknowledge, however, that "some aspects" of its monetary policy strategy had "proved difficult to communicate effectively."[58]

The Committee's conclusions on the ECB's definition of price stability

79. **We welcome the fact that at the start of its operations the ECB announced a quantitative numerical value for its objective of price stability. Such a decision was essential for transparency and accountability. The ECB's initial definition of price stability as being a "year-on-year increase in the Harmonised Index of Consumer Prices (HICP) for the euro area of below 2%" did not make it clear that there was a lower limit. This led to some confusion and left the ECB open to criticisms that it was not sufficiently vigilant about the risks of deflation.**

80. **In the light of the ECB's announcement on 8 May 2003 of the results of the Governing Council's review of its monetary policy, the bank's definition of price stability is clearer than it was before and not so open to criticisms of asymmetry. Nonetheless, comparisons with the symmetrical inflation targets of some other central banks remain unfavourable, and the ECB's definition of price stability could still be clearer.**

81. **The ultimate test for the success of a central bank's monetary policy strategy is its record of actual policy decisions. As we say above (paragraph 25), this has generally been good so far. Where the strategy has not performed so well is in communicating the bank's decisions.**

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[54] 'The first lustrum of the ECB', Speech by the President of the ECB at the International Frankfurt Banking Evening, Frankfurt, 16 June 2003.

[55] Answer to the questionnaire drawn up by the Economic and Monetary Affairs Committee of the European Parliament for its hearing on 11 September 2003 on the appointment of Mr Trichet as President of the ECB (available on that committee's website).

[56] Press seminar on the evaluation of the ECB's monetary policy strategy, Frankfurt, 8 May 2003.

[57] 'Overview of the Background Studies for the Reflections on the ECB's Monetary Policy Strategy', ECB, 8 May 2003, p.10. (See also E. Castelnuovo, S. Nicoletti Altimari and D. Rodriguez-Palenzuela, 2003, 'Definition of price stability, range and point inflation targets: The anchoring of long-term inflation expectations', Background study for the ECB's review of its monetary policy strategy, 2003, available on the ECB's website.)

[58] 'The outcome of the ECB's evaluation of its monetary policy strategy', *ECB Monthly Bulletin*, June 2003, pp.79–80 (see also Chart One on p.81 of this edition).

82. **The ECB's definition of price stability has recently been reaffirmed and clarified. We hope that Mr Trichet, the bank's incoming president, will sustain this process of clarification of the current definition in order to safeguard the bank's credibility and that of its monetary policy strategy.**

83. **The task remains of communicating the ECB's new strategy effectively. It is with a view to improving this external communication that we recommend that the ECB should in due course adopt an inflation target, expressed as a symmetric range around a central figure. Such a target would constitute a natural focal point that could be observed and understood by the public; it would provide observers with a more precise focus for forming inflation expectations and taking forward-looking decisions. An explicit target for inflation would be entirely transparent and so would reduce the uncertainties for other economic agents, by giving clearer guidance for their inflation expectations, which should in turn help to stabilise the economy. A symmetrical inflation target would also provide a clearer benchmark against which the bank could be held to account.**

84. **The two main criticisms of the ECB that concern its definition of price stability are the related claims that the ECB has not focused enough on growth and employment and that the ECB is not sufficiently vigilant in fighting deflation. We think that these claims are unfounded. A symmetrical inflation target would, however, address these two fears directly. The lack of symmetry to the ECB's definition of price stability has contributed to the perception that the bank does not take sufficient account of deflationary risks, pays inadequate attention to growth and is only concerned with achieving a low rate of inflation; a symmetrical inflation target would reduce these uncertainties over the ECB's aims.**

The timescale over which the ECB is committed to achieving price stability

85. The ECB's original announcement of its monetary policy strategy referred to developments in the HICP "over the medium term". In announcing the outcome of its review of the strategy, the central bank confirmed this timescale, which some of our witnesses complained was rather ambiguous. They wanted clarification of the phrase 'medium term'. Without an explicit time span for the horizon over which price stability was to be achieved, the bank could not be held properly to account. As Professor Wyplosz put it: "Accountability is meaningless unless the agent can be blamed or sanctioned in the event that it does not deliver on its mission."[59] Professor Giavazzi complained that it was "very difficult" to hold the ECB accountable. Yet, he pointed out, the ECB's lack of clarity over this issue could also work the other way, causing the bank to be blamed for changes in the level of inflation for which it should not be blamed: "We know that monetary policy works with lags of a year or a year and a half. […] Assume that inflation jumps up three months from now. They could be held responsible for this even if they do not have an influence on the situation." (QQ 1, 49, 85, 88; p.86)

86. The ECB, however, explicitly rejected "the choice of a pre-specified, fixed horizon for the conduct of monetary policy". Monetary policy did not have an immediate impact on the rate of inflation; it worked with lags of a year or more, depending on the specific nature and size of the shock affecting the economy to which it was trying to respond. The bank argued that the choice of any explicit figure for a time horizon would be "arbitrary" since the transmission mechanism spanned "a variable, uncertain period of time."[60] The ECB did, however, acknowledge the concern of critics:

> "You might ask what 'medium term' means exactly. It is certainly not a fixed time horizon, as some have argued. Experience in recent years has taught us that flexibility in this respect is very important. From this point of view, the ECB's monetary policy strategy is different from pure forms of inflation targeting."[61]

87. UNICE noted that the ECB's monetary policy strategy was less precise in this regard than that of central banks, such as the Bank of England, but it did not consider that that had had a detrimental effect on the ECB's ability to shape inflation expectations because the bank had shown that it was committed to price stability and had proved itself credible in delivering this. Director General Regling of the Directorate-General for Economic & Financial Affairs at the European Commission agreed that the absence of a precise definition of a specific number of months or years for the concept medium term "should not be seen as a disadvantage." (pp.88, 90–91)

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59 'The Strategy Review', *op.cit.*, p.4.

60 'The outcome of the ECB's evaluation of its monetary policy strategy', *ECB Monthly Bulletin*, June 2003, p.82.

61 'The first lustrum of the ECB', Speech by the President of the ECB at the International Frankfurt Banking Evening, Frankfurt, 16 June 2003.

The Committee's conclusion on the time horizon of the ECB's definition of price stability

88. **We agree that the medium term is the right period of time for the ECB to be aiming to achieve price stability. Monetary policy should dampen or smooth fluctuation in both output and inflation without causing undesirable volatility in interest rates, employment or GDP. The medium-term orientation of the ECB's strategy allows such a flexible response to temporary shocks.**

SHOULD THE ECB MAINTAIN ITS TWO-PILLAR MONETARY POLICY STRATEGY?

89. In October 1998, when the Governing Council first announced its monetary policy strategy, it declared that, in order to assess risks to price stability, the ECB would use a 'two-pillar' approach. This would involve, under the first pillar, a prominent role for money, as signalled by a reference value for the growth of the broad monetary aggregate M3, and, under the second pillar, a broadly-based assessment of the outlook for future price developments.

90. Having reviewed its monetary policy strategy, the Governing Council confirmed on 8 May 2003 that its monetary policy decisions would continue to be based on an analysis of the risks to price stability founded on a two-pillar framework. However, henceforth the order in which these two pillars would be presented would be reversed, and they would be referred to as the 'economic analysis' and the 'monetary analysis'.

The role of the two pillars and their different time perspectives

91. The 'economic analysis' would focus on the most proximate causes of inflation, as President Duisenberg explained:

> "The broadly based economic analysis focuses mainly on the assessment of current economic and financial developments and the implied short to medium-term risks to price stability from the perspective of the interplay between supply and demand at those horizons. In this respect due attention is paid to the need to identify shocks hitting the economy. To this end, the developments analysed include a broad range of information on, for example, wages, commodity prices and exchange rates, asset prices, wealth, external demand, fiscal policy, and domestic financing conditions and costs."[62]

92. Mr Eugenio Solans, the Member of the Executive Board of the bank responsible for amongst other things statistics, added that:

> "The economic and financial statistics supporting the 'economic analysis' include, for example, national accounts' main aggregates, government finance statistics, short-term business and labour market indicators, exchange rates, the balance of payments for the euro area, financial market statistics and the financial balance sheets of euro area sectors."[63]

The ECB aimed to use all of these statistics to help the Governing Council to assess the dynamics of real economic activity within the euro area and the global economy, and the likely development of prices over short-term horizons. Mr Solans explained that in contrast to, and complementing, the economic analysis:

> "The 'monetary analysis' focuses on money and liquidity considerations and mainly serves as a means of cross-checking, from a medium to long-term perspective, the short to medium-term indications resulting from the 'economic analysis'. The statistics supporting the 'monetary analysis' include, for example, the sufficiently detailed consolidated balance sheet of the euro area banks, in particular the monetary aggregates and counterparts, the balance sheet of euro area investment funds, securities issues statistics and the financial balance sheets of the non-financial sectors, including any changes."[64]

93. The monetary analysis would thereby look at longer term developments and would be used to 'cross-check' the short to medium-term indications coming from the economic analysis to make an overall and unified assessment of the risks to price stability. The ECB also announced that, as previously, its monetary analysis would take into account "developments in a wide range of monetary

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62 'Overview of the Background Studies for the Reflections on the ECB's Monetary Policy Strategy', ECB, 8 May 2003, p.16.

63 'Official Statistics for a Global Economy', Speech delivered at the 54th Session of the International Statistical Institute, Berlin, 20 August 2003.

64 *ibid.*

indicators including M3, its components and counterparts, notably credit, and various measures of excess liquidity."[65]

94. The ECB further announced that whilst it would continue to publish a reference value for M3 as part of its monetary analysis (which was currently 4.5%), it would discontinue the practice of the Governing Council reviewing the reference value in December each year. This was because the bank was worried that this process had led to the "misperception" that the yearly review would lead to a yearly reference value indicator, which people outside the ECB had taken as a kind of normative indicator for the development of money, which had never been the bank's intention.[66]

The two-pillar strategy is an instrument to organise and convey information

95. Professor Issing explained that the ECB's two-pillar strategy had two main functions. First, it informed the Governing Council's decisions on setting interest rates for the euro area, by providing a framework for the internal analysis of information and thus facilitating the debate within this decision-making body. The two pillars provided a structure that ensured that the Governing Council examined and weighed all relevant information and did so in a considered manner.

96. Secondly, the two pillars also performed an outward-looking function by providing a framework for external communication. In relation to this second function of the two-pillar strategy, Professor Issing was keen to stress that by giving weight to both monetary and economic analyses, the bank aimed to avoid the impression that its decisions on interest rates for the euro area came from a single analysis. The ECB argued that it should not deny the complexity of its setting monetary policy: "a strong focus on a single inflation forecast would not do justice to the complexity of the decision-making process and would also not provide a transparent means to communicate this complexity."[67] The final assessment was indeed a single one, but the Governing Council's approach was based on its two pillars. The bank's aim was to make this process transparent through a thorough explanation of the rationale for its decision, which would thereby improve the public's understanding of how the bank conducted monetary policy. In that regard, UNICE noted that the ECB's two-pillar strategy required the central bank to provide "a more in-depth and comprehensive analysis than inflation targeting" (p.91). Effective communication of monetary policy decisions would have a further benefit in that it would facilitate the transmission of those decisions to the economy.[68]

What status should be accorded to monetary analyses?

97. The role accorded to money and monetary analyses in the monetary policy strategy of the ECB generated particular controversy among ECB watchers. Many of our witnesses questioned whether money was a sound indicator for price developments and questioned the correlation between money growth and the Governing Council's decisions on interest rates. They claimed that, contrary to the ECB's aim, the two-pillar strategy had confused the communication of the Governing Council's interest rate decisions.

98. Several witnesses explained that before the ECB's review of its monetary policy strategy, the bank had appeared to disregard the information from its money supply pillar. The Governing Council seemed not to place much weight on the growth rate of the monetary aggregate M3, which had been above the reference value almost continuously since the start of the bank's operations in January 1999 (see Box 3). Despite money growth being at times substantially above the reference value, the ECB had never taken any action in order to resolve that issue. The relationship between monetary growth and the bank's interest rate at times even appeared to be inverse, in that when M3 had grown faster than the reference value, the ECB had cut interest rates (QQ 36, 66, 72, 166, 182; pp.23, 85–86).

99. Mr Walton concluded that it was "pretty clear" that M3 had not been a very good guide to the ECB's interest rate decisions. The ECB evidently regarded money and credit as important indicators for inflation, but it was not obvious that they merited a particular status in the bank's strategy over and above everything else which the ECB examined as part of its economic analysis. He therefore supported the ECB's decision to 'downgrade' the first pillar by presenting the monetary analysis after the economic analysis and ascribing to it only a cross-checking role. He suggested that this reform should make the bank's communication strategy a lot easier. The UK Government also welcomed the

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65 'The ECB's monetary policy strategy', ECB Press Release, 8 May 2003.

66 'Overview of the Background Studies for the Reflections on the ECB's Monetary Policy Strategy', ECB, 8 May 2003, p.16.

67 *ibid.*, p.17.

68 'ECB Watchers Conference: The evaluation of the strategy', Opening remarks by Professor Issing, Frankfurt, 11 July 2003.

fact that ECB had "explicitly downgraded their monetary pillar to the second pillar rather than the first pillar of monetary policy" (QQ 1, 13, 224).

100. The ECB placed greater emphasis on money as a medium to long-term benchmark for inflation "in view of the robust relationship between money and prices over extended horizons."[69] A build-up of excessive liquidity could pose an inflationary threat two years or more down the road, and so the monetary analysis provided a cross-check, which allowed the Governing Council to evaluate the impact of monetary growth over a longer time horizon than that of the staff projections that the bank published. Moreover, the ECB stressed that although the reference value for M3 had been misinterpreted by many to be a target, it was in fact only "a benchmark" against which monetary developments could be assessed and described to the public.[70] That was why the ECB had not and would not react "mechanistically" to deviations of M3 growth from its reference value.[71]

101. A number of witnesses accepted this explanation from the ECB, which appeared to de-emphasise what had been the first pillar. They agreed that the focus on money remained of relevance for monetary policy; there was some medium or long-term relationship between the money supply and inflation. The monetary analysis could ensure that the Governing Council maintained a focus on the medium-term and long-term consequences in terms of price stability of its monetary policies. These witnesses accepted that the monetary analysis provided the Governing Council with a useful check that discouraged it from responding to a series of specific situations in a way which could create an inflationary threat in the long term. The Governing Council would now examine not just M3 but a range of monetary and credit variables as well. This was welcomed, but Professor Goodhart called for great clarity as to what the components of the monetary analysis were, and what weights were ascribed to the different monetary aggregates. Witnesses considered that decision to 'downplay' the role of monetary aggregates would make the ECB's communication of its monetary policy decisions easier and more effective (QQ 36, 45, 180, 182; pp.82, 85).

102. For the Bank of England, inflation was "ultimately a monetary phenomenon," and economic forecasts were "necessarily uncertain and often wrong." Monetary developments might therefore be "used as a complement to the broad-based analysis of inflation prospects" that took place under the ECB's economic analysis. Sir Samuel Brittan too would keep the monetary analysis where it now was: "in the background". He saw it as providing the Governing Council with a useful "amber light" that said: "'Do not forget about the money supply'". Professor Thygesen considered that the two pillars had been modified in a way that was reasonable and which could provide "an intelligent longer term framework for monetary policy" (p.84; QQ 66, 165, 170).

Does there need to be a separate monetary pillar?

103. Some witnesses questioned whether it was useful to have a separate 'money' pillar or analysis. They suggested that inflation forecasts could include all of the relevant information about how prices would develop that those making decisions on monetary policy needed in order to take a well-informed judgement about the risks to price stability. Whilst recognising that money could provide an indication of future rates of inflation, these witnesses maintained that this information could simply be included in the inflation forecasts. They proposed that the risks to overall price stability should be assessed on the basis of a comprehensive judgement encompassing all available evidence.

104. Dr Schmieding, for example, agreed that the ECB had gone in the right direction by emphasising that money was a long-term concern and that money would be used to cross-check the information from the economic analysis, but, he argued, "it would be better if the ECB were to go further. The ECB should leave the old Bundesbank model […] further behind and come to what one could call a unified assessment of future inflation prospects in one rather than two pillars" (Q 66). The Bank of England, however, claimed that the contrast with its own procedures could be "overstated":

> "The regular monthly briefing provided to the MPC always includes an analysis of monetary developments. And while projections of inflation (and growth) two years out are a key ingredient of our quarterly Inflation Report, the process of preparing those projections incorporates a detailed consideration of monetary developments (see A. Hauser and A. Brigden, "Money and credit in an inflation-targeting regime", *Bank of England Quarterly Bulletin*, Autumn 2002). Consideration as to the appropriate setting for interest rates also takes on board considerations about possible developments beyond the two-year forecast horizon." (p.84)

[69] 'Overview of the Background Studies for the Reflections on the ECB's Monetary Policy Strategy', ECB, 8 May 2003, p.14.

[70] *ibid.*, p.15.

[71] *ibid.*, p.16.

105. In contrast though, the ECB insisted that the role it gave to money demanded explicit and separate reflection so that it was given due consideration in the assessment of risks to price stability:

> "The short to medium-term economic analysis – with its focus on real activity and financial conditions – is well equipped to study shorter-run deviations of inflation from its long-term trend. However, it often fails to track the mechanisms by which monetary factors act over extended horizons and thus to pin down such trends. There is, therefore, a need for monetary policy to explicitly take information from monetary developments, which might otherwise risk being overlooked or underestimated, into due account in policy considerations."[72]

106. The monetary analysis could not simply be seen as part and parcel of a single economic analysis. To critics who argued that the ECB should combine both analyses into one single assessment or pillar, Professor Issing retorted that there was no easy way to combine the analysis of real economic trends with that of phenomena that were broadly "monetary" in nature. It was not yet possible to bring these two analyses together in a unified framework:

> "I think that anybody who can solve this problem of integrating money into the usual models deserves the Nobel Prize. So far there has been no approach which, in a satisfactory, comprehensive way, combines monetary and the usual economic forecasting analysis. And so, we are keeping this two-pillar structure unchanged."[73]

107. The ECB was committed to ensuring that monetary phenomena – which it claimed were "likely to be overlooked within a framework centred on short-term inflation forecast procedures" – were sufficiently considered in the policy deliberations of the Governing Council.[74] Mr Trichet and Professor Issing also argued that "the very complex problem of asset prices" was "more naturally and better taken into account" in the bank's two-pillar strategy.[75] Although Mr Walton countered that the best way to observe whether or not there might be an asset price bubble was "actually to watch the asset prices themselves rather than to look at it indirectly through some money supply indicator" (Q 13).

108. Some witnesses criticised the two-pillar strategy as being confusing, saying that it was unclear what weight the Governing Council placed on each of the pillars. Professor Von Hagen, for example, was concerned that there had not even been an attempt to clarify how the two pillars would be combined into a consistent decision-making process (Q 182). The ECB argued though that at the end of the day monetary policy always involved judgment; it was not a mechanistic operation, and the bank did not want to over-simplify it. The ECB claimed that its two-pillar approach was the clearest way "to convey the notion of diversification of analysis to the public."[76]

The Committee's conclusions on the ECB's two-pillar monetary policy strategy

109. **The monetary pillar does not appear to have significantly affected the ECB's interest rate decisions. The prominent position of this monetary analysis in the ECB's presentation of these decisions did, however, cause problems and hindered the bank's communication of its monetary policy. We therefore welcome the changes in the President's press statement and the editorial in the bank's monthly bulletin, in which the monetary growth pillar plays a less prominent role, which helps the bank's communication strategy.**

110. **We believe that it is sensible that the Governing Council continue to monitor monetary developments in order to inform its decisions on interest rates. We accept that the two pillars of the ECB's monetary policy strategy provide a useful framework for the internal analysis of information that facilitates the debate within the Governing Council. We respect the ECB's view that it does not want to create the wrong impression that controlling inflation is an exact science. However, the ECB's decision to reject inflation targeting and maintain its two-pillar framework does not imply that the bank is prevented from adopting an inflation target. The ECB could announce an explicitly symmetrical inflation target and state that that its actions in trying to**

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72 'The outcome of the ECB's evaluation of its monetary policy strategy', ECB Monthly Bulletin, June 2003, p.87.

73 'Overview of the Background Studies for the Reflections on the ECB's Monetary Policy Strategy', ECB, 8 May 2003, p.19.

74 *ibid.*, p.18.

75 Answer by Mr Trichet to the questionnaire drawn up by the Economic and Monetary Affairs Committee of the European Parliament for its hearing on 11 September 2003 on the appointment of Mr Trichet as President of the ECB (available on that committee's website); and 'ECB Watchers Conference: The evaluation of the strategy', Opening remarks by Professor Issing, Frankfurt, 11 July 2003.

76 'Overview of the Background Studies for the Reflections on the ECB's Monetary Policy Strategy', ECB, 8 May 2003, p.17.

achieve this target will be based upon its two-pillar framework rather than be guided solely by the relationship between forecasted and target inflation.

111. **The ECB has said that its "two-pillar framework has over time become the hallmark of the strategy in conjunction with the medium-term orientation of the ECB's policy framework."[77] Our proposals do not necessarily call for either of these aspects of ECB's monetary policy strategy to be changed. We believe that our recommendations represent a sensible compromise between the ECB's determined attachment to its two pillars and calls for the bank to change to an inflation-targeting regime. The ECB could combine what it considers to be the organisational advantages of its two-pillar framework with the important communication benefits associated with the anchoring role of an inflation target. Were the ECB to adopt a symmetrical inflation target, however, it might reconsider the role and necessity of its monetary analysis.**

SHOULD THE ECB CONDUCT FURTHER REVIEWS OF ITS MONETARY POLICY IN THE FUTURE?

112. Mr Walton told us that "the ECB should not regard this review of monetary strategy as the only review it ever conducts into its monetary strategy." He suggested that this was a procedure that the bank should follow every few years or every time another Member State joined the euro area. There was a precedent for conducting regular periodical reviews of monetary policy, he pointed out, citing the example of the central bank of New Zealand, which conducted such a review every time a new governor was appointed or the governor was re-appointed:

> "These things should never be fixed in stone. There are always going to be advancements in economic thinking and there are always going to be changed circumstances. The ECB should never think that this is a one-off shot at trying to get the system right." (Q 29)

113. Whilst stressing that the Governing Council's reflection on its monetary policy strategy was "an ongoing process",[78] Professor Issing said that he did not expect the ECB to conduct another review of its monetary policy during his term at the bank (which ran until 2006).[79]

The Committee's conclusion of future reviews of the ECB's monetary policy strategy

114. **We are encouraged that the ECB has said that the process of review is ongoing. We hope that the bank will adopt the practice of conducting regular reviews of its monetary policy strategy. By the time such a review next takes place, the perceived dangers to the bank's credibility of changing its definition of price stability should have receded and the bank might at that point find it made sense to adopt a symmetrical inflation target.**

Should the ECB have an Exchange Rate Policy?

The current institutional arrangements for the exchange rate of the euro

115. The international monetary system is one of floating exchange rates. The main international currencies (notably the euro, US dollar, yen, pound sterling, Canadian dollar and Swiss franc) float freely as demand for and supply of the various currencies increases or decreases. The central banks concerned conduct policies that aim at maintaining price stability in their respective domestic economies, which can lead to quite large exchange rate fluctuations over the short to medium term.

116. Exchange rates fall within the competence of the Council rather than the ECB. Article 111 TEC states that the Council, acting unanimously, may "on a recommendation from the ECB or from the Commission, and after consulting the ECB in an endeavour to reach consensus consistent with the objective price stability, […] conclude formal agreements on an exchange rate system for the ecu in relation to non-Community currencies". In addition, it provides that the Council, acting with a qualified majority, either on a recommendation from the Commission and after consulting the ECB or on a recommendation from the ECB, can also formulate "general orientations" for exchange rate policy in relation to one or more non-community currencies. A resolution of the Luxembourg

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[77] 'Overview of the Background Studies for the Reflections on the ECB's Monetary Policy Strategy', ECB, 8 May 2003, p.11.

[78] 'ECB Watchers Conference: The evaluation of the strategy', Opening remarks by Professor Issing, Frankfurt, 11 July 2003.

[79] Press seminar on the evaluation of the ECB's monetary policy strategy, Frankfurt, 8 May 2003.

European Council of 13 December 1997 further elaborates the relationships between the Council, the Commission and the ESCB in the matter of exchange rates. [80] The resolution states:

> "While in general exchange rates should be seen as the outcome of all other economic policies, the Council may, in exceptional circumstances, for example in the case of a clear misalignment, formulate general orientations for exchange rate policy in relation to non-EC currencies […]. These general orientations should always respect the independence of the ESCB and be consistent with the primary objective of the ESCB to maintain price stability."

Do exchange rates matter for monetary policy?

117. Exchange rate fluctuations impact on price stability in the world's different currency areas: when a currency depreciates, there is what can be termed "imported inflation"; when a currency appreciates there is "imported disinflation". Dr Schmieding explained that the exchange rate thereby matters "significantly for economic growth and the inflation outlook". He argued that the main potential cause of deflation in the euro area would be the exchange rate, because according to some economic models "a rise of 10% of the euro in effective rate terms, would depress the price level by something like 1% over a period of a couple of years," which would temporarily reduce inflation quite sharply." Large fluctuations might therefore require some offsetting monetary action (QQ 68, 84; p.24).

118. Mr Volcker argued that large exchange rate movements between the euro and the dollar had had a negative impact on the structure of the economy and economic activity. He was concerned that central banks and governments – and "particularly in the big countries and particularly in the biggest economic areas, Europe and the United States" – had been "very *blasé*, to say the least, about exchange rate movements." He thought that central banks could become preoccupied with delivering internal stability of the price index and the absence of inflation in their currency area; and, if that happened, they could not afford to worry much about the exchange rate. The institutional arrangements were partly to blame:

> "If the Government is in charge of exchange rate policy, but the biggest most fundamental influence on the exchange rate policy is monetary policy, it is inherently a strange and difficult situation, which basically every country has faced and reached its own kind of practical compromise, or sometimes conflict. I do not have any solution to it, except I do believe whoever controls the policy it is unfortunate more attention has not been paid to the desirability of not fixing the exchange rate but avoiding these really extreme movements." (Q 131)

Should or could the ECB have an exchange rate target?

119. Our witnesses welcomed the fact that the euro area did not have a formal exchange rate policy. They did not consider that it was possible for the central bank to try systematically to steer the level of the exchange rate towards some ideal level and at the same time maintain price stability. They did not want the central bank to have to aim for two nominal targets, because the exchange rate might suggest monetary policy go one way and inflation considerations within the euro area might suggest that it should go the other way.[81] As Mr Smith, Chief Economist at KPMG, put it: "you either have to have a very strong exchange rate policy if you are going to have one or you do not have one at all, because anything in the middle normally leads to some sort of disaster". The Government stressed, however, that despite the absence of an exchange rate target the ECB might occasionally want to intervene in the markets (QQ 24–25, 48, 189, 225). Professor Draghi agreed that all previous experience of setting an exchange rate target showed that it was "pointless" and very often had even been the source of "serious policy mistakes". He explained that whilst in the past it had always been "very difficult" to steer exchange rates towards ideal targets or ranges, nowadays it was "practically impossible", unless there was a concerted multilateral effort by all central banks towards the targets. He warned that even in a multilateral framework, there had been cases of failure, because capital markets were "simply too big." (Q 195)

120. All of our witnesses agreed that the ECB could never adopt a 'strong exchange rate policy', such as an exchange rate target with the dollar, because any attempt at such a policy could only be achieved by bilateral negotiation between the EU and the US, which would inevitably flounder on the difficulties of the EU reaching an understanding with the US on how to effect the policy. Dr

[80] OJ C 35, 2.2.1998, p. 3.

[81] The EC Treaty was quite clear about which objective would take priority. Article 4(2) of the Treaty stated that the activities of the Member States and the Community included "the definition and conduct of a single monetary policy and exchange-rate policy the primary objective of both of which shall be to maintain price stability and, without prejudice to this objective, to support the general economic policies in the Community".

Schmieding explained that such an arrangement was only practicable in an asymmetric relationship when a small country pegged its currency itself to a bigger one, so that there was no question as to who was following whom (Q 84). Professor Goodhart said:

> "On an exchange rate target it takes two to tango, and that means if there is a fixed exchange rate between the US and the euro (and that is the only one that is really relevant) then there is a question of who follows whom. There is no question in my mind that the Fed would insist on maintaining its complete independence in deciding interest rates and monetary conditions. That would mean, if you wanted an exchange rate target, the ECB would have to follow, effectively pretty slavishly, exactly what the Americans were doing. I do not see the euro zone, when faced with that possibility, wanting to go down that road at all." (Q 48)

Sir Samuel Brittan expressed this view most bluntly when he said that "any attempt to have an exchange rate policy against the dollar would lead to an almighty row with the United States" (Q 172).

121. Professor Draghi cautioned that the rejection of an exchange rate target did not mean that the ECB could be indifferent to what happened to the exchange rate. Professor Thygesen said that the central bank did take movements in the exchange rate into account, although he considered the ECB tended to underplay their importance. He questioned whether the ECB was "too sanguine about the disinflationary impact of euro appreciation" and thought that the ECB should provide a "more explicit commentary" on movements in the exchange rate, "particularly when the speed of movement of currencies is rapid" (Q 84; p.24). The ECB's remarks when announcing interest rate decisions clearly demonstrated that the bank kept watch on developments in the exchange rate. Mr Trichet clarified how this process worked within the Governing Council:

> "The Governing Council takes into account all the available information, relevant data and analyses provided in the report by the member of the Executive Board in charge of the economic and monetary analysis. Exchange rates and their impact on monetary and financial conditions and price developments of course feature in these data and are factored into the analyses and assessment of the outlook for price stability together with all the other elements."[82]

122. One further argument put forward against the euro area adopting an exchange rate target was that it was impossible to say with any confidence what the correct exchange rate should be. As Sir Samuel Brittan put it, "you will find as many economists saying that the European exchange rate is still too low as those saying that it is now too high" (Q 172). Nonetheless, Mr Volcker argued that the policy makers concerned ought to be able to arrive at some conclusion about what constituted "a reasonable range of exchange rates that could be relatively accommodated and would give the market room to go up and down". They should try and reach agreement on some such range, which could be as wide as 10% or 20% from an agreed figure, because although that was still a lot of fluctuation, it was only half of what was being seen in practice and would be "much less damaging" to the economy. He admitted, however, that judgments differed as to whether such a range could be sustained:

> "My own view is that the exchange markets presently have no sense of conviction about what is a sustainable equilibrium exchange rate. They take great pleasure in making money out of these fluctuations. In terms of political dynamics, the great difference in my professional lifetime has been that Wall Street was a great defender of stability and fixed exchange rates, but when they found out how much money they could make from instability, they are now the big proponents of no government intervention and instability, which makes it difficult to take action. But, without any sense of what the right exchange rate is, and the Government is completely agnostic about what the right exchange rate is by their performance, the markets just carried it to extremes. That is the way markets go. I would think if Governments were able to give some reasonable indication of what they thought was a kind of central tendency, the market would give some weight to that. You would have to build up some credibility over time." (Q 142)

Mr Volcker confessed that, in fact, he saw no realistic possibility of either an EU or a US administration being prepared to co-ordinate their actions together in the way that he suggested was desirable to avoid excessive volatility of exchange rates (Q 146).

Conclusion of the Committee on whether the ECB should adopt an exchange rate target

123. **It would be a mistake for the euro area to adopt an exchange-rate target. We are satisfied that the ECB has paid attention to the exchange rate when making its interest rate decisions, but it is clear that affecting the exchange rate has not been the primary aim of the**

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82 Answer to the questionnaire drawn up by the Economic and Monetary Affairs Committee of the European Parliament for its hearing on 11 September 2003 on the appointment of Mr Trichet as President of the ECB.

bank's monetary policy. This has not, and should not, preclude occasional interventions by the ECB in the markets to dampen excessively rapid swings. We are convinced that this is the correct policy for the ECB to pursue.

PART 4: REFORM OF THE GOVERNING COUNCIL

Introduction

124. As we mentioned in our introduction, the composition of the ESCB can be seen as a series of concentric circles. The innermost circle represents the full-time Executive Board of the ECB (which comprises the President, the Vice-President and four other members). Moving outwards, the next circle corresponds to the Governing Council of the ECB, which is composed of the members of the Executive Board and the governors of the national central banks (NCBs) of the countries that have adopted the euro. Moving outwards again, the outer circle signifies the General Council of the ECB, whose membership comprises the President and Vice President of the ECB and the governors of the NCBs of all Member States. All decisions about monetary policy are taken by the Governing Council of the ECB.

125. The European Council of Heads of State or Government recently decided to modify the voting modalities in the Governing Council of the ECB on the basis of a recommendation from the ECB. This reform is aimed at preventing the Governing Council from becoming too large, which, it was feared, would prevent it from taking decisions in a timely and efficient manner in an enlarged euro area. The ECB proposal came in for a large amount of criticism and was rejected by the European Parliament. Nonetheless, it was adopted by the Council, despite the fact that critics argue that the reform will not solve the problems posed to the workings of the Governing Council by enlargement of EMU, indeed some say that it could compound the difficulties. Furthermore, they argue that the reform will increase the complexities of the decision-making process and make the ECB less transparent.

HOW THE GOVERNING COUNCIL CURRENTLY OPERATES

126. The Governing Council consists of the 6 members of the Executive Board and the 12 NCB governors of the euro area. The Governing Council usually operates by consensus, but if there were a vote on monetary policy, each member of the Governing Council would have one vote (making 18 votes in total), and the decision would be taken by simple majority, with the President having a casting vote.

HOW ENLARGEMENT OF EMU WOULD AFFECT AN UNREFORMED GOVERNING COUNCIL

An enlarged Governing Council would be inefficient…

127. Under the current proposals for enlargement of the EU, the Governing Council could greatly expand from its present size of 18 members up to a possible 33 members (the 6 members of the Executive Board, plus the governors of the NCBs of the 15 current Member States, the 10 accession countries and the 2 applicant countries, Bulgaria and Romania). All of our witnesses considered this number to be far too large for efficient decision-making. If each speaker had 10 minutes to present his or her position, that alone would take over five hours!

… and would create the possibility of a controlling coalition of smaller Member States

128. Professor Thygesen wrote of the importance of avoiding a structure in which a coalition of smaller countries could override the consideration of the larger, more economically significant participants (p.24). An enlarged Governing Council run on the principle of 'one member one vote' could result in a situation where a coalition of smaller countries could effectively control the monetary policy decisions of the ECB, despite only accounting for little more than 20% of euro area GDP.[83]

[83] At present, the weighted average inflation for the euro area is dominated by 7 Member States (Germany, France, Italy, Austria, Belgium, Netherlands and Luxembourg), whose macro-economies are reasonably in line with one another and make up 85% of the euro area GDP. After enlargement of EMU, the economies of what are currently the accession countries are likely to have higher levels of growth and inflation than these 7 'core' countries. Under the present voting rules, the smaller Member States, despite accounting for only a small proportion of the euro area GDP, could achieve a blocking coalition in the Governing Council. Although perhaps improbable in practice, the theory has caused academics some concern (see, for example, 'The New Governing Rules of the ECB', Briefing Paper for the Economic and Monetary Affairs Committee of the European Parliament, February 2003, Professor Guillermo de la Dehesa, pp.2–3).

The agreed reform of the voting modalities of the Governing Council

THE LIMITATIONS IMPOSED BY THE NICE 'ENABLING CLAUSE'

129. The need to reform the Governing Council was recognised in the Nice Treaty (which was meant to pave the way for enlargement of the EU). Article 5 of the Nice Treaty introduced a new Article 10.6 into the Protocol on the Statue of the European System of Central Banks and of the European Central Bank, annexed to the EC Treaty. This 'enabling clause' has the effect of allowing changes to be made to the Governing Council voting modalities as laid down in Article 10.2 of the Protocol. The enabling clause allows the European Council, acting unanimously, and after having consulted the European Parliament, to approve reform of the voting procedures of the Governing Council on a proposal from the Commission or a unanimous recommendation from the Governing Council itself. The ECB shall be consulted about any proposal from the Commission and vice versa.

130. The enabling clause thus imposes significant constraints and limitations on the type of reforms that the ECB and Commission can propose. They can only propose amendments to Article 10.2 of the Protocol, which concerns the voting procedures of the Governing Council; the ECB and the Commission do not therefore have the mandate to put forward a proposal for more fundamental reform of the governing structure of the ECB. Changes to the composition of the Governing Council or to the distribution of tasks between the Executive Board and the Governing Council cannot be considered under an amendment to Article 10.2.

FROM ECB PROPOSAL TO COUNCIL AGREEMENT OF THE REFORM

131. On 20 December 2002, the ECB announced that it was going to put forward a recommendation for reform of the voting procedures in the Governing Council. The Governing Council formally adopted a proposal on 3 February 2003, just two days after the Nice Treaty came into force. On 19 February the Commission issued its Opinion on the ECB proposal (COM(2003)81). On 10 March the Economic and Monetary Affairs Committee of the European Parliament rejected the ECB's proposal (A5-0063/2000). On 21 March 2003, the European Council endorsed the ECB proposal and agreed to its proposed reform of the voting modalities of the Governing Council.

AN OVERVIEW OF THE AGREED REFORM

132. The agreed reform caps the number of members of the Governing Council that can vote on monetary policy decisions at 21. All the governors of the NCBs of the euro area will continue to be present at all Governing Council meetings, but the right to vote in the meetings will be rotated between them. The 6 members of the ECB's executive board will maintain permanent voting rights, but the NCB representatives will share on rotation up to 15 votes.[84] In determining how the votes are to be rotated between the NCB governors (who may number up to 27), the agreed reform distinguishes between different groups of countries.

133. The votes will not be rotated equitably between the Member States; this is so that the larger Member States with more financial influence vote more frequently than the smaller Member States. This is a notable change from previous ECB policy. The concern was that otherwise a coalition of smaller Member States representing a small proportion of the euro area economy could push through a decision against the wishes of the larger Member States and the members of the Executive Board (see above paragraph 128). Therefore, the Member States will be divided into groups according to a composite ranking indicator based on two components: the relative size of the economy (measured by the Member State's share in the aggregate euro area GDP at market prices), and the relative size of the financial sector (measured by Member State's share in "the total assets of the aggregated balance sheet of monetary financial institutions" in the euro area).

134. The reform will happen in two stages. When there are more than 15 but less than 22 Member States, the Member States of the euro area will be divided into two groups. In this first stage of reform, the 5 largest Member States (measured by the ranking indicator) will form the first group, which will have 4 votes.[85] The remaining 11–16 smaller countries will share the other 11 votes. The Governing Council can decide to postpone the start of the rotation system until the number of governors exceeds 18. This would mean that the 14–16 smaller Member States would share 11 votes, and so they would less frequently than the 5 largest Member States, who would share 4 votes.

[84] The Commission questioned whether the limit of the number of voting national central bank governors might possibly increase to 18 during a transitional period. It considered that the Governing Council could defer the effective start of the rotation model until the number of governors exceeded 18 (rather than 15) (p.89 and COM(2003)81 final, p.4.).

[85] The Member States that would form this first group are currently France, Germany, Italy, Spain and the Netherlands; if the UK joined the euro area, it would replace the Netherlands in this group.

135. In the second stage of reform – to be implemented from the point when the euro area expands to 22 or more Member States – the Member States will be divided into three groups. The first group will remain confined to the 5 largest Member States, who will still share 4 votes. The second group will comprise the next largest countries; it will contain half the total number of euro area Member States, rounding up if necessary (i.e., 11–14 countries); these countries will share 8 votes. The third group will contain the remaining 6–9 countries, and will have 3 votes.

Box 6

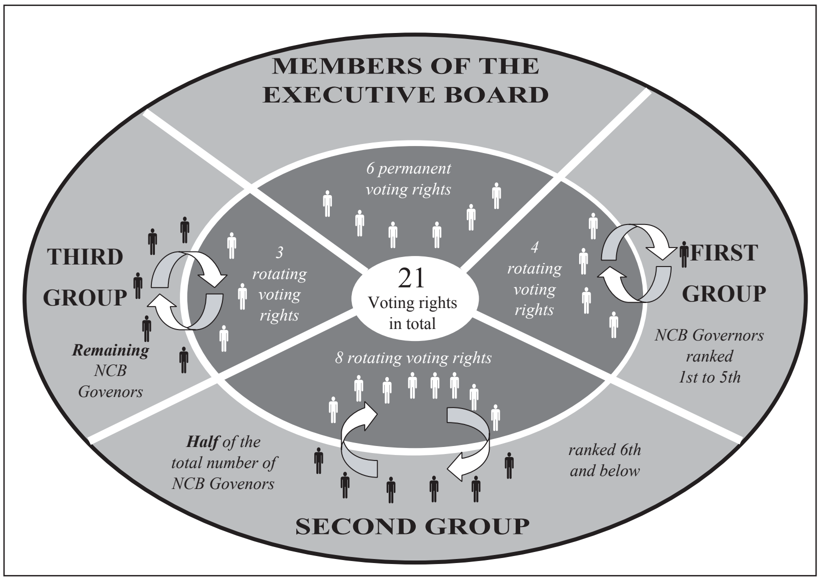
Possible distribution of countries into voting groups in the Governing Council

	Euro-28	**Euro-25 (Euro-28 without BG, RO and TUR)**	**Euro-22 (Euro-25 without UK, SW and DK)**
Group 1	Germany United Kingdom France Italy Spain	Germany United Kingdom France Italy Spain	Germany France Italy Spain The Netherlands
Group 2	The Netherlands Belgium Sweden Austria Denmark Ireland Poland Portugal Turkey Greece Luxembourg Finland Czech Republic Hungary	The Netherlands Belgium Sweden Austria Denmark Ireland Poland Portugal Greece Luxembourg Finland Czech Republic Hungary	Belgium Austria Ireland Poland Portugal Greece Luxembourg Finland Czech Republic Hungary Slovak Republic
Group 3	Romania Slovak Republic Slovenia Bulgaria Lithuania Cyprus Latvia Estonia Malta	Slovak Republic Slovenia Lithuania Cyprus Latvia Estonia Malta	Slovenia Lithuania Cyprus Latvia Estonia Malta

Source: Dr Daniel Gros 'Reforming the composition of the ECB Governing Council in view of enlargement: How not to do it!', Briefing paper for the Economic and Monetary Affairs Committee of the European Parliament, February 2003. Dr Gros established the table by his own calculations, which were based on data for the 2002.

Box 7

An illustration of how the reform of the Governing Council will work



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CRITICISMS OF THE AGREED REFORM

The Governing Council would be too large, making it inefficient

136. The ECB's Recommendation for a Council Decision states that there is "a need to maintain the Governing Council's capacity for efficient and timely decision-making in an enlarged euro area, irrespective of the number of Member States that adopt the euro." This is patently true. However, our witnesses were certain that the agreed reform would not achieve this vital objective. All members of the Governing Council (with and without the right to vote) would continue to sit at the table and have the right to participate in the discussion. The agreed reform would thus not solve the problem of the excessive size of the forum. Our witnesses dismissed the agreed reform because it would create a decision-making body that would be "totally unwieldy". Professor Buiter pointed out that in an enlarged euro area there could be 27 NCB governors present at the meetings of the Governing Council, plus 6 Executive Board members, making 33 members in total for the discussion,[86] with 21 voting: "That is three football teams for the discussion, and two with one man sent off for the voting! It is too large." If implemented, the reform would create an unprecendently large body for monthly monetary policy decision-making. Professor Thygesen criticised the ECB and the Council for paying insufficient attention to considerations of efficiency, which would certainly have made it desirable to reduce the size of the Governing Council. Instead, the Governing Council would take a form "more suited to a parliamentary debate than to a decision-making forum on interest rates."[87] There was concern that with such a large number of members the Governing Council might suffer from "an inability to react promptly to changes in the economic environment" (QQ 26, 35–36, 62, 73; pp.24–25, 80–81).

The proposal is not entirely clear on a number of points

137. In its Opinion on the ECB recommendation, the Commission asked why, for determining which Member State would be in which group, the ranking indicator employed the criterion of the relative size of the financial sector.[88] The Commission suggested that it might have been more appropriate to use population size, since the Maastricht Treaty uses GDP and population size (in a

[86] In fact, the number for the discussions could be even higher, because the President of the Eurogroup and a representative of the Commission also have the right to attend meetings of the Governing Council and participate in the discussion.

[87] This comment by Professor Thygesen echoes that of Dr Gros, Deputy Director of the CEPS, who said that if the Governing Council ended up with over 30 members it would be "more like a mini-parliament than a decision-making body that has to manage a global currency in fast-moving financial markets." (*op.cit.*, p.1)

[88] COM(2003)81 final, pp.3–4, 7.

balanced 50-50 split) to determine country contributions to subscribed capital of the ECB. If these factors had been used in this way in the ECB's rotation model, they would have had the effect of placing Luxembourg in the third group, rather than the second group as it will be under the agreed reforms.

138. The Commission also pointed out that the ECB proposal left several questions unanswered. The details of the reform are not fully specified in the ECB's proposal. For example, the length of time of the rotation period, which will determine the frequency of rotation, has not been announced. It is not even explicit that the rotation frequency will be identical for each of the three groups. Similarly, the sequence to be followed for assigning voting rights within a group is still unknown, as is the time from when the rotation model will take effect. Furthermore, the ECB has not announced when it will provide these details.

It is far too complex and is not therefore transparent

139. Transparency is one of the five fundamental principles that the ECB, in its Recommendation, said should guide reform of the Governing Council. On 19 December 2002, President Duisenberg wrote to Pat Cox, President of the European Parliament, and emphasised that "the Governing Council sought to design a rotation scheme which is transparent so that its main features and functioning can be communicated easily." The agreed reform cannot be described as transparent, however; its functioning is difficult to communicate because it is so complicated. The Governing Council "requires broad and ongoing public support in Europe," because, as Professor Bofinger explained, "from time to time the common monetary policy will exert negative effects on certain areas." One consequence of this situation is that citizens need to be able to trust in and "easily understand the workings of this system."[89] Yet, as Professor Buiter said, the ECB's proposal is "an incredibly complicated scheme. You literally have to use a formula to figure out who is going to vote how often and what the rotation scheme is." He called the outcome "an inelegant mess". (Q 35)

140. President Duisenberg has admitted that the adopted changes in the voting modalities are complex.[90] But, as explained above (paragraphs 129–30), the Nice Treaty imposed strict conditions to the proposal that the ECB was allowed to put forward. President Duisenberg explained that in formulating a proposal the Governing Council found "the most stringent" condition to be the need to ensure unanimity:

> "I can certainly think of a simpler system, but not if, at the same time, I had to ensure unanimity."[91]

It emphasizes nationality as the basis for who can vote

141. One of the founding principles of the ECB statutes is that NCB Governors sit on the Governing Council "in a personal and independent capacity", not as national representatives.[92] This principle of so-called "ad personam participation" is there to try and guarantee that members participate in a personal and independent capacity and make their own personal judgement without being influenced by national interests. One of the commendable aspects of the Governing Council's decisions so far is that it seems to have focused on aggregates for the euro area in reaching its conclusions. The rotation system, however, establishes nationality as the basis for who has a vote at any one time; the NCB governors will be given different voting rights according to the economic importance of the Member States that they represent. There was concern that, by giving up the principle of equality of Member States, the proposal threatens to undermine the theory that all members of the Governing Council "should forget the particular interests of their home country and act only in the interest of the euro area."[93] The reform will create "a three-class voting scheme which treats the governors differently according to their national origin." This system may "threaten the independence of the ECB's decision-making processes from national considerations." Professor Buiter explained that the result of the reform was a "very uncomfortable paradox of an institution with a euro area-wide mandate, and specifically charged to ignore national considerations and not to take orders

89 'Consequences of the modification of the Governing Council rules', Briefing paper for the Economic and Monetary Affairs Committee of the European Parliament, 7 February 2003.

90 'Presentation of the ECB's Annual Report 2002 to the European Parliament', Introductory statement delivered by President Duisenberg, Strasbourg, 3 July 2003.

91 Monetary Dialogue with the Economic and Monetary Affairs Committee of the European Parliament, Brussels, 12 June 2003.

92 The importance of this principle is stressed in the Explanatory Memorandum of the ECB's Recommendation to amend the voting modalities of the Governing Council (*Official Journal of the European Union*, C 29, 7 February 2003).

93 Dr Gros, *op. cit.*, p.2.

from national authorities, yet with the majority of the Governing Council, selected not on competency grounds, but subject to nationality constraints." He criticised this "internal contradiction", which meant that national appointments were given a mandate to consider exclusively the euro area (QQ 35, 54).

THE SPEED WITH WHICH THE PROPOSAL WAS AGREED BY THE COUNCIL DID NOT ALLOW THE REQUISITE TIME FOR PARLIAMENTARY SCRUTINY

142. Under the Protocol on the role of national parliaments in the European Union,[94] a minimum period of 6 weeks is provided to enable documents to be scrutinised by national parliaments before they are agreed to in the Council of Ministers by governments. In the case of this proposal, the Financial Secretary signed a short, cursory explanatory memorandum for the UK Parliament on 8 March 2003; she then wrote to our Committee on 20 March 2003, saying that the Government intended to override scrutiny and agree to the proposal at the Council meeting on 21 March.

143. In its recent report, *The UK and the euro*, the Treasury Committee in the House of Commons concluded that it was "regrettable that such an important decision on reform was taken so quickly and with limited debate."[95] Professor Thygesen also regretted that there had not been "more discussion of [the proposal] in public", including in the UK, as the proposal raised "serious questions of concern" (Q 73).

The way forward: how should the Governing Council be reformed?

A COMPARISON WITH OTHER CENTRAL BANKS

144. In the US, the Federal Open Market Committee (FOMC) uses a similar rotating voting system to that agreed for the Governing Council of the ECB, although it is considerably simpler and more transparent. The 7 members of the Federal Reserve Board, which is the equivalent in the Federal Reserve of the ECB's Executive Board, have permanent voting rights on the FOMC; 5 others votes are shared between the 12 Federal Reserve Bank presidents. The President of the New York Reserve has a permanent seat, due to the importance of the financial sector in New York; the remaining 4 seats rotate among the Presidents of the remaining 11 regional central banks on one-year terms. All members participate in the meetings and in the discussions, and contribute to the overall assessment of the economy and policy option, but the total number of members on the FOMC is only 19 (compared to a possible total of 33 in the Governing Council). Furthermore, the FOMC only consists of 12 voting members, whereas there could be 21 in the Governing Council of an enlarged euro area.

145. At the Bank of England, there are only 9 members on the Monetary Policy Committee (5 full-time executive members and 4 external experts appointed by the Chancellor); there are also 9 members on the Reserve Bank Board of the Reserve Bank of Australia (Australia's Central Bank). This board, which has responsibility for monetary policy decision-making, comprises 3 *ex officio* members—the Governor (who is Chairman), the Deputy Governor (who is Deputy Chairman) and the Secretary to the Department of the Treasury—and 6 external members, who are appointed by the Treasurer. The Executive Board of the Riksbank (the central bank of Sweden) makes all of the bank's monetary policy decisions. The Executive Board comprises six full-time members appointed for six-year terms. The Reserve Bank of New Zealand (New Zealand's Central Bank) employs two external advisors on one-year contracts (with one possible renewal) to provide advice to the Governor, who has responsibility for setting the Official Cash Rate. As can be seen from these comparisons, the agreed reform of the Governing Council of the ECB will make it "by far the largest monetary policymaking body among industrial countries."[96]

THE CONSIDERATIONS OF EFFICIENCY AND NATIONALITY

146. All of our witnesses agreed that it would be highly desirable to have a much smaller group of people making monetary policy decisions for the ECB; the reduction in members would make for a more efficient Governing Council (QQ 26, 40). Dr Schmieding considered that the "awkward nature" of the agreed voting reform was a result of:

> "the compromise between what you could call technocratic efficiency, which would call for a small group of experts taking the interest rate decisions, and what you could call the legitimacy of the multinational institution, which in the extreme would call for the one-country one-vote

[94] Annexed to the EU and EC Treaties by the Treaty of Amsterdam.

[95] Sixth report of session 2002-03, HC 187-I, paragraph 28.

[96] 'The ECB and Euro-Area Enlargement', Herge Berger, IMF Working Paper WP/02/175, p.4.

system. The real question is whether, given the probably inevitable nature of making such awkward compromises, the compromises or trade-offs have gone too far against efficiency or not" (Q 61).

147. His position was that, from an academic or theoretical point of view, it would be "easy to improve on" the ECB's proposal, but the ECB faced some difficult political realities when making its proposal—namely, the feasibility of securing unanimity within the Governing Council for its proposal (Q 73).

148. Professor Thygesen also referred to a compromise between efficiency and the need to assure continuing democratic legitimacy. He considered that in reforming the Governing Council, "equality of treatment of participants" had been discontinued but "without significant gains in efficiency" (p.24). Mr Lorenzo Codogno, Managing Director, Co-Head of European Economics at the Bank of America, also recognised that there was an inevitable "trade-off between the political need to maintain country representation and the even more understandable and justified economic need to have the best designed decision-making body". He argued that the agreed reform tilted the balance between the political considerations of nationality and the economic considerations of efficiency too far in the direction of a political fix. He understood the context in which the decision was made and concluded that the "only benefit" of the new reform was "to provide a politically acceptable way to accommodate EMU enlargement." (p.81)

149. In designing an ideal model for the euro area, Professor Buiter would abandon national representation on the rate-setting body. Instead, he would "have people appointed on the basis of expertise without regard to nationality – outside members and Executive Board members." (QQ 46, 48)

150. When Governor of the Bank of England, Sir Edward George, in testimony to the Treasury Select Committee, said that he did not see the reform as "the end point" in the evolution of how the ECB sets monetary policy. This reform was "a first stage", possibly towards a smaller, technical committee that would make proposals to the Governing Council (QQ 1166-71).

151. Mr Walton pointed out that whilst economists would favour reducing the size of the body making interest-rate decisions, there was an argument that said that the ECB needed to maintain the direct link to the Member States that the governors currently represented (Q 26). The question was whether the time was right to move from a system of national representation on the Governing Council to a system based purely on individual expertise. Professor Thygesen pointed out, however, that considerations of efficiency and national representation need not be mutually exclusive. Monetary policy decisions could be taken by a small, technical body, whilst the NCB governors would continue to sit on the Governing Council, where they would "contribute their unique, indeed indispensable, knowledge of economic developments and sensitivities in their own area," but they would delegate decisions on policy interest rates to the smaller Monetary Policy Council which presumably would be "better placed to evaluate the financial market indicators for the euro area as a whole" that were so crucial to reaching the proper monetary stance in the shorter run (pp.24–25). Mr Codogno also supported this idea of a small technical committee taking monetary policy decisions for the euro area, working under the guidance of the Governing Council, which would have "an advisory role". The NCB governors would exchange views on their national situations and monitor developments at regional level. In doing so, they would continue to bring to the ECB important information of local conditions. The Governing Council could even set broad guidelines for the MPC to follow when making interest-rate decisions. This two-level arrangement would probably close "the perceived democracy-gap of not having a representative from each country presenting regional issues to the decision-making body of the ECB." Moreover, "it would enable central bank governors of this enlarged Council to communicate ECB policy in a credible way to market participants and to the wider public." (p.81)

152. Dr Schmieding advised that the nature of the trade-off between national representation and technocratic efficiency changes over time. Initially, it might be advisable to have a system of one-country one-vote. "But, as the bank acquires credibility on its own over time and legitimacy with the population in the nations at large within the monetary union, then over time probably the balance of arguments could shift more in favour of technocratic efficiency." (Q 61)

THE WAY FORWARD IN THE IGC

153. A number of witnesses called for progress on the issue of reform of the Governing Council to be made at the IGC. They did not expect the Member States, who only agreed to endorse the ECB proposal in March 2003, to reverse this decision in the IGC and immediately reach a decision on an alternative model. Instead, a feasible way in which progress could be achieved would be for a new

'enabling clause' to be provided by the new constitutional Treaty. Dr Schmieding favoured this method of approach which would allow the Member States to revisit the issue of reform of the Governing Council without the need to convene a full IGC. The UK Government explained that Finland was likely to propose such a provision at the current IGC. Mr Codogno suggested that the IGC could go further and "design a 'road map' to move gradually away from the current country-based representation in favour of appointments based exclusively on professional grounds." (QQ 74, 216; pp.81–82)

154. Professor Giavazzi cautioned that a new enabling clause should be drafted more carefully than the previous one introduced by the Treaty at Nice. This was for two reasons. First, reform needed to go beyond the voting modalities outlined in Article 10.2. Secondly, urgent consideration needed to be given as to who should be mandated to come up with the further proposal for reform – he favoured the Commission:

> "The bottom line is that NCB governors are simply the wrong group of individuals to propose new voting rules for the ECB. It was inevitable that they would come up with a set of rules that preserves their current rights, rather than proposing the most efficient mechanism for setting interest rates in the eurozone. More generally, the institutional design of a central bank should not be delegated to the central bankers themselves."[97]

Conclusions of the Committee on reform of the Governing Council

155. **The Governing Council is the highest decision-making body of the ECB; it sets interest rates for the euro area. The question of reform of the Governing Council of the ECB is therefore an issue of major importance. It is regrettable that the enabling clause provided by the Treaty of Nice was drawn so tightly as to prevent the Commission and the ECB from considering more radical proposals for reform of the Governing Council but instead limited them to considerations of its voting procedures.**

156. **The agreed reform, based on an overly complex rotation model, is not a sensible way to deal with the fundamental problems posed to the workings of the Governing Council by enlargement of the euro area. It fails to achieve what it was meant to do because it does not satisfy the principles on which it was supposed to be based. It is not an efficient mechanism for setting interest rates in the euro area; it caps the number of voting and non-voting members of the Governing Council at a level which is far too high; it is not transparent; it is overly complicated and difficult to communicate, so it will be extremely difficult for it to gain the trust of the public. Furthermore, it violates the principle of the ECB statutes, which prescribe that the NCB Governors sit on the Governing Council as individual experts, not as representatives of their own countries. All in all, we do not consider that the agreed reform will work satisfactorily. It is extremely disappointing that such an important decision on reform was taken so quickly and with limited opportunity for consultation, debate or parliamentary scrutiny.**

157. **There is a functional need for the ECB to have the best possible design for its interest-rate setting body. The reason that we have independent central banks is to ensure that monetary policy is not compromised by political considerations. For this reason we recommend that the ECB should eventually have a small Monetary Policy Council composed of the six members of the ECB Executive Board and up to six independent external experts. These part-time, non-executive members of the Monetary Policy Council would be appointed for their individual expertise, without regard to their nationality, by an open and transparent process; like the Members of the Executive Board, they would be mandated to consider exclusively the interests of the euro area. We believe that such a model is the most sensible consequence of the decision to operate a single monetary policy. We recognise and appreciate the political impetus for there to be some national input into the running of the ECB. That is why we recommend that the Monetary Policy Council should operate under the oversight of the current Governing Council, where the central banks of all of the Member States of the euro area are represented. The Monetary Policy Council would meet monthly and take decisions on interest rates; the Governing Council would retain all the other responsibilities that it currently holds. The Governing Council would continue to formulate the monetary policy strategy for the ECB, which the Monetary Policy Council would follow and implement. The Governing Council would set general guidelines for monetary policy in, say, quarterly meetings and monitor the policy execution by the Monetary Policy Council. Such meetings would allow the national central bank governors to continue to contribute their indispensable knowledge of economic developments**

[97] *The UK and the euro* (House of Commons Treasury Committee, Sixth Report of Session 2002–03, Volume II, HC 187-II), p.198.

and sensitivities in their own countries to the working of the ECB. If independent experts were appointed to the Monetary Policy Council, it would mean that all the members of the rate-setting board would become directly accountable to the European Parliament, which is not currently the case, as it cannot call the national central bank governors to appear before it.

158. **The Member States should, as a matter of urgency, reconsider reform of the Governing Council at the present Inter-Governmental Conference. A new enabling clause should be provided allowing fundamental reforms to the structure of the ECB to be agreed by the European Council, acting unanimously. There should be a new provision in the Protocol on the Statute of the European System of Central Banks and of the European Central Bank that would facilitate reforms that go beyond amending Article 10.2 of Protocol. Proposals for reform under a broader remit are necessary to allow changes to the functions of the Governing Council and the establishment of a Monetary Policy Council as a decision-making body of the ECB. Without such a provision, it would be extremely difficult to amend the structure of the ECB any further, making reform of the Governing Council unlikely in the foreseeable future.**

PART 5: TRANSPARENCY AND ACCOUNTABILITY

Introduction

159. The inter-connected concepts of transparency and accountability are of central importance to the image and reputation of institutions such as the ECB that are independent of much democratic political control. In its response to our first report on the ECB, the Government said: "Openness and transparency are key to ensuring the ECB gains the trust of the European public and financial markets. They help provide the credibility needed to deliver monetary policy effectively."[98] In the ECB's own words: "Accountability is a fundamental precondition for, and core element of, democratic legitimacy." Transparency and accountability are so interrelated that it is helpful to consider them together. Accountability is impossible without a substantial degree of transparency of decision-making processes and outcomes.[99]

160. We have already discussed and recommended changes to the transparency of the ECB's monetary policy objectives and how the ECB communicates its monetary policy strategy. The issue of transparency, however, goes beyond communication and, for instance, deals with the fact that not only markets, but also other participants in the political process in Europe, want to know the reasons for the ECB's monetary policy decisions and how they are reached. Transparency has to do not only with the clarity of objectives but has to do also with issues such as whether the ECB should publish the minutes of meetings of the Governing Council and whether the names of the individual participants behind the decisions which are being taken should be visible in the minutes. It is important that the transparency of the ECB's objectives is matched by the transparency of its decision-making processes. An academic study to compare the transparency of six central banks placed the Bank of England top, with the ECB in second place.[100] We are not contesting that the ECB is opaque, rather we examine whether there are ways in which its transparency could be enhanced.

161. In this section we first set out the current reporting arrangements for the ECB, describing the different communication tools that the bank uses to explain its monetary policy decisions. We then examine the two most common communication tools employed by other central banks: publication of minutes of the decision-making body and publication of the votes within that body. We analyse why the ECB rejects these tools and if it is right to do so. Finally, we scrutinize the way in which people are appointed to the Executive Board of the central bank and ask whether that process is adequately transparent.

The current reporting arrangements for the ECB

162. Under the EC Treaty, the ECB is accountable to the European Parliament. Under Article 113(3), the ECB is required to submit an annual report on the activities of the ESCB and on the monetary policy of the previous and the current year to the European Parliament, the Council and the Commission. The President of the ECB has to present the report to the Council and to the European Parliament, which can hold a general debate on it. The President of the ECB and the other members of the Executive Board can be asked to appear before the Committee on Economic and Monetary Affairs of the European Parliament (EMAC) at the request of the Board or the Parliament. In practice, the President appears before EMAC four times a year. A verbatim account of these meetings can be found on the European Parliament website. In the same way that the President of the ECB has four monetary dialogue meetings per year with EMAC, the Chairman of the Federal Reserve System meets four times per year with a committee of the American Congress and the Governor of the Bank of England appears four times per year before the Treasury Committee of the House of Commons.

163. Additionally, Article 15 of the Protocol requires the ECB to publish reports on the activities of the ESCB "at least quarterly". These reports are to be made available to interested parties free of charge. In practice, the ECB publishes monthly reports.

164. Mr Volcker, who was Chairman of the Board of Governors of the US Federal Reserve System from 1979–87, considered interactions between the American Congress and the Federal Reserve to be

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98 *Government Responses* (Session 2001–02, 2nd Report, HL 13), p.1.

99 The ECB itself stresses that the two terms are distinct and should not be used interchangeably. See the two articles "The Accountability of the ECB" and "Transparency in the monetary policy of the ECB", in the November 2002 edition of the *ECB Monthly Bulletin*.

100 'Is the ECB sufficiently accountable and transparent?' Lorenzo Bini-Smaghi and Daniel Gros, European Network of Economic Policy Research Institutes (ENEPRI) Working Paper no.7, September 2001. When using this statistic in its EMU study *Policy frameworks in the UK and EMU*, the Government cautioned that the ranking "should be seen as indicative only, as the choice of criteria cold affect the result" (p. 43). The six central banks examined were the Bank of England, the ECB, the Federal Reserve, the Bank of Canada, the Bank of Japan, and the Bundesbank.

"somewhat more rigorous" than those between the European Parliament with the ECB, partly because the European Parliament does not yet enjoy the same level of authority as the American Congress. This sentiment was shared by several other witnesses. Professor Thygesen agreed that whilst the quarterly testimonies of the ECB President to the EMAC have not yet have reached the prominence and stature of the similar hearings with the Chairman of the Federal Reserve in the US Congress, the meetings seem to be improving in the nature of the give and take, which has been increasingly apparent. For Miss Pepino, Vice-President, Economic and Policy Research at JPMorgan, the European Parliament did "a very good job of holding the ECB to account, with Committee members asking "well-informed and penetrating questions" (QQ 82, 127, 134, 171, 180; pp.25, 87).

165. **Central banks should be subject to the scrutiny of a democratically-elected body. For the ECB, this accountability needs to be in a form which does not put its independence at risk. It is a popular misconception that, unlike the Bank of England, the ECB is not accountable to parliament. The ECB is accountable to the European Parliament, and we remain of the view that it would not be practicable, or even desirable, to make the ECB also directly accountable to national parliaments.**[101]

166. **The President of the ECB and other members of the Executive Board regularly appear before the Committee on Economic and Monetary Affairs of the European Parliament. Ever since the establishment of the ECB, we have said that we would expect these hearings "to be televised and to become a prime means of [the ECB] communicating with the people of the euro zone countries."**[102] **We are disappointed that this is still not the case.**

CONTACTS WITH ACADEMICS

167. Since 1999 the Center for Financial Studies (CFS) organises an annual conference of ECB watchers. The ECB itself regularly intervenes in the conference meetings. The bank took this decision at the outset of its operations, when it decided to participate in order to establish quickly "active channels of debate with the market, academic, and press communities."[103]

168. The ECB disseminates its own research findings by publishing Working Papers and Occasional Papers by members of its staff. The central bank also organises academic conferences, seminars and workshops. Professor Thygesen was impressed by the fact that the ECB did not work in isolation. He admired the way in which it listened to ideas and suggestions from academics and engaged them in discussions. The Government and the Bank of England both also praised the ECB for having "shown a willingness to listen to the academic debate" and "engaged actively with academics and other members of the economics profession." (QQ 65, 213, 217, 224; p.84)

INFLATION PROJECTIONS

169. In November 2000, the ECB announced that it would publish the Eurosystem's internal economic projections to improve the market's understanding of its monetary policy and dispel criticisms of excessive secrecy. The European Parliament had been calling for this to be done for some time; it regarded the publication of forecasts as a necessary part of transparency, without which it was difficult to hold the ECB properly to account.

170. The staff of the Eurosystem make inflation projections for the euro area economy over 1–2 years. These projections are published twice a year – in the June and December editions of the *ECB Monthly Bulletin*. The projections are updated quarterly (in March and September) by the ECB staff, but these updates are not published, being kept instead for the ECB's internal use. The projections assume that key variables, such as interest rates and exchange rates, will remain at recent market values for the forecasting period. The ECB stresses that these studies do not constitute inflation forecasts but are projections of economic variables if the variables remain unchanged. The projections are one input to the Governing Council's decision-making process, which includes analyses made by academics or by those in the private sector.[104] The projections have become key elements in the bank's justification of its monetary policy decisions.

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[101] See our earlier report *How is the euro working?* (Session 1999-2000, 18th Report, HL 124), paragraph 16.

[102] *The European Central Bank: Will It Work?* (Session 1997–98, 24th Report, HL 112), paragraph 110. We repeated this call in our report *How is the euro working?* (Session 1999-2000, 18th Report, HL 124), paragraph 122.

[103] 'ECB Watchers Conference: The evaluation of the strategy', Opening remarks by Professor Issing, Frankfurt, 11 July 2003.

[104] See Box 1 'The publication of Eurosystem staff economic projections by the ECB' on page 11 of the 2001 edition of the *ECB Annual Report*. See also the introductory statement of President Duisenberg for the Monetary Dialogue with the Economic and Monetary Affairs Committee of the European Parliament, Brussels, 23 November 2000.

171. **We welcome the publication of economic projections by the ECB, but the bank should increase the frequency of their publication to four times per year, as there can be significant change in the economic outlook over six months. More frequent publication would help the Bank to provide clearer and more transparent explanations for their monetary policy decisions.**

THE PRESIDENT'S PRESS CONFERENCES AND THE *ECB MONTHLY BULLETIN*

172. At the conclusion of each meeting of the Governing Council where an interest rate decision is made, the ECB immediately puts out a press release, giving the details of the decision. Shortly after each of these meetings, the President holds a press conference, which starts with the President reading out a prepared introductory statement, which is then followed by a question and answer session with journalists. A copy of the statement is put on the web immediately and is followed shortly by a transcript of the questions and answers. The *ECB Monthly Bulletin* is published a week after the meeting of the Governing Council and includes a description of the economic and monetary developments in the euro area that informed the Governing Council's decision. The bulletin's 'editorial' broadly reflects the President's introductory statement to the press conference.

173. The ECB's decision to hold press conferences to explain its monetary policy decision 'in real time', rather than several weeks later, was unprecedented in 1999; no other central bank produced such timely explanations of its monetary policy decisions. In contrast, the minutes of the Federal Open Market Committee (FOMC) of the Federal Reserve are only made available after an interval of six weeks; whilst the minutes of the MPC of the Bank of England are published after two weeks.

174. **The President's press conferences after meetings of the Governing Council provide a most timely opportunity for the ECB to present and explain its monetary policy decisions. We would welcome it if the incoming President, Mr Trichet, continued this practice.**

Do press conferences provide full transparency?

175. Mr Smith, Chief Economist at KPMG, cautioned that the press conferences should not be seen as a substitute for publication of the minutes of the meetings of the Governing Council; the two were fundamentally different. The press conferences provided *ex post* transparency, in that they explained what the Governing Council had done and why it had done it. The minutes of the MPC of the Bank of England and the FOMC of the Federal Reserve, on the other hand, provided a form of *ex ante* transparency, where discussions of what might happen under various contingencies were presented, as well what the committee members considered were the risks to price stability (Q 6).

176. Professor Goodhart also disagreed with the ECB's position that the press conferences were at least as good a communication tool as minutes. His experience of being part of the MPC was that the exercise of taking part in the discussions was a tiring one; it was difficult after a thorough and involved discussion to extract immediately all the various nuances of the argument. To put a President, however able, up before a group of journalists almost immediately after such a long and tiring discussion, without much time to reflect and prepare was, he said, "really quite dangerous." Many of the ECB's presentational problems had arisen as a result of statements made at that press conference which, if the President had been somewhat fresher and had had more time to prepare, would have been better delivered. Professor Buiter agreed that the press conferences were "counterproductive […] and certainly no substitute for minutes, attributed or not" (Q 57). Mr Codogno also complained that the press conferences sometimes did not deliver a clear message and only created confusion. Crucially, they relied entirely on the personality of the President and his or her ability to explain clearly the decisions of the Governing Council and the different aspects of the debate within the Council (p.82).

Publication of minutes of the meetings of the Governing Council and the results of any votes taken

THE POSITION OF THE EUROPEAN PARLIAMENT

177. The European Parliament repeatedly called for the minutes of the Governing Council's meetings to be published in the form of a summary of the arguments discussed, including dissenting opinions. The European Parliament further proposed that the minutes should indicate, in an anonymous way, the balance of any votes in the Governing Council.[105]

[105] See, for example, European Parliament resolutions of 2 April 1998 on democratic accountability in the third stage of EMU (OJ C 138, 4.5.1998, p. 177); 27 October 1999 on the 1998 Annual Report of the ECB (OJ C 154, 5.6.2000, p.60); 6 July 2000 on the 1999 Annual Report of the ECB (OJ C 121, 24.4.2001, p.456); 4 July 2001 on the 2000 Annual Report of the ECB (OJ C 65 E, 14.3.2002, p. 159); 3 July 2002 on the 2001 Annual Report of the ECB; and 3 July 2003 on the 2002 Annual Report of the ECB.

ARGUMENTS FOR THE PUBLICATION OF MINUTES AND VOTES

Minutes could better reflect the range of views within the Governing Council…

178. The main criticism of the press conferences was that they did not explain fully enough the range of views that likely exist within the Governing Council. They did not give "the full flavour of the debate" but were often "too defensive": whilst there was some explanation of the reasons for the decision taken, insufficient weight was given to the other elements of the discussion, particularly any arguments put forward against the decision. Mr Walton said that whatever form of communication tool the ECB chose, it needed to "reflect to a greater extent" than the press conferences currently did "the shades of opinion within the Council" by giving "an indication of balance of risks" and the way the arguments were going. This could most easily be achieved in a set of minutes. There was not, however, a need for the ECB to publish detailed proceedings of the Governing Council's meetings. The important thing was to have a set of minutes that reflected in a serious way the range of issues under consideration, making it clear that there were disagreements about the policy decision. Professor Giavazzi said that publishing minutes was important, but the style of the minutes was crucial. He cautioned the ECB against adopting the model of minutes produced by the Federal Open Market Committee of the Federal Reserve; such minutes were not particularly helpful, as they did not expose adequately the different sides of the discussions (QQ 7–8, 49, 55, 74, 112, 118, 171; pp.85, 87). Mr Bootle agreed that the usefulness of minutes depended on the way in which they were written. Importantly, there should not be any concern about showing disagreements within the Governing Council:

> "These are difficult issues and there should not be any worry about revealing that some members were extremely worried about deflation and others were not. We should see what the arguments and what the reasons are for decisions." (Q 117)

…which would lead to a greater understanding of the Governing Council's decisions

179. Mr Bootle argued that the ECB could demonstrate a more open approach to how it reached its policy decisions by publishing summary minutes of the meetings of the Governing Council. This move would in turn stimulate a better discussion between the central bank and commentators and experts outside the ECB. In the UK, the Government agreed that the publication of minutes by the Bank of England had made "a very useful contribution to the debate" (Q 227). For Mr Bootle, the Bank of England's monetary policy had been "greatly improved" by the decision to publish minutes:

> "We understand much better the way the MPC is thinking and, dare I say it, I think also the MPC's thought processes are improved by having this sort of interchange. It is extremely healthy. What emerges out of that is a much stronger decision making process in which people can have much more faith and confidence." (Q 113)

Publication of attributed minutes and votes would increase accountability and could ensure that members of the Governing Council acted in the European interest

180. Professor Buiter argued that in the UK publishing the voting record of individual MPC members improved accountability, because individual members had to be ready to justify their position before the Treasury Committee in the House of Commons. These benefits could equally be achieved with the ECB:

> "With the votes in the open, the European Parliament can very easily call to account a governor whose pattern of voting clearly makes no sense from the euro area point of view, but makes perfect sense from a national point of view, so I think this is even more important than the minutes, the individually identified votes." (Q 57)

181. The members of the Governing Council were professionals who would want to pursue their duties sensibly and independently. That would particularly be the case as their reputation would be associated with their performance.[106] Professor Draghi agreed with this position and said that ideally he would support a move to such full transparency. The members of the Governing Council usually had lives with high ethical standards; they would understand that, once they sat in the Governing Council, they had to consider the interests of the euro area. They might therefore be reluctant to see their names associated with a narrow defence of their national interests: "publishing names could help

[106] This position was shared by Chris Huhne MEP, who argued it forcibly within the Economic and Monetary Affairs Committee of the European Parliament (see, for example, his remarks in the hearing confirming Mrs Gertrude Tumpel-Gugerell's appointment as a member of the ECB's executive board, 29 April 2003).

the case for transparency and could make these people glad to be viewed as champions of Europe" (Q 195).

Publishing even just the balance of votes in an anonymous way would help to make the Governing Council more predictable

182. Professor Giavazzi explained that it made a big difference if a monetary policy decision was a marginal one (say 10 for and 8 against) or was taken by a large majority (such as 17 for and 1 against, or 18 members voting unanimously): "if we know the vote, we know what they think around the table. […] We would learn a lot. […] The market would have a lot of information, knowing whether the last decision was marginal or unanimous." That information on the last decision would inform commentators' views about the likelihood of a change of interest rates at the next meeting (Q 119). The BDI also wanted the ECB to conduct a formal vote on interest rate decisions and publish the result in an anonymous form in order to create more transparency in monetary policy decision-making, both for markets and the general public. (p.85)

WHY IS THE ECB AGAINST PUBLISHING MINUTES AND VOTES?

The legal position

183. Article 10.4 of the Protocol provides that "the proceedings of the meetings [of the Governing Council] shall be confidential. The Governing Council may decide to make the outcome of its deliberations public." The ECB is therefore of the position that its decision not to publish the detailed proceedings of the Governing Council's meetings is consistent with the EC Treaty. The European Parliament counters that publication of summary minutes is not ruled out by the Treaty.[107]

The Governing Council operates by consensus…

184. Article 10.2 of the Protocol states: "the Governing Council shall act by a simple majority. In the event of a tie, the President shall have the casting vote." The ECB argues that while the EC Treaty provides that the Governing Council should take decisions by simple majority, it does not exclude the possibility of consensus-building. Monetary policy decisions in the Governing Council are often, if not always, taken consensually. As votes do not occur, no results can be published.

…and is a collegiate body

185. President Duisenberg said that one of the reasons why the Governing Council did not vote but operated by consensus was that, like the Commission, it was a collegiate body. To move away from this position risked dividing the Council and losing its cohesive collegiate attitude:

> "at all costs we want to preserve the phenomenon that the Governing Council's decisions are decisions by a collegiate body and that every individual member of that body will defend and describe the outcome of certain discussions as if he had been 100% enthusiastic about those decisions. They will be supported by the entire Governing Council. We do not want to undermine that attitude in the Governing Council."[108]

186. It seems unlikely that this situation is going to change in the near future. Mr Trichet, the in-coming President of the ECB, identified "collegial decision-making" as one of the three guiding objectives that he will pursue during his eight-year mandate.[109]

Publication of attributed minutes and votes could lead to political pressure to deviate from a euro-area perspective

187. When making their interest rate decisions, members of the Governing Council are mandated to consider the performance of the euro area as a whole and not the situation in individual countries. The ECB was concerned that publication of minutes and voting records could lead to an unwanted nationalisation of the debate. It could invite political pressure on the individual NCB governors to vote along national lines rather than considering the appropriate interest rate for the euro area as a whole. President Duisenberg identified this as the principal reason for not changing the ECB's communication strategy. He consistently argued that if the bank published voting records,

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107 See resolutions referred to in footnote 106.

108 'Presentation of the ECB's Annual Report 2001 to the European Parliament', Strasbourg, 2 July 2002.

109 Answer to the questionnaire drawn up by the Economic and Monetary Affairs Committee of the European Parliament for its hearing on 11 September 2003 on the appointment of Mr Trichet as President of the ECB.

"those who vote and whose votes could be identified and recognised would come under pressure from their national governments or parliaments to vote differently in future, for purely national reasons and considerations. One of the Governing Council's greatest assets is that it has always taken a euro-area-wide point of view, and I would hate to lose that."[110]

188. A number of our witnesses agreed with that analysis and opposed publication of attributed minutes and votes on the grounds that undue pressure, from politicians or the populist press, could be applied on individual members of the Governing Council in their own countries, particularly if there were a conflict between a country's immediate economic interest and that of the euro area. In such a situation, identifying individual opinions of Governing Council members could be "counterproductive", because it might make it more difficult for national governors to stick to an aggregate view of the required monetary stance for the euro area (QQ 58, 62, 81, 128; pp.25, 82).

189. Professor Buiter, however, strongly rejected this argument:

"I personally do not see the problem. I have never understood, I may be terribly naive, these terrible pressures that would be applied. The tabloids or the people that appointed me to the job are not going to take my family hostage. Really, any central banker who is seriously worried about what the tabloids write about his or her vote, should be looking for another job. It is not a consideration that plays a role. The truth of a particular proposition is not determined by the number of people who believe in it or the amount of voice that they can give to that particular view. I really think that the issue of pressure is probably overstated." (Q 60)

190. Mr Smith agreed that the concern that members of the Governing Council might deviate from a euro-area perspective as a result of national pressure in their own Member State was "somewhat overdone." He accepted that, if attributed minutes and voting records were published, more national pressure could be applied on individual central bank governors, but he suggested that equally within the Governing Council itself there would be a lot of peer pressure for the members to maintain a euro-area perspective. He was not convinced that it was "such a big issue as people suspect it might be." (Q 10)

The minutes could be published in an anonymous form

191. Our witnesses pointed out that if the ECB's main concern about publishing attributed minutes was that it could lead to members of the Governing Council deviating from a euro-area perspective, an easy and straight forward solution would be for the central bank to adopt the UK system, where a whole range of views were represented, but without attributing them to individuals. Professor Draghi considered that this was certainly "the very least" that the ECB should do to improve the transparency of its decision-making process. Mr Weale agreed that if the minutes referred to the situations in particular countries in a way that obscured the identities of those making the points, it would be "a very valuable contribution to transparency". Care would have to be taken in the drafting of the minutes, however, to preserve the substance of anonymity as well as the form of anonymity (QQ 8, 57, 195).

192. Mr Smith suggested that if the ECB started publishing anonymous minutes and the balance of the vote, it would not be very difficult for people to find out who had voted which way. Professor Goodhart explained though that the reason why the press in the UK had become good at guessing who said what was because although the minutes were anonymous, the votes were actually identified (QQ 10, 58).

If the Governing Council were reformed, the publication of attributed minutes and votes could be reconsidered

193. Many of those witnesses who considered that it might be unwise at present to publish attributed minutes and votes of the Governing Council recognised that the situation could change over time. Professor Draghi argued that as the ECB became more self-confident, and its track record on monetary policy more established, the institution would become less hostile to the idea of publishing minutes and votes. Gradually, these issues would become less controversial and the central bank would become more open to the ways in which it could increase transparency of its decision-making processes. Dr Schmieding agreed that the more the ECB acquired its own gravitas and track record, the easier it would find it to open up and to publish minutes: "Over time the arguments for more transparency will become more forceful." (QQ 74, 195)

[110] Monetary Dialogue with the Economic and Monetary Affairs Committee of the European Parliament, Brussels, 10 September 2003.

194. Reform of the Governing Council would open to door to much greater transparency, as it would render irrelevant many of the current arguments against the publication of minutes and votes. As Mr Codogno remarked: "An independent Governing Council, not formed on the basis of country representation but exclusively on professional grounds, would change the current debate on communication and transparency." In the current set-up, where the Governing Council was composed of NCB governors, Professor Giavazzi was against publishing identified votes because of the potential press reaction the next day; taking this step would not be a concern if the ECB had a MPC where the members were appointed as individual experts. If members of the Governing Council participated exclusively in a personal and independent capacity – and not because they were the governor of a NCB – there would be less suspicion that they would be influenced by national interests. With this type of Governing Council, it would be much easier for the ECB to change its communication policy and publish attributed minutes and votes without concern. For this to happen, individual positions would have to be fully de-linked from perceived national interests. Dr Schmieding thought that the ECB should be told to move towards greater transparency in a series of stages that would lead eventually to attributed minutes and votes. It could start by publishing unattributed publish minutes, and then later add the balance of votes, if there were votes; the next stage could be to publish attributed votes and then finally attributed minutes. Although the bank should only move towards this goal step by step, it was "a legitimate demand of the public" that it should eventually get to that stage (QQ 74, 119; p.82).

Conclusions of the Committee on the publication of minutes and votes

195. **On the basis of the evidence received, we accept that it would not be appropriate for the ECB to publish minutes of the meetings of the Governing Council which are attributed and contain full voting records: to do so would run the risk of exposing individual members of the Governing Council to criticisms or pressures from their own countries, and thus of impairing, or at least appearing to impair, the independence of the ECB itself.**

196. **However, the ECB's communication strategy will need to develop and evolve over time. The bank should, by a series of incremental steps, gradually move towards greater transparency of the Governing Council. The first step could be taken without further delay by announcing that the central bank is to publish records of the meetings of the Governing Council in which the various arguments and reasoning would be spelled out clearly but not attributed. Such a move would enhance transparency and understanding of the ECB's decision-making processes and win wide public support, both in the press and with commentators and the markets. We see no reason for the bank to delay in providing more detailed information about the arguments used in the meetings of the Governing Council, whilst protecting the identity of those participating.**

197. **If it were to be decided that the ECB's interest-rate decisions should be taken by a Monetary Policy Council where the non-executive members were appointed as individual experts (see above paragraph 157), the publication of attributed minutes and the balance of votes within the Monetary Policy Council could be given further consideration.**

Appointments to the ECB Executive Board

THE CURRENT PROCESS FOR APPOINTING MEMBERS OF THE EXECUTIVE BOARD

198. The ECB Executive Board has six members: the President, the Vice-President and four other members. The EC Treaty provisions for appointing the members of the Executive Board require that those appointed are persons of recognised standing and professional experience in monetary or banking matters. Under Article 112(2)(b) TEC, the President, the Vice-President and the other members of the Executive Board of the ECB shall be appointed "by common accord of the Governments of the Member States at the level of Heads of State or of Government, on a recommendation from the Council, after it has consulted the European Parliament and the Governing Council of the ECB. Their term of office shall be eight years and shall not be renewable."

199. In practice, the appointment process currently works as follows:

- the Ecofin Council recommends a candidate;
- the Governing Council of the ECB and the European Parliament are consulted;
- the ECB Governing Council issues an Opinion;

- the Economic and Monetary Affairs Committee of the European Parliament (EMAC) holds a hearing with the candidate and issues a Report, which then goes to a plenary session of the European Parliament for endorsement; and
- the Council's Recommendation is submitted for decision to the Heads of State or Government of the Member States that have adopted the euro.

SHOULD THE MANNER BY WHICH THE COUNCIL SELECTS CANDIDATES FOR APPOINTMENT BE MADE MORE TRANSPARENT?

How the Council's reaches its decision

200. None of our witnesses questioned whether it was right that members of the Executive Board were appointed by the Council. As Dr Schmieding said, appointing the Executive Board of the ECB was a highly political decision; it was quite legitimate that senior politicians made this decision. It was in their interests "to take great care that they choose the right candidate because, given the independence of the ECB, they would then have to live with the consequences of that for a long time" (Q 80; p.25). The Commission said, however, that "it would be appropriate [for the European Council] to appoint the different members of the Executive Board by qualified majority rather than by common accord (i.e. unanimity)" as was currently the case. It explained that this proposition would be "particularly relevant in the context of an enlarged Union composed of 25 Member States and eventually even more." It reported that this view had "received support from many Member States", and the Commission therefore hoped that this change would be agreed in the IGC. (p.89)

The appointment of the first President of the ECB

201. The initial appointments to the Executive Board of the ECB, including the first President, Dr Wim Duisenberg, were made at the beginning of May 1998. They were appointed in a way that avoided their mandates all expiring at the same time. President Duisenberg, from the Netherlands, was to be appointed for eight years, Vice-President Noyer, of France, was appointed for four years and the other four members (from Germany, Spain, Italy and Finland) for between five and eight years. The Heads of Government also agreed that, "in future appointments to the executive board, appropriate weight and consideration would be given, according to a balanced system of rotation, to recommendations for nationals of member states not on the initial slate."

202. Prime Minister Blair reported that there were "very difficult" and "frustrating" negotiations over the presidency of the ECB. It was agreed that Dr Duisenberg, who had been head of the European Monetary Institute—the ECB's predecessor, would be the first President of the central bank. It was further agreed that his successor would be French (and it was expected that the French candidate would be Mr Trichet, as indeed was the case). There was disagreement, however "on the length and form of Mr. Duisenberg's tenure as president". What the Prime Minister referred to as "the argument about the presidency" centred on a split between the Member States as to whether, under the EC Treaty, the Council could stipulate a fixed date for Dr Duisenberg to retire. In the end, Duisenberg was appointed for the full eight years, but only on the understanding that he would voluntarily retire early after four years.[111]

203. A number of our witnesses described the manner of Mr Duisenberg's appointment as "unfortunate". It was discreditable because it seemed to be a "national contest"; the political horse-trading showed the force of national pride in connection with the ECB despite the "technical nature of the appointment". Professor Thygesen said that it would "certainly be desirable to avoid similar situations in the future." (QQ 79–80, 124; p.25)

204. **The manner by which the first President of the ECB was appointed was regrettable and did not conform to the spirit of the Treaty. A situation of split mandates should not be allowed to happen again.**

Suggestions for preventing a similar situation from occurring again in the future

205. Professor Giavazzi complained that the procedure whereby the Council chose candidates for the Executive Board was shrouded in secrecy. No one knew how the Council came to its nomination for the candidate; the process was not subjected to any scrutiny. Who were the alternatives, for example, when the Council nominated Mr Trichet to replace Mr Duisenberg as President of the ECB? From which pool of people was he chosen? Professor Giavazzi also mentioned the recent replacement

[111] Statement by Prime Minister Blair to the House of Commons, 5 May 1998 (Hansard, Column 563–65).

on the Executive Board of Sirkka Hämäläinen, the former governor of the Bank of Finland, by the deputy governor of the Bank of Austria, Gertrude Tumpel-Gugerell. Again, there was no discussion as to who might be the best candidate to replace Ms Hämäläinen, and no alternatives to Ms Tumpel-Gugerell were openly proposed:

> "What was the process whereby the deputy governor of the Bank of Austria was chosen? Most likely she is the best candidate for the post, but I do not think there has been an open scrutiny. Because individuals are so important, the way they are selected is very important and here the political process falls down. It is not the fault of the bank. It is the fault of the way that the Council of heads of state, which is responsible for the appointments, comes to a decision."

206. Professor Giavazzi contrasted the appointment procedure for members of the ECB with that for posts in the European Commission,

> "where the top administrative jobs, notably recently the appointment of the Director General for economic and financial affairs, Mr Regling, happened through a process of committee. The Commission, in the case of Mr Regling, had appointed a committee which included both insiders from the Commission and outside experts. These people went through a list of potential candidates and came back to the Commission with a list of three candidates who were deemed suitable for the job."

207. That type of process of selecting candidates was "far ahead" of what happened for the Executive Board. Professor Giavazzi suggested that for these candidates too the Council should adopt a procedure with a nominating committee. The European Council could appoint a committee and individual countries could come up with suggested names, but then the nominating committee would have a procedure whereby the alternatives were discussed and compared. The committee would then present the European Council with a list of three or four people for it to decide on a nomination. Professor Giavazzi recognised that it would be difficult to set down operating rules for this committee, but the fact that it was not easy did not mean it should not be attempted. Having a committee that would openly compare candidates would be "an enormous step" forward (QQ 100–02, 105).

208. Other witnesses agreed that the appointment procedure could be improved and made more transparent by the Council being presented with a list of possible candidates. Dr Schmieding suggested that an initial list of candidates could be drawn up publicly by the Commission. He further added and that perhaps the Council should only pick candidates to which neither the ECB nor the European Parliament had objected. Mr Codogno's view was that "a special commission of the European Parliament or the EU Commission" should propose candidates "purely on technical grounds." (Q 80; p.81)

SHOULD THE EUROPEAN PARLIAMENT HAVE THE POWER TO REJECT CANDIDATES FOR THE EXECUTIVE BOARD?

209. At the moment, the European Parliament is only consulted on the Council's recommendation. As was seen in the recent decision to amend the voting modalities of the Governing Council – where the European Parliament was consulted and rejected the proposal, but this rejection did not affect the decision of the European Council, which adopted the proposal regardless – a process whereby the European Parliament is only consulted allows the Council to disregard the European Parliament's opinion. The European Parliament is concerned that its voice carries little weight in these matters, and it therefore wants the power to confirm the appointment of the Council's nominations. This would mean that rather than just offering a view on a the Council's nomination, Parliament would have the right to veto the candidate. EMAC argued that this would increase the accountability of the appointment process:

> "a key element of accountability [for the ECB] could materialise when new members of the ECB board are designated. Even if the treaty gives some leeway on the matter, the European Parliament claims the right to confirm their appointment in the same manner as the American Senate with the Federal Reserve. Board members have a particular responsibility: they are responsible for the day-to-day management of the ECB in key areas and have a particular duty to represent all the Europeans. That's why the Parliament should designate them through a clear and democratic procedure. Far from being a threat to their independence, this confirmation would give them added credibility."[112]

210. The European Parliament wants the new constitutional Treaty to give it the capability to confirm appointments to the Executive Board and is pushing for this issue to be considered at the IGC. A substantial number of witnesses supported amending the Treaty to give the European Parliament (on

[112] EMAC Report on the 2000 Annual Report of the European Central Bank, A5-0225/2001, p.14.

the advice of EMAC) the power to veto the candidates. Mr Bootle argued that for the EMAC hearing to be constructive, the Committee had to have "some teeth". With the power to overturn an appointment would come responsibility. Mr Volcker added that the extra responsibility could have a positive knock-on effect and might change the psychology of other meetings between the two institutions, making the ECB's regular monetary dialogues with EMAC "potentially more meaningful" (QQ 105–07, 134; p.87).

211. Professor Giavazzi further argued that if the European Parliament had the power to reject the Council's candidates, the introduction of this discipline could improve the prospects of the Council adopting a more open procedure for nominating candidates based on a nominating committee, because such a procedure would allow the Council easily to demonstrate that it was putting forward good candidates (Q 109).

212. Professor Draghi agreed that ideally the European Parliament should be given the power to hold formal confirmation hearings, which would include the power to reject the candidate nominated by the Council. Such a move would increase the democratic accountability of the ECB, which was a very important institution that was necessarily run by unelected officials. The question was whether now was the right time to make such a move. Professor Thygesen considered that the current system of hearings in the European Parliament was already "a reassuring practice" and at the moment it was enough that EMAC issue an opinion and raise critical questions. Mr Trichet testified to the European Parliament that "an official confirmation procedure would be indispensable in a totally federal political structure." He said that "should political Europe evolve in this direction" official confirmation hearings would "become necessary."[113] The Commission and the UK Government were against modifying the existing roles of the different institutions involved in the appointment process of the members of the Executive Board and would not be pursuing amendments in the IGC (QQ 79–80, 196–98; pp.25, 72, 90).

213. **We see the hearings that the European Parliament holds with candidates for the Executive Board as an extremely valuable part of the appointment procedure. The hearings bring some openness and democratic legitimacy to the process. Over time the nature of these hearings may evolve and their significance will probably increase. At some later date consideration could be given to granting the European Parliament the power to confirm the Council's nomination for the Executive Board; but it is essential to prevent the process from becoming unduly politicised. We are strongly of the opinion that the time is not yet right to take the final decision on appointments to the Executive Board away from the Member States.**

[113] Answer to the questionnaire drawn up by the Economic and Monetary Affairs Committee of the European Parliament for its hearing on 11 September 2003 on the appointment of Mr Trichet as President of the ECB.

PART 6: ECONOMIC GOVERNANCE OF THE EURO AREA

Introduction

214. Whilst monetary policy in the euro area has been unified and is now conducted by the ECB, fiscal policy is decentralised and remains under the responsibility of the separate national governments. There is therefore no single natural interlocutor with which the ECB can communicate and co-ordinate its policies; in short, the ECB lacks an equal economic partner for managing the economy of the euro area. President Duisenberg has described the ECB as "the only central bank in the world without a government."[114] It is this asymmetry between institutions and the consequential potential imbalance between policies which causes concern for some commentators.

215. As Professor Buiter explained, in countries with an independent central bank, the ability to coordinate monetary and fiscal policy is never automatic. Consequently, "coordination is hard in a single country like the US or the UK. It is very, very hard if you have 12 national authorities." (QQ 37, 42, 67, 71). Nonetheless, co-ordination between monetary policy and fiscal policy and the different economic policy-making institutions in the euro area is important to ensure that the separate authorities do not enact policies that pull in opposite directions. We raised the question of how to ensure a sensible 'policy mix' in the euro area in our earlier report *How is the euro working?*[115] At that very early stage of the single currency, however, we could only conclude that the asymmetry between monetary and fiscal policies would "remain an issue". In this section, we re-examine whether the structures in place in the euro area for the exchange of information between the different authorities are sufficient for effective economic governance of the euro area or whether an alternative structure for more active co-ordination of particular policies might be necessary.

Why is there a need for co-ordination between monetary and fiscal policy?

216. Co-ordination of economic policies in the euro area is complicated because there is a single monetary authority (the ECB) but multiple fiscal authorities (the national governments). Although fiscal policy in the EU is controlled at the national level, the EC Treaty is clear that how such policies are managed is nonetheless "a matter of common concern". One of the reasons for this is that, in setting interest rates for the euro area, the ECB has to take account of the fiscal position of the euro area as a whole. Mr Smith argued that as the ECB was not dealing with a single fiscal agent, it was difficult for the ECB to know what fiscal policy the euro area would pursue (Q 22). Professor Goodhart proposed that because of the difficulties that the ECB had in dealing with different national fiscal policies, a logical procedure would be to "move to a more integrationist system" in which more fiscal competencies were given to "the federal centre to accompany the single federal monetary policy" (Q 48).

217. As a consequence of the unified monetary policy in the euro area, it is important that participating Member States' fiscal policies are tightly co-ordinated.[116] The individual fiscal policies of the Member States are therefore subject to the constraints of the Stability and Growth Pact (SGP). The SGP sets out rules for the EU, establishing a framework within which Member States have agreed to co-ordinate their fiscal policies. The Pact is aimed at ensuring the fiscal discipline of the Member States and operates through a comprehensive surveillance procedure, which aims to ensure the fiscal discipline of the Member States through monitoring the national budgets across the EU.

218. The level of government deficits is important for the conduct of monetary policy and affects the ECB and the consequent 'policy mix'. The architects of EMU were concerned that without a co-ordination mechanism such as the SGP, individual EU governments might adopt divergent approaches, which would lead to difficulties for the ECB. The SGP entered into force at the start of Stage Three of EMU (when the ECB started operating and the euro was launched). The restriction on public borrowing imposed by the Pact was intended to ensure that the policy mix in the euro area combined a tight fiscal policy (i.e., budget balances 'close to balance or in surplus' in the medium term) with a less tight monetary policy that would lead to price stability at low interest rates, which would encourage private investment, and thus growth. **The Stability and Growth Pact can help Member States to control their debt and deficits, which should provide stability for the ECB.**

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[114] Monetary Dialogue with the Economic and Monetary Affairs Committee of the European Parliament, Brussels, 12 June 2003.

[115] The report (Eighteenth Report, Session 1999-2000, HL 124) was debated in the House on 5 February 2001.

[116] On the reasons why co-ordination of fiscal policies through a tool such as the Stability and Growth Pact is necessary in the euro area, see paragraphs 26–49 of our report *The Stability and Growth Pact* (Session 2002–03, 13th report, HL 72). The report was debated in the House on 4 June 2003.

219. The UK Government said that clear lines of communication between the fiscal and monetary authorities were particularly important in the context of the ECB's independent ability to define price stability. A system of co-ordination where the fiscal authorities understood what the monetary policy reaction would be to a change in fiscal stance would lead to a more predictable policy-making environment. Developing such a situation in the euro area was "a very important area", the Government said (QQ 217–18). Commentators were concerned that the lack of formal co-ordination of economic policies in the euro area could potentially lead to a breakdown of communication and possibly even an abdication of responsibility, where no authority was prepared to take the lead and implement policy changes before one of the other actors changed their policy first. Professor Jean-Paul Fitoussi summarised the potential impasse as follows:

> "The monetary policy authorities think that the responsibilities lie with the governments (bad management of fiscal policies of which high budget deficits are a consequences), and the resistance of societies to structural reforms. The governments think that they lie with the central bank (delayed and weak responses to shocks) and also with societies (the difficulty to implement reforms). The average citizen thinks that all actors have a share of responsibilities: fiscal and monetary authorities by not reacting enough, and the private sector by opposing reforms and/or by trying to escape the burden of adjustment to shocks."[117]

220. An example of this type stand off between the ECB and the Member States came in the ECB's announcement in June 2003 that the Governing Council's had decided to reduce interest rates by 0.5% to an historic low of 2%. President Duisenberg argued that the ECB had achieved price stability and he promised to maintain it. He added: "I think that we are credible enough for people to believe that we will deliver what we promise to deliver. And now it is the turn of the governments to do the same thing."[118] This statement was taken by some commentators as a signal that the ECB considered that it had done its part and that responsibility for increasing growth in the euro now lay with the national governments; the ECB would not consider reducing interest rates further until there was a clear sign of commitment to the SPG (through raising taxes and reducing public spending) by those Member States in breach of its rules.[119] A month later in July 2003, announcing that the ECB had decide to hold interest rates at 2%, President Duisenberg again told the Member States that it was time for them to "make their contributions" to boost the economy:

> "With medium-term inflation expectations firmly anchored at levels consistent with price stability, and with interest rates at historical lows, monetary policy has made a significant contribution to improving the conditions for a recovery in economic growth. However, other policy-makers also have to assume their responsibilities. Part of the weakness in economic growth in the euro area can be linked to a lack of ambition in the areas of fiscal and structural reform to further improve the conditions for investment and employment."[120]

221. Meanwhile, with Germany still in the position of having an excessive deficit, the German Chancellor, Gerhard Schröder, questioned whether the ECB had "done enough in the context of the dollar/euro exchange rate to maintain the competitiveness of exports from Europe."[121]

The current institutional arrangements for co-ordination

222. There is no formal mechanism for co-ordinating monetary, fiscal and structural policies in the euro area.[122] Indeed, the EC Treaty, which provides the ECB with strong constitutional protection against undue political influence from the outside, explicitly prohibits such co-ordination. A resolution of the Luxembourg European Council emphasised the need for close liaison between the Council and ECB. The resolution stated that "the harmonious economic development of the Community in Stage 3 of EMU will call for continuous and fruitful dialogue between the Council and the ECB, involving the Commission and respecting all aspects of the independence of the ESCB."[123] Policy co-ordination can,

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117 'The ECB's monetary policy strategy and structural reforms', Briefing paper for the Economic and Monetary Affairs Committee of the European Parliament, 30 May 2003.

118 ECB Press Conference, Frankfurt, 5 June 2003.

119 See, for example, 'Can Aggregated Demand In The Euro Area Be Boosted?', Briefing Paper submitted to the Economic and Monetary Affairs Committee of the European Parliament for the Third Quarter 2003 by Professor Guillermo de la Dehesa, p.3.

120 ECB Press Conference, Frankfurt, 10 July 2003 and the 'Editorial', ECB Monthly Bulletin, July 2003, p.6.

121 'Schröder urges ECB action on euro', Andrew Gowers, Tony Major and Hugh Williamson, *Financial Times*, 11 July 2003.

122 Economic governance must include structural policies, as these can ease the constraints on short-term macroeconomic policies, leading to lower structural budget deficits and enlarging the scope for monetary easing.

123 OJ C 35, 2.2.1998, p. 3.

of course, take a number of different forms, and there are a number of arrangements in place to enable the ECB and the Member States to co-ordinate with one another.

Meetings between the different institutions

223. Provision for liaison between the ECB and the Council is made in the EC Treaty, which sets out a number of ways in which the two institutions shall meet. Under Article 113 TEC, the President of Ecofin and a member of the Commission may participate (but not vote) at meetings of the Governing Council of the ECB. In reciprocal fashion, when Ecofin is discussing matters relating to the ESCB, the President of the ECB is invited to participate.

224. Article 114(2) TEC set up an Economic and Financial Committee (EFC) as the main supporting committee for the Ecofin Council. The Member States, the Commission and the ECB can each appoint up to two officials as members of the EFC. The EFC appears to have a vital and wide-ranging liaison function bringing together the knowledge and opinions of the Member States, the Commission and the ECB.

225. The Eurogroup is an informal structure that brings together the Finance Ministers that represent Member States from the euro area; it was designed to promote the exchange of information. The ECB has a standing invitation to meetings of the Eurogroup. The Eurogroup is normally chaired by the Economic Minister whose country is chairing the EU. When the Member State that chairs the EU is not a member of the euro area, however, the representative of the Member State that will hold the next presidency of the EU chairs the Eurogroup and is entitled to attend the meetings of the Governing Council.[124]

226. The Government said, however, that the meetings to facilitate co-ordination between the fiscal and monetary institutions had "not worked very well" in practice. The ECB, for example, had viewed its role "as listening rather than engaging" (Q 219). President Duisenberg denied this and assured the European Parliament that at meetings of the Eurogroup, Ecofin and EFC the representatives of the ECB "urge governments to stand by the Stability and Growth Pact and to exert maximum peer pressure on each other to observe the rules [and] constantly, and sometimes boringly, insist on the necessity for further structural reforms."[125]

227. In spite of this, Mr Trichet acknowledged that there were "disadvantages associated with the current framework."[126] The Government further complained that the representative of the Eurogroup did not always attend the meetings of the Governing Council. Furthermore, when he or she did attend, there was no regular mechanism by which they could report back on what had been discussed at those meetings. The Government supported formalising these arrangements and making it compulsory for the President of the Eurogroup to attend the meetings of the Governing Council (Q 219).

WHAT MIGHT HAPPEN TO NECESSITATE A GREATER DEGREE OF CO-ORDINATION BETWEEN MONETARY AND FISCAL POLICY?

Difficulties with the Stability and Growth Pact?

228. Mr Weale considered the lack of formal coordination between monetary and fiscal policy in the euro zone to be a "weakness" in the current EMU set up. His concern was that there no explicit mechanism for the ECB to co-ordinate its interest rate changes with the fiscal plans of the national authorities. He was worried that in such circumstances the euro area could get into a situation, particularly if the SGP was ignored, where the fiscal authorities were pulling in one direction and the monetary authority was pulling in a different direction, and the outcome would be "rather unpleasant." He concluded that some sort of formal co-ordination was "desirable" (QQ 20, 34).

The prospect of deflation?

229. Combating deflation would require close co-ordination between the fiscal authority and the monetary authority. Conducting unorthodox policies in the euro area to deal with deflation, such as the

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[124] For example, when Denmark, which has not adopted the euro, held the EU Presidency in the second half of 2002, it fell to the Minister of Finance of Greece, which held the EU Presidency during the first half of 2003, to chair the Eurogroup for a year, starting on 1 July 2002.

[125] Monetary Dialogue with the Economic and Monetary Affairs Committee of the European Parliament, Brussels, 12 June 2003.

[126] Hearing on the appointment of the Economic and Monetary Affairs Committee of the European Parliament on the appointment of Mr. Jean-Claude Trichet as president of the European Central Bank, Brussels, 11 September 2003.

monetization of debt, would require delicate co-ordination between the ECB and the 12 Member States, each of which might have different objectives, priorities and operational theories.

230. Professor Buiter said that if deflation happened in the euro area it would be because of an "inability to co-ordinate policy choices". He explained that sustained deflation was "always a policy choice," in the sense that the combined monetary and fiscal authorities could always stop it by creating inflation: "You just run budget deficits and finance them by printing money." One of the difficulties in the EU was that the EC Treaty prevented the ECB from directly financing national governments in the primary debt markets. That did not stop them from monetising the debt, if both the 12 fiscal authorities and the ECB were willing to do so and co-ordinated their activities. "They would simply have the national governments borrowing in the capital markets, and the central bank buying up the debt in the secondary markets." It could be done, but it would require close co-ordination and would be "very, very hard". Professor Buiter did add, however, that the risks of deflation in the euro area were very limited (Q 37). Dr Schmieding also stressed that the euro area was a long way away from the point where any formal co-ordination between fiscal and monetary policies might be needed (Q 67).

SHOULD MORE BE DONE TO ENSURE THE POSSIBILITY OF FORMAL CO-ORDINATION OF MONETARY AND FISCAL POLICY?

231. The ECB was adamant that it could not accept any formal co-ordination of monetary and fiscal policies. Vice-President Papademos made this position very clear when he stated categorically that there was "no scope for any *ex ante* co-ordination" of policies.[127] Professor Thygesen counselled that calls for explicit co-ordination should be resisted, because formal co-ordination would weaken the autonomy and independence of the ECB (p.25). President Duisenberg explained, however, that this was not the main reason for the ECB's position, rather the central bank was concerned that any formal co-ordination would jeopardise the bank's ability to deliver its primary mandate of price stability:

> "The fact that there can be no question of *ex ante* co-ordination of monetary and fiscal policies derives not so much from the fact that it would compromise the independence of the Central Bank, but from the fact that it would compromise our dedication to our primary mandate [of price stability]. If we were to co-ordinate, *ex ante*, our monetary policy with the fiscal policies contemplated by the different governments, we would have to make concessions regarding the pursuit of our primary mandate".[128]

232. Whilst recognizing that some of the arguments for co-ordination of policies were "theoretically rather compelling", Dr Schmieding cautioned against establishing a more formal procedure. The ECB's reticence to enter into any formal mechanism of co-ordination was quite legitimate and was due to the fact that, whilst an independent central bank could look to the medium term, elected national policy makers would continue to be concerned with shorter-term issues. If agreement were reached on the response of fiscal policy if monetary policy were loosened, the ECB might fulfil its side of the bargain and then be let down by the Member States, who could find themselves in a situation where they could not deliver their side of the arrangement. The net result of such a situation would not be positive for the economy. As Dr Schmieding put it:

> "politicians find it very, very difficult actually to commit to [an optimal steering of the economy] and to keep their side of the bargain. It is very easy for the Central Bank the next week to act on interest rates. It is much more difficult for fiscal policy to actually push the laws through Parliament. […] Fiscal policy tends to run on its own election dictated cycle with any tightening, if possible, coming after the election and any loosening ahead of the next election. That may or may not by accident meet the requirements of the business side, but it does not lend itself easily to co-ordination with the Central Bank." (Q 71)

233. Dr Schmieding concluded that "for practical purposes" the euro area should maintain the current institutional arrangements and make moves to improve the exchange of information. His advice to the Member States and the ECB was simple: "keep each other informed as much as possible about what fiscal policy may be up to and what monetary policy may be up to; but do not try to rely on any explicit coordination." (Q 71)

[127] ECB Press Conference, Frankfurt, 4 September 2003. (cf. 'Monetary and fiscal policy in the euro area', Introduction by President Duisenberg at the International Monetary Conference, Berlin, 3 June 2003.)

[128] Monetary Dialogue with the Economic and Monetary Affairs Committee of the European Parliament, Brussels, 10 September 2003.

What could be done to improve the exchange of information between the fiscal and the monetary authorities?

234. We heard several such calls for the monetary and fiscal authorities to improve their means and communication and intensify their exchange of information. The question is how this might be achieved.

235. The UK Government called for the reporting arrangements between the ECB, the Commission and the Eurogroup to be strengthened and formalised in the new constitutional Treaty (Q 220).

236. Professor Thygesen suggested that the euro area should move towards "intensified informal co-ordination" of the type practised in the US where there were weekly unrecorded breakfast meetings between the Chairman of the Federal Reserve and the Secretary of the US Treasury. For this to happen in the euro area, the Eurogroup would have to adopt a more permanent leadership than allowed under the present six-monthly rotation of the presidency. If provision for this change could be made in the new constitutional Treaty, it would be "a promising step forward". It would get around the current vacuum that meant that the ECB lacked a body with which it could conduct a regular dialogue about economic policy.[129]

Conclusions of the Committee on economic governance of the euro area

237. **EMU has led to the unprecedented combination of a single monetary policy co-existing with separate national fiscal policies. There are those who suggest that some other body is needed as a partner for the ECB. Whether this unique, historical asymmetry can succeed in the long term without further steps towards economic union remains an unanswered question. It is generally accepted that the economic fortune of a nation depends on the monetary, fiscal and structural policies that it pursues. Co-ordination between these three policy elements in the euro area, while theoretically desirable, is difficult to achieve fully in practice, especially between countries in different economic conditions. We have seen no evidence, however, to suggest that a lack of such co-ordination has had any major adverse effects on economic performance in the euro area so far. Evidence provided suggested that other factors, including the unwillingness and dilatoriness of Member States to face up to the need for structural reforms in capital, labour and product markets in their own economies, have been more important in this regard.**

238. **As of yet, there has not been a great need for co-ordination of monetary and fiscal policies in the EU to go beyond the exchange of information. We note that there is some concern that economic circumstances might change to the extent that more active and explicit co-ordination of particular policies could become necessary at some point in the future. In such circumstances, it is hard to know at present how the EU would respond.**

239. **There is a case for strengthening the arrangements for communication between the ECB and the Eurogroup. We do not think that this would jeopardise the ECB's independence, which should be rigorously observed and maintained. If the Treaty formalised the Eurogroup and enabled it to operate under a more permanent leadership than presently allowed under the six-monthly rotation of the presidency, it would provide the ECB with a more stable and coherent interlocutor, which could facilitate their dialogue and the exchange of information between them. It could thus strengthen the capacity of the ECB to perform its own functions effectively. Such a change would not alter the powers of the Eurogroup, which would remain a body that could not take any formal decisions on policy.**

[129] 'Macroeconomic Policies and the Case for Policy Coordination in the Euro Area', Briefing paper for the Economic and Monetary Affairs Committee of the European Parliament, by Professor Thygesen, Fourth quarter, 2001.

PART 7: SUMMARY OF CONCLUSIONS

240. **Our overall assessment of the ECB's monetary policy since its started operating on 1 January 1999 is positive. We commend the ECB for the fact that its monetary policy is achieving the desired objective of price stability. The consensus in the evidence we received was that the ECB had performed well so far given its mandate, and this is a view that we share. The ECB is still a young institution, but it has rapidly built up a high level of credibility. It is in the context of this positive assessment that our criticisms and recommendations that follow are to be understood.** (paragraph 25)

241. **In this inquiry, we did not examine the EU's institutional arrangements for prudential supervision, but we are aware of the debate on the adequacy of the current institutions arrangements for financial stability in the EU. We recognise that the Government considers that "official support operations remain a national responsibility for euro area members", yet the Financial Secretary also called for "more clarity in the arrangements" as to who the lender of last resort should be in the euro area. We would like the Government to explain how it would like the system of prudential supervision in the EU to develop over time, whether it considers that the ECB should be given any powers in the area of financial supervision, and what it considers to be the ideal institutional set up for prudential supervision in the EU.** (paragraph 30)

242. **As part of its contribution to the smooth conduct of supervisory policies in the EU, we would encourage the ECB to publish regular broad reports on financial stability in the EU.** (paragraph 31)

243. **We regard the strength of the ECB's mandate to be its unambiguous nature. The EC Treaty makes it clear that the primary objective of the bank is to achieve price stability. Price stability is desirable because it is conducive to, and a pre-requisite for, long-term stable growth and employment. It is right therefore that price stability is the primary objective of the ECB; we would not seek to change that.** (paragraph 45)

244. **Without prejudice to that objective, the ECB must also support growth and employment. For citizens of the EU, economic success must go beyond a narrow definition of price stability; EMU will be judged by its ability to deliver what the EC Treaty terms sustainable and non-inflationary growth and a high level of employment. As the EU's most visible financial institution, how people judge the ECB will inevitably be influenced by the level of growth and employment in the euro area; it is right therefore that the Treaty places these as key but subsidiary elements of the bank's mandate. It should be recognised, however, that there are limits as to what monetary policy alone can achieve.** (paragraph 46)

245. **The ECB enjoys a high degree of independence. The question arises whether greater political involvement could and should be introduced to the process by which price stability is defined for the euro area without seriously prejudicing that independence. Giving the right to define price stability for the euro area to a political body could arguably help to address perceptions that the process currently lacks sufficient political accountability. We believe, however, that for the time being the ECB should continue to define price stability for the euro area. If at some later date a political body outside the ECB were to define price stability for the euro area, that body could perhaps best be the Heads of State or Government of those Member States that have adopted the euro, acting on a recommendation from the Eurogroup.** (paragraph 56)

246. **We welcome the fact that at the start of its operations the ECB announced a quantitative numerical value for its objective of price stability. Such a decision was essential for transparency and accountability. The ECB's initial definition of price stability as being a "year-on-year increase in the Harmonised Index of Consumer Prices (HICP) for the euro area of below 2%" did not make it clear that there was a lower limit. This led to some confusion and left the ECB open to criticisms that it was not sufficiently vigilant about the risks of deflation.** (paragraph 79)

247. **In the light of the ECB's announcement on 8 May 2003 of the results of the Governing Council's review of its monetary policy, the bank's definition of price stability is clearer than it was before and not so open to criticisms of asymmetry. Nonetheless, comparisons with the symmetrical inflation targets of some other central banks remain unfavourable, and the ECB's definition of price stability could still be clearer.** (paragraph 80)

248. **The ultimate test for the success of a central bank's monetary policy strategy is its record of actual policy decisions. As we say above, this has generally been good so far. Where the strategy has not performed so well is in communicating the bank's decisions.** (paragraph 81)

249. **The ECB's definition of price stability has recently been reaffirmed and clarified. We hope that Mr Trichet, the bank's incoming president, will sustain this process of clarification of the current definition in order to safeguard the bank's credibility and that of its monetary policy strategy.** (paragraph 82)

250. **The task remains of communicating the ECB's new strategy effectively. It is with a view to improving this external communication that we recommend that the ECB should in due course adopt an inflation target, expressed as a symmetric range around a central figure. Such a target would constitute a natural focal point that could be observed and understood by the public; it would provide observers with a more precise focus for forming inflation expectations and taking forward-looking decisions. An explicit target for inflation would be entirely transparent and so would reduce the uncertainties for other economic agents, by giving clearer guidance for their inflation expectations, which should in turn help to stabilise the economy. A symmetrical inflation target would also provide a clearer benchmark against which the bank could be held to account.** (paragraph 83)

251. **The two main criticisms of the ECB that concern its definition of price stability are the related claims that the ECB has not focused enough on growth and employment and that the ECB is not sufficiently vigilant in fighting deflation. We think that these claims are unfounded. A symmetrical inflation target would, however, address these two fears directly. The lack of symmetry to the ECB's definition of price stability has contributed to the perception that the bank does not take sufficient account of deflationary risks, pays inadequate attention to growth and is only concerned with achieving a low rate of inflation; a symmetrical inflation target would reduce these uncertainties over the ECB's aims.** (paragraph 84)

252. **We agree that the medium term is the right period of time for the ECB to be aiming to achieve price stability. Monetary policy should dampen or smooth fluctuation in both output and inflation without causing undesirable volatility in interest rates, employment or GDP. The medium-term orientation of the ECB's strategy allows such a flexible response to temporary shocks.** (paragraph 88)

253. **The monetary pillar does not appear to have significantly affected the ECB's interest rate decisions. The prominent position of this monetary analysis in the ECB's presentation of these decisions did, however, cause problems and hindered the bank's communication of its monetary policy. We therefore welcome the changes in the President's press statement and the editorial in the bank's monthly bulletin, in which the monetary growth pillar plays a less prominent role, which helps the bank's communication strategy.** (paragraph 109)

254. **We believe that it is sensible that the Governing Council continue to monitor monetary developments in order to inform its decisions on interest rates. We accept that the two pillars of the ECB's monetary policy strategy provide a useful framework for the internal analysis of information that facilitates the debate within the Governing Council. We respect the ECB's view that it does not want to create the wrong impression that controlling inflation is an exact science. However, the ECB's decision to reject inflation targeting and maintain its two-pillar framework does not imply that the bank is prevented from adopting an inflation target. The ECB could announce an explicitly symmetrical inflation target and state that that its actions in trying to achieve this target will be based upon its two-pillar framework rather than be guided solely by the relationship between forecasted and target inflation.** (paragraph 110)

255. **The ECB has said that its "two-pillar framework has over time become the hallmark of the strategy in conjunction with the medium-term orientation of the ECB's policy framework." Our proposals do not necessarily call for either of these aspects of ECB's monetary policy strategy to be changed. We believe that our recommendations represent a sensible compromise between the ECB's determined attachment to its two pillars and calls for the bank to change to an inflation-targeting regime. The ECB could combine what it considers to be the organisational advantages of its two-pillar framework with the important communication benefits associated with the anchoring role of an inflation target. Were the ECB to adopt a symmetrical inflation target, however, it might reconsider the role and necessity of its monetary analysis.** (paragraph 111)

256. **We are encouraged that the ECB has said that the process of review is ongoing. We hope that the bank will adopt the practice of conducting regular reviews of its monetary policy strategy. By the time such a review next takes place, the perceived dangers to the bank's credibility of changing its definition of price stability should have receded and the bank might at that point find it made sense to adopt a symmetrical inflation target.** (paragraph 114)

257. **It would be a mistake for the euro area to adopt an exchange-rate target. We are satisfied that the ECB has paid attention to the exchange rate when making its interest rate decisions, but it is clear that affecting the exchange rate has not been the primary aim of the bank's monetary policy. This has not, and should not, preclude occasional interventions by the ECB in the markets to dampen excessively rapid swings. We are convinced that this is the correct policy for the ECB to pursue.** (paragraph 123)

258. **The Governing Council is the highest decision-making body of the ECB; it sets interest rates for the euro area. The question of reform of the Governing Council of the ECB is therefore an issue of major importance. It is regrettable that the enabling clause provided by the Treaty of Nice was drawn so tightly as to prevent the Commission and the ECB from considering more radical proposals for reform of the Governing Council but instead limited them to considerations of its voting procedures.** (paragraph 155)

259. **The agreed reform, based on an overly complex rotation model, is not a sensible way to deal with the fundamental problems posed to the workings of the Governing Council by enlargement of the euro area. It fails to achieve what it was meant to do because it does not satisfy the principles on which it was supposed to be based. It is not an efficient mechanism for setting interest rates in the euro area; it caps the number of voting and non-voting members of the Governing Council at a level which is far too high; it is not transparent; it is overly complicated and difficult to communicate, so it will be extremely difficult for it to gain the trust of the public. Furthermore, it violates the principle of the ECB statutes, which prescribe that the NCB Governors sit on the Governing Council as individual experts, not as representatives of their own countries. All in all, we do not consider that the agreed reform will work satisfactorily. It is extremely disappointing that such an important decision on reform was taken so quickly and with limited opportunity for consultation, debate or parliamentary scrutiny.** (paragraph 156)

260. **There is a functional need for the ECB to have the best possible design for its interest-rate setting body. The reason that we have independent central banks is to ensure that monetary policy is not compromised by political considerations. For this reason we recommend that the ECB should eventually have a small Monetary Policy Council composed of the six members of the ECB Executive Board and up to six independent external experts. These part-time, non-executive members of the Monetary Policy Council would be appointed for their individual expertise, without regard to their nationality, by an open and transparent process; like the Members of the Executive Board, they would be mandated to consider exclusively the interests of the euro area. We believe that such a model is the most sensible consequence of the decision to operate a single monetary policy. We recognise and appreciate the political impetus for there to be some national input into the running of the ECB. That is why we recommend that the Monetary Policy Council should operate under the oversight of the current Governing Council, where the central banks of all of the Member States of the euro area are represented. The Monetary Policy Council would meet monthly and take decisions on interest rates; the Governing Council would retain all the other responsibilities that it currently holds. The Governing Council would continue to formulate the monetary policy strategy for the ECB, which the Monetary Policy Council would follow and implement. The Governing Council would set general guidelines for monetary policy in, say, quarterly meetings and monitor the policy execution by the Monetary Policy Council. Such meetings would allow the national central bank governors to continue to contribute their indispensable knowledge of economic developments and sensitivities in their own countries to the working of the ECB. If independent experts were appointed to the Monetary Policy Council, it would mean that all the members of the rate-setting board would become directly accountable to the European Parliament, which is not currently the case, as it cannot call the national central bank governors to appear before it.** (paragraph 157)

261. **The Member States should, as a matter of urgency, reconsider reform of the Governing Council at the present Inter-Governmental Conference. A new enabling clause should be provided allowing fundamental reforms to the structure of the ECB to be agreed by the European Council, acting unanimously. There should be a new provision in the Protocol on the Statute of the European System of Central Banks and of the European Central Bank that would facilitate reforms that go beyond amending Article 10.2 of Protocol. Proposals for reform under a broader remit are necessary to allow changes to the functions of the Governing Council and the establishment of a Monetary Policy Council as a decision-making body of the ECB. Without such a provision, it would be extremely difficult to amend the structure of the ECB any further, making reform of the Governing Council unlikely in the foreseeable future.** (paragraph 158)

262. **Central banks should be subject to the scrutiny of a democratically elected body. For the ECB, this accountability needs to be in a form which does not put its independence at risk. It is a**

popular misconception that, unlike the Bank of England, the ECB is not accountable to parliament. The ECB is accountable to the European Parliament, and we remain of the view that it would not be practicable, or even desirable, to make the ECB also directly accountable to national parliaments. (paragraph 165)

263. **The President of the ECB and other members of the Executive Board regularly appear before the Committee on Economic and Monetary Affairs of the European Parliament. Ever since the establishment of the ECB, we have said that we would expect these hearings "to be televised and to become a prime means of [the ECB] communicating with the people of the euro zone countries." We are disappointed that this is still not the case.** (paragraph 166)

264. **We welcome the publication of economic projections by the ECB, but the bank should increase the frequency of their publication to four times per year, as there can be significant change in the economic outlook over six months. More frequent publication would help the Bank to provide clearer and more transparent explanations for their monetary policy decisions.** (paragraph 171)

265. **The President's press conferences after meetings of the Governing Council provide a most timely opportunity for the ECB to present and explain its monetary policy decisions. We would welcome it if the incoming President, Mr Trichet, continued this practice.** (paragraph 174)

266. **On the basis of the evidence received, we accept that it would not be appropriate for the ECB to publish minutes of the meetings of the Governing Council which are attributed and contain full voting records: to do so would run the risk of exposing individual members of the Governing Council to criticisms or pressures from their own countries, and thus of impairing, or at least appearing to impair, the independence of the ECB itself.** (paragraph 195)

267. **However, the ECB's communication strategy will need to develop and evolve over time. The bank should, by a series of incremental steps, gradually move towards greater transparency of the Governing Council. The first step could be taken without further delay by announcing that the central bank is to publish records of the meetings of the Governing Council in which the various arguments and reasoning would be spelled out clearly but not attributed. Such a move would enhance transparency and understanding of the ECB's decision-making processes and win wide public support, both in the press and with commentators and the markets. We see no reason for the bank to delay in providing more detailed information about the arguments used in the meetings of the Governing Council, whilst protecting the identity of those participating.** (paragraph 196)

268. **If it were to be decided that the ECB's interest-rate decisions should be taken by a Monetary Policy Council where the non-executive members were appointed as individual experts, the publication of attributed minutes and the balance of votes within the Monetary Policy Council could be given further consideration.** (paragraph 197)

269. **The manner by which the first President of the ECB was appointed was regrettable and did not conform to the spirit of the Treaty. A situation of split mandates should not be allowed to happen again.** (paragraph 204)

270. **We see the hearings that the European Parliament holds with candidates for the Executive Board as an extremely valuable part of the appointment procedure. The hearings bring some openness and democratic legitimacy to the process. Over time the nature of these hearings may evolve and their significance will probably increase. At some later date consideration could be given to granting the European Parliament the power to confirm the Council's nomination for the Executive Board; but it is essential to prevent the process from becoming unduly politicised. We are strongly of the opinion that the time is not yet right to take the final decision on appointments to the Executive Board away from the Member States.** (paragraph 213)

271. **The Stability and Growth Pact can help Member States to control their debt and deficits, which should provide stability for the ECB.** (paragraph 218)

272. **EMU has led to the unprecedented combination of a single monetary policy co-existing with separate national fiscal policies. There are those who suggest that some other body is needed as a partner for the ECB. Whether this unique, historical asymmetry can succeed in the long term without further steps towards economic union remains an unanswered question. It is generally accepted that the economic fortune of a nation depends on the monetary, fiscal and structural policies that it pursues. Co-ordination between these three policy elements in the euro area, while theoretically desirable, is difficult to achieve fully in practice, especially between countries in different economic conditions. We have seen no evidence, however, to suggest that a**

lack of such co-ordination has had any major adverse effects on economic performance in the euro area so far. Evidence provided suggested that other factors, including the unwillingness and dilatoriness of Member States to face up to the need for structural reforms in capital, labour and product markets in their own economies, have been more important in this regard. (paragraph 237)

273. **As of yet, there has not been a great need for co-ordination of monetary and fiscal policies in the EU to go beyond the exchange of information. We note that there is some concern that economic circumstances might change to the extent that more active and explicit co-ordination of particular policies could become necessary at some point in the future. In such circumstances, it is hard to know at present how the EU would respond.** (paragraph 238)

274. **There is a case for strengthening the arrangements for communication between the ECB and the Eurogroup. We do not think that this would jeopardise the ECB's independence, which should be rigorously observed and maintained. If the Treaty formalised the Eurogroup and enabled it to operate under a more permanent leadership than presently allowed under the six-monthly rotation of the presidency, it would provide the ECB with a more stable and coherent interlocutor, which could facilitate their dialogue and the exchange of information between them. It could thus strengthen the capacity of the ECB to perform its own functions effectively. Such a change would not alter the powers of the Eurogroup, which would remain a body that could not take any formal decisions on policy.** (paragraph 239)

RECOMMENDATION

275. The Committee considers that the subject of the European Central Bank raises important questions to which the attention of the House should be drawn, and we make this Report to the House for debate.

APPENDIX 1

Sub-Committee A (Economic and Financial Affairs, Trade and External Relations)

Members of the Sub-Committee

Lord Armstrong of Ilminster
Lord Geddes
Lord Hannay of Chiswick
The Rt Hon the Lord Jones
The Rt Hon the Lord Lamont of Lerwick
Lord Lea of Crondall
Lord Marlesford
The Rt Hon the Lord Radice (Chairman)
Lord Sharman
The Rt Hon the Lord Sheldon
Lord St John of Bletso
Lord Taverne

The Specialist Adviser was Professor Richard Portes, CBE.

Members of the Sub-Committee declared the following interests:

Lord Radice
Board Member, Britain in Europe
Board Member, European Movement
Chairman, British Association for Central and Eastern Europe
Chairman, Franco-British Council

Lord Armstrong of Ilminster
Chairman, Forensic Investigative Associates plc
Chairman, Board of Governors, Royal Northern College of Music
Chancellor, University of Hull
Chairman, Leeds Castle Foundation
Chairman, Hestercombe Gardens Trust
Trustee, RVW Trust

Lord Geddes

Non-Executive Chairman:

Photo Corporation (UK) Limited

Trinity College London

Chrome Castle Limited

Non-Executive Director:

Portman Settled Estates Limited

Trinity College of Music

Lord Hannay of Chiswick

Tangguh Independent Advisory Panel (for BP)

Member, Council of Britain in Europe

Non-Executive Director, Chime Communications

Pro-Chancellor, University of Birmingham

Director Salzburg Seminar

Chairman, International Advisory Board of EDHEC (French Business and Management Schools)

Member, Advisory board, Centre for European Reform

Member, Advisory board, European Foreign Affairs Review

Member, Advisory board, Prospect Magazine

Lord Lamont of Lerwick:

Chairman, East European Food Fund

Director, Balli plc

Director, Banca Commerciala Robank SA

Director, Compagnie Internationale de Participations Bancaires et Financieres

Director, European Growth and Income Trust (managed by Aberdeen Asset Management)

Director, Jupiter Finance and Income Trust (Investment Trust) Consultant, Fintrade

Consultant, Rotch Group Chairman, Bruges Group

Consultant. Stanley Leisure

Member of Advisory Board, Merchant Bridge

Chairman, Le Cercle

Director, British Iranian Chamber of Commerce

Director, British Romanian Chamber of Commerce

Lord Lea of Crondall

Treasurer, Parliamentary Group on Macedonia

Treasurer, Parliamentary Group on the Federal Republic of Yugoslavia

Member, Central Arbitration Committee

Lord Marlesford

Adviser, Board of John Swire and Sons

Adviser, Sit Investment Associates (Minneapolis)

Adviser, World View Incorporated (New York)

Non-Executive Director, Baring New Russia Fund Ltd

Independent National Director, Times Newspaper Holdings Ltd

Chairman Marlesford Parish Council

Vice-President, Council for the Protection of Rural England

President, Suffolk ACRE (Action for Communities in Rural England)

President, Suffolk Preservation Society

Lord Sharman

Chairman and Shareholder, Aegis plc

Chairman, Securicor plc

Supervisory Board member of ABN Amro NV

Director and Shareholder, B G International plc

Director, Reed Elsevier plc

Chairman, Advisory Panel, Good Corporation

Adviser/consultant to Bain Capital

Lord Taverne

Chairman, Trustees Sense About Science

Director, IFG Capital Ltd

Chairman, Monitoring Board, Axa Sun Life plc

Chairman of Trustees, Alcohol and Drug Addiction Prevention and Treatment (ADAPT) Ltd

Chairman of Trustees, Iran Aid Foundation

Trustee, The Health and Science Communication Trust

APPENDIX 2

List of Witnesses

The following witnesses gave evidence. Those marked ** gave both oral and written evidence; those marked * gave oral evidence only; those without an asterix gave written evidence only.

Bank of England

* Mr Roger Bootle, Capital Economics

** Sir Samuel Brittan, Financial Times

* Professor Willem Buiter

Mr Lorenzo Codogno, Bank of America

* Professor Mario Draghi, Goldman Sachs

Mr Klaus Regling, European Commission

Federation of German Industries (BDI)

* Professor Francesco Giavazzi, Bocconi University

* Professor Charles Goodhart, CBE

** HM Government

Professor Seppo Honkapohja, University of Helsinki

Miss Silvia Pepino, JPMorgan

* Dr Holger Schmieding, Bank of America

* Mr Andrew Smith, KPMG

** Professor Niels Thygesen, University of Copenhagen

* The Honourable Paul A. Volcker

* Professor Dr Jürgen von Hagen, Bonn University

* Mr David Walton, Goldman Sachs

* Mr Martin Weale, CBE, NIESR

Union of Industrial and Employers’ Confederations of Europe

APPENDIX 3

Glossary

Note: Terms defined elsewhere in the Glossary are shown in italics.

BDI: The Federation of German Industries

BSC: Banking Supervision Committee, a committee of the ESCB that provides structural and macroprudential analyses.

CEPR: Centre for Economic Policy Research

CEPS: Centre for European Policy Studies

CER: Centre for European Reform

CFS: Center for Financial Studies

ECB: European Central Bank

Ecofin: The Council of Ministers of the EU responsible for Economic and Financial Affairs; it is made up of the economics and finance ministers of the Member States.

EFC: Economic and Financial Committee. In accordance with Article 114(2) of the EC Treaty, an Economic and Financial Committee was set up at the start of the Stage Three of EMU. For further information on the EFC, see the Council Decision of 21 December 1998 on the detailed provisions concerning the composition of the Economic and Financial Committee (98/743/EC), together with the Council Decision of 31 December 1998 adopting the Statutes of the Economic and Financial Committee (1999/8/EC).

EMAC: The Committee on Economic and Monetary Affairs of the European Parliament

EMU: Economic and Monetary Union

ESCB: The European System of Central Banks, which consists of the ECB and the national central banks of all the Member States of the EU.

EU: European Union

Euro area: Term used to refer collectively to those Member States which are participating in Stage Three of EMU, that is, who have adopted the euro. Currently, twelve of the fifteen Member States have adopted the euro: Belgium, Germany, Greece, Spain, France, Ireland, Italy, Luxembourg, the Netherlands, Austria, Portugal and Finland.

Eurogroup: The group of government finance ministers of the Member States in the euro area; they meet every time there is a meeting of Ecofin.

European Council: The European Council consists of the heads of state or government of the EU.

Eurostat: The Statistical Office of the European Communities, which is based in Luxembourg.

Eurosystem: The central banking system of the euro area, which is constituted of the ECB and the national central banks of the Member States that have adopted the euro.

Eurozone: See euro area

Federal Reserve System: The central banking system of the United States of America. Established in 1913, it began to operate in November 1914. Its setup, although somewhat altered since its establishment, particularly by the Banking Act of 1935, has remained substantially the same.

FOMC: The Federal Open Market Committee is the most important monetary policymaking body of the Federal Reserve System.

GDP: Gross Domestic Product

HICP: Harmonised Index of Consumer Prices developed, compiled and disseminated by Eurostat in close co-operation with the national statistical institutes.

IGC: Inter-Governmental Conference – the negotiations that are held between the governments of the Member States with a view to amending the Treaties.

IMF: International Monetary Fund

M3: In December 1998 the ECB announced that "M3 will consist of currency in circulation plus certain liabilities of Monetary Financial Institutions (MFIs) resident in the euro area and, in the case of deposits, the liabilities of some institutions that are part of central government (such as Post Offices and Treasuries). These liabilities included in M3 are: overnight deposits; deposits with an agreed maturity of up to two years; deposits redeemable at notice up to three months; repos; debt securities with maturity of up to two years; unit/shares of money market funds and money market paper (net)." (See also monetary aggregates.)

Monetary aggregates: a monetary aggregate can be defined as the sum of currency in circulation plus outstanding amounts of certain liabilities of financial institutions that have a high degree of "moneyness" (or liquidity in a broad sense). The narrow monetary aggregate M1 has been defined by the Eurosystem as currency in circulation plus euro area residents' (other than central government) holdings of overnight deposits with euro area money-issuing institutions. The monetary aggregate M2 comprises M1 plus deposits with an agreed maturity of up to two years and deposits redeemable at notice of up to three months. The broad monetary aggregate M3 includes M2 plus repurchase agreements, money market fund shares/units and money market paper and debt securities with a maturity of up to two years. The Governing Council has announced a reference value for the growth of M3.

MPC: Monetary Policy Committee of the Bank of England, which sets interest rates for the UK.

NCB: National central bank of one of the Member States of the EU.

Policy mix: The overall stance of fiscal and monetary policy. The policy-mix may consist of various combinations of expansionary and restrictive policies, with a given fiscal stance being either supported or offset by monetary policy.

SGP: Stability and Growth Pact

TEC: Treaty establishing the European Community

UNICE: Union of Industrial and Employers' Confederation of Europe