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# How Central Bankers See It

## The First Decade of European Central Bank Policy and Beyond

Stephen G. Cecchetti and Kermit L. Schoenholtz

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### 9.1 Introduction

Otmar Issing: “There was a clear view from a number of outside observers that we would fail and that it would be a disaster in any respect.”

As late as 1997, less than a year before the European Central Bank (ECB) was scheduled to come into existence, there was widespread skepticism about whether the European Monetary Union (EMU) would begin on schedule as a broad union and, in some quarters, whether it would happen at all. Yet here we are a full decade after the advent of EMU and today there are fifteen countries where the euro is legal tender. The twenty-one members of the Governing Council of the ECB make monetary policy for a region of 320 million people with a gross domestic product (GDP) of roughly €9 trillion. And it is hard to find major fault with what they have done over the past decade.

In this chapter, we begin with a brief history of the challenges that faced

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This chapter was prepared for the NBER conference “Europe and the Euro,” 17–18 October 2008, Milan, Italy. It is traditional to use the introductory footnote to thank colleagues who contributed comments and advice. In this case, there were dozens of people without whom we could not have written this chapter. First, seventeen senior officials sat for interviews that their staffs helped organize; second, Citigroup facilitated interview transcription; third, several economists helped with data and filled in parts of the history (notably, Jose Luis Alzola); and finally, the editors of this volume spurred us to write this chapter. To all of them we extend our heartfelt thanks. We also would like to thank Alberto Alesina, Vitor Gaspar, and Francesco Giavazzi for comments on an earlier draft, and Malcolm Spittler of Citigroup for his excellent research assistance.

the people who forged the policies of the ECB in its first decade. What tests did these central bank pioneers face as the European Monetary Institute was transformed into the ECB on 1 June 1998? With hindsight, it is fair to say that the preparations were a success in nearly every way. The ECB was able to conduct monetary policy operations immediately without a major misstep. The original Governing Council's interest rate decisions were sound, overcoming a lack of data and models that would have panicked most people. While communication at the start may not have been as smooth as some people wished, it improved over time. Looking back, nearly every possible contingency that the ECB actually faced was anticipated and successfully addressed, reflecting careful preparation and unusual foresight.

Our task does not stop at recounting the past. Looking forward, we go on to ask what the likely challenges are for the next decade. The ECB is an evolving institution that is changing in unique ways. The euro area continues to expand. Enlargement could bring ten additional members into the monetary union over time—and more if the European Union itself grows. Each of these countries has its own language, cultural traditions, and social norms. Adding them to the euro system affects decision making and communication, as well as policy itself.

Beyond increasing its size, the ECB faces challenges in retaining public support for its own policies and in promoting the structural reforms needed to increase the flexibility of member economies. Regional economic divergences *within* a country may create problems, but they are unlikely to be as severe as the political difficulties that the ECB is likely to face should the economies of the various countries in the euro area experience dramatically different economic fortunes for extended periods. Furthermore, as we look forward, prosperity in Europe does not depend on monetary policy alone. The decisions by member governments have an important impact on what the ECB can and cannot achieve.

Finally, there is the question of financial stability. Here, the ECB position as a pan-euro area financial institution is unique. While the Governing Council has clear control over the combined balance sheet of the central banks in the euro system (those of the National Central Banks plus that of the ECB itself), it does not have regulatory or supervisory authority. And unlike the United Kingdom, where regulation and supervision resides in a single institution, financial oversight in the euro area is at the national level and *each country is different*.

In drafting this history, we have benefited from many studies that analyzed ECB policy, from its rate-setting patterns to its effectiveness in securing price and economic stability to its communication efforts. The ECB itself has been an excellent source, reflecting its admirable penchant for self-assessment.<sup>1</sup>

1. The *Monetary Policy of the ECB*, first published in 2001 and revised in 2004, as well as Issing et al. (2001) are early examples of comprehensive explanations and assessments.

But there is no shortage of outside reviews and critiques.<sup>2</sup> Furthermore, we now have nearly a decade of data with which to characterize the economic outcomes of ECB policy.

However, our unique advantage arises from a series of seventeen extended interviews conducted between June 2007 and February 2008 with a range of current and former ECB policymakers, and with other policymakers and scholars who viewed the evolution of the ECB from privileged vantage points outside the institution. The questionnaire that we employed as a basis for the interviews forms appendix A of this chapter. Appendix B reports the prominent themes in response to these questions. Abbreviated biographies of the interviewees are in appendix C.

The ground rules for our interviews were straightforward: we asked each interviewee to review and correct an edited transcript of the interview, adding or deleting anything they wished. While we have used their responses to inform our judgment and understanding, all direct quotes in either the main text or the footnotes have been approved by the interviewees. We are very grateful for their generous support, especially considering that our interviews were conducted during the financial crisis that began in August 2007.

The remainder of this chapter proceeds as follows. This introduction is followed by a brief discussion of the initial conditions in 1998 and the challenges that participants expected as the monetary union was getting under way. In section 9.3, we move to a more detailed discussion of the construction of the ECB's operational framework, including the creation of the euro area money market as well as the initial implementation of the policy and communication strategies. We then proceed to an evaluation of ECB policy performance in the first decade of monetary union in section 9.4. We provide a brief discussion of the euro area inflation experience, as well as the stresses and strains created by various aspects of the policy strategy. Section 9.5 looks to the future. Here, we report on the key challenges that our interviewees foresee over the second decade of EMU. Enlargement and financial stability are the issues that are clearly on people's minds, so that is where we focus most of our attention. Section 9.6 concludes.

While we base nearly everything that we write on the series of interviews we conducted, the narrative that follows (including any errors or faulty judgments) is our own. We include extensive quotes in the form of footnotes to provide a sense of why we have drawn the conclusions that we have.

2. A list would start with the *Monitoring the European Central Bank* series published by the Center for Economic Policy Research in London, and include analysis from the Observatorio del Banco Central Europeo in Madrid as well as the Center for European Policy Studies in Brussels.

## 9.2 Initial Conditions

Jean-Claude Trichet: “The main challenge we saw was to transfer to the new currency what had been promised: namely, that it would be as confidence inspiring, as credible, and as good a store of value as the previous national currencies had been.”

The European Central Bank (ECB) came into existence on June 1, 1998—replacing its predecessor, the European Monetary Institute (EMI). At the start of 1999, the ECB took over monetary control in the initial eleven countries of the euro area.

The ECB was a new and unprecedented institution without a track record, but it was not born in a vacuum. The treaty of Maastricht provided for its independence from governments and established a hierarchical mandate for ECB policy with price stability as the top priority.<sup>3</sup> Because any alteration of the treaty requires unanimous support of the member states of the European Union, this mandate remains widely perceived as immutable. While the ECB began with only a few hundred employees, it drafted a significant portion of its staff from national central banks (NCBs) which, together with the ECB, form the euro system.

Nevertheless, the policy tests facing the ECB at its inception were numerous and daunting. Section I, part a, of appendix B identifies the most prominent concerns that our interviewees perceived when the ECB began. From this list, it is evident that the ECB faced an extraordinary challenge as it sought to inherit from the start the credibility of its most successful predecessor central banks.<sup>4</sup> There also were great risks, as there would be no honeymoon or grace period. Any significant rise of inflation expectations or of inflation risk premia in the run-up to EMU might have branded policy a failure even *before* the ECB began to exercise monetary control.

By day one, the new central bank needed to promote the development of a euro area-wide money market in which it could operate. The euro system needed to determine which matters would be centralized within the ECB, and which would be delegated to the NCBs for execution or oversight. There was concern whether the powerful NCB governors—and their large staffs—would overwhelm the ECB, and potentially undermine the euro area focus of the new central bank.<sup>5</sup> While the EMI had narrowed the options for the

3. The treaty allows the region's finance ministers to negotiate an international agreement (such as a fixed-exchange rate regime) that could theoretically override ECB monetary independence. So far, however, there has been no such proposal, let alone indications of consensus among finance ministers to alter the floating-rate regime.

4. Axel Weber: “The biggest challenge for the newly-founded euro system—operating without a track record—was to gain credibility in financial markets and among the citizens of Europe.”

5. Six members of the ECB Executive Board would join eleven NCB Governors in the initial Governing Council. While exaggerated by the inclusion of NCB operational personnel, the NCB workforce was about 100 times larger than that of the ECB at the ECB's inception. At

policy strategy, the ECB had only seven months in 1998 to consider specific alternatives (principally inflation or monetary targeting), to specify the strategy in detail (including the operational methodology), and to prepare the apparatus for making decisions and communicating. In doing so, it lacked the timely data and reliable models of the euro area that modern central bankers rely on in making policy rate decisions. Moreover, the structural changes induced by the creation of the euro—which favored a rapidly integrating financial market and economy—meant fundamental uncertainty about the monetary transmission mechanism. In a virtually unique manner, at the start the ECB had to manage a currency that did not exist in notes or coin.

Also, the ECB was to begin operations in an environment of overt skepticism.<sup>6</sup> Some observers anticipated currency disturbances reminiscent of the Exchange Rate Mechanism (ERM) crises even after the start of EMU (see, e.g., Garber 1999).<sup>7</sup> Prior to EMU, it was common among prominent economists to conclude that the euro area's lack of labor mobility and of a mechanism for fiscal burden-sharing made it a suboptimal currency area that would be prone to country-level divergences in activity, employment, and fiscal balances (see Feldstein [1997] or Obstfeld [1998]).

Against this background, the broad membership of EMU—which included several formerly high-inflation countries—raised doubts about credibility: would the euro area yield curve be an amalgam of EMU member yield curves, or would it mimic those with the most favorable inflation track records (such as Germany, Benelux, and France)? The former outcome might even have prompted speculation about secession from EMU, however difficult. Similarly, would cross-country yield spreads be so wide as to cast doubt on EMU's sustainability?

Finally, it was unclear at the outset to what extent monetary union would promote European political union, or even whether fiscal and supply-side reforms could keep pace with monetary and financial integration. The EMU's most extreme critics viewed it as a political device to secure bureaucratic mastery over Western Europe, rather than as a means of promoting euro area welfare.<sup>8</sup>

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end-2007, ECB employment had trebled from its end-1998 level of 450, but was still only a fraction of NCB staff.

6. Andrew Crockett: "A few years before the start most observers would not have believed you if you'd told them there would be twelve members, or at least eleven and soon twelve, at the beginning of monetary union."

7. Vitor Gaspar: "People worried about the possibility of turbulence in the foreign exchange markets."

8. See, for example, Connolly (1995). With regard to the ECB, Connolly writes: "But if the ECB *is* ever created, it will certainly not act in a disinterested way in the interest of the Community as a whole, simply because there is no such thing as the Community interest. Either it will act in French interests or it will not. If it does, then Germany will destroy it, putting an end to fifty years of a 'European Germany.' If it does not, then it might well destroy France" (391).

### 9.3 An Operational Framework

Otmar Issing: “What really shocked me [when I arrived] was the lack of any reasonable information (data, etc). We were preparing monetary policy for totally uncharted waters.”

Alexandre Lamfalussy: “I feared that they would have technical problems of all kinds. Ultimately, I was wrong. The implementation went extraordinarily smoothly.”

Vitor Gaspar: “An explicit strategy was clearly necessary to ensure the internal cohesion of the decision-making bodies of the ECB. It also was necessary to have a consistent framework which would enable the bank to communicate to a very diverse set of constituencies.”

In light of these initial conditions, how would the ECB secure the goal of price stability and the subsidiary goals established by the treaty?

#### 9.3.1 A Single Money Market

No ECB policy using interest rates as a tool could be implemented effectively without the existence of a deep, efficient euro area money market. Such a market did not exist before EMU. From a technical perspective, the euro system introduced a real-time gross settlement system, TARGET, as the foundation for a single market for overnight liquidity at the start of the ECB. The system had to be fully functional by January 4, 1999 when the ECB conducted its first open-market operation.<sup>9</sup> Interviewees who were involved in these preparations recalled concern about the lack of time for testing and worries that any operational failure would significantly damage the reputation of the ECB and the single currency even before it got going. There was at least one brief occasion in the spring of 1999 when money markets seemed slow to react to policy developments, but TARGET has been viewed as an extraordinary achievement, bringing about a near-instant integration of the national markets for overnight liquidity. Further evolution of TARGET over the years (including the November 2007 introduction of TARGET II) built effectively on this success.

In contrast, several interviewees viewed the public reaction to the 2002 introduction of euro notes and coin as the ECB’s greatest self-made disappointment in its first decade. From a technical perspective, this enormous logistical process went more quickly and smoothly than many had expected. Most of the legacy currency was replaced within a matter of weeks rather than months, and there were no notable disruptions of retail activity. Official

9. Christian Noyer: “The greatest concern was to be sure to start operations effectively on the 4th of January 1999. If we wanted to have a single money market functioning in euros, we needed absolutely to have the TARGET system working to enable banks to exchange liquidity and the central bank to intervene. We needed the system working from the start to enable us to provide liquidity to the market.”

estimates indicate that the changeover boosted the price level on average by 0.12 percent to 0.29 percent (Eurostat 2003).<sup>10</sup> However, as the ECB subsequently observed, this modest one-off price adjustment prompted an unanticipated (albeit temporary) rise of inflation expectations in some countries that may have contributed to doubts about EMU in the public mind. (Various explanations of this phenomenon may be found in the essays collected in Del Giovane and Sabbatini [2008] as well as in Dzuida and Mastrobuoni [2007]). Some policymakers still wonder whether a more aggressive communication effort would have anticipated and blunted these doubts.<sup>11</sup>

### 9.3.2 Objectives and Strategy

Prior to the start of operations, the ECB stated a quantitative definition of price stability: inflation of less than 2 percent as measured by the Harmonized Index of Consumer Prices (HICP). Some outside observers criticized this goal as asymmetric (in contrast with the inflation level or bandwidth objectives commonly used by inflation-targeting central banks). Concerns about goal asymmetry appeared particularly acute amid the deflation scare earlier in this decade. In 2003, following a broad policy review, the ECB clarified its numerical objective, but did not alter it substantively—it was restated as “less than, but close to 2 percent.” Since that time, the ECB’s announced goal has not changed, and objections to its asymmetry have waned. In part, that may reflect the judgment of some observers that the actual target is roughly symmetric around 2 percent (see Galí et al. 2004). The ECB’s response to the record 2008 overshoot of its target appears consistent with that view.

In October 1998, the ECB announced the “two-pillar” strategic framework that included a focus on monetary developments (Pillar I) and on all other factors affecting the economic and inflation outlook (Pillar II). The official policy review in 2003 left these two pillars in place, but described the approach in a more eclectic (and less mechanical) fashion that focused on the use of the monetary pillar as a “cross-checking” device in which monetary analysis utilizes a broad array of financial variables. Galí et al. (2004) characterized the 2003 shift as a deemphasis of M3 growth that made clear that “money growth is not an alternative policy target” (18).

There is a voluminous literature studying this unique framework, which would seem to be neither fish (inflation targeting) nor fowl (monetary targeting). Much of the analysis from outside the ECB has criticized the monetary

10. Popular claims that official measures understate the price impact of the changeover have not been supported by subsequent analysis (see Del Giovane and Sabbatini 2008).

11. According to Eurobarometer 58 (2003), 77 percent of euro area respondents judged that prices had been “rounded up” during the conversion to the euro. Ignazio Angeloni: “None of us thought at the beginning that a key problem would come from the introduction of the euro bank notes and coins (rather than from the 1999 introduction of the euro). . . . Specifically, I refer to the impact of the introduction of the euro on retail prices and to the effect on expected inflation and perceived inflation in particular.”



pillar as superfluous in securing price stability under a flexible inflation-targeting framework; Svensson (2000) quipped that the first pillar was really just a brick in the second pillar. One early study argued that the negative correlation between monetary signals and policy rates in some periods confirms that the ECB “ignores the monetary pillar” (see Begg et al. 2002, 20). A later analysis expressed doubt that policy decisions would have been any different had been there no “explicit role for money” (see Galí et al. 2004, 59).

In contrast, ECB analysis has focused on establishing the importance of monetary developments for price stability over a horizon longer than that of most economic forecasts. The ECB officials, such as Issing (2003), also have suggested that monetary developments can help policymakers anticipate threats to price stability from asset price bubbles. Nevertheless, ECB policymakers have been obliged to account for sustained overshoots of monetary aggregates beyond reference values that have not appeared linked to price developments. This pattern has tended to downgrade the perceived policy importance of such overshoots and has reinforced doubts about the monetary pillar on the part of many skeptics. It remains distinctly possible that the modest signal-to-noise ratio of monetary developments eventually could erode the credibility of a central bank that emphasizes its reliance on information from monetary analysis.

However one may view the lingering debate about the two pillars, as Issing (2006b) emphasizes, critics underestimate the historical utility of the hybrid strategy in securing for the ECB from its inception the credibility of its most effective predecessor, the Bundesbank. Failure to do so at the start could have been extremely costly, if not irretrievable. By its nature, the ECB must communicate to a more diverse public than virtually any central bank. Even in the distant future, the differences in languages, traditions, institutions, and legal systems across EMU members are unlikely to disappear. In Germany—which represented one-third of EMU economic activity at the start—the association of low inflation with Bundesbank monetary targeting in the public mind probably warranted an ECB emphasis on euro area monetary developments as a means to anchor inflation expectations. Achieving this desired continuity required a consistency of objectives and communication mechanisms suited to the unique historical circumstances. Looking forward, it remains to be seen whether the ECB’s low-inflation reputation will spur it over time to simplify the policy strategy while keeping inflation expectations well-anchored.<sup>12</sup>

### 9.3.3 Communications

Otmar Issing: “Translation was, of course, linguistically always very good, but the same words and phrases may seem different against the back-

12. For example, Papademos (2006) describes how the two pillars eventually could merge into one.

ground of different historical experiences. For example, one colleague once said to me, ‘Otmar, we have a paragraph containing three times a reference to price stability. I think this is too much for this argument. In my country, if you say three times why you seek price stability, it weakens your argument.’ And my argument was, if in Germany it’s only two times, they say, ‘Oh, is the ECB less stability oriented than the Bundesbank?’”

In the course of linking its communication strategy with its objectives and instruments, the ECB developed innovative mechanisms for communication to compensate for constraints that differentiate it from other large central banks. Like most modern central banks, the ECB views transparency both as a goal in itself—necessary for accountability in a democratic society—and as a means to make its policies more effective.<sup>13</sup> It is now a commonplace that central bank policy is transmitted to the economy through forward-looking financial markets, so that clear objectives, a systematic approach to analysis and decisions, and timely public statements are indispensable.

Yet the ECB has also been keen to shield individual members of the Governing Council from pressures to pursue national, rather than euro area, policy goals. The concern, which appeared particularly acute at the start of EMU but remains notable today, is that domestic politics could make Council members less inclined to support policies that would be in the best interests of the euro area, but not necessarily optimal for their home countries. For this reason, the ECB eschews the publication of minutes that would detail Council members’ statements or votes.<sup>14</sup> The ECB’s alternative—the immediate post-meeting press conference held by its President—narrows the information loss due to the lack of detailed minutes, while accelerating the diffusion of the consensus judgment.<sup>15</sup>

As with other major central banks, ECB communications is a work in progress characterized by a trend toward greater transparency. Some interviewees noted that, in the early years, failure to synchronize public statements by Governing Council members occasionally contributed to confusion.<sup>16</sup> Jansen and de Haan (2004) show that NCB Presidents “made at least as many statements” in the early years as the Executive Board, but also indi-

13. Lucas Papademos: “What matters for the effectiveness of communication is to explain as clearly as possible the decisions taken and the policy being implemented in relation to the central bank’s objective and strategy. It is essential to explain how the monetary policy stance contributes to the achievement of the objective. The more transparent and convincing a central bank is about the consistency of its actions with its objective and strategy, the greater the effectiveness of its policy.” See also European Central Bank (2006b).

14. Fabrizio Saccomanni: “[P]ublication of minutes would be taken in Europe as an excuse to speculate about national preferences regarding monetary policy. We have to be careful not to create unnecessary problems of sensitivity at the national level.”

15. Sirkka Hämäläinen: “From the very beginning, I have seen the press conference as the best way to communicate.”

16. Sirkka Hämäläinen: “Communication and public statements of the members of the Governing Council (the Board members included) were not initially always fully synchronized and thus monetary policy messages sent to markets were somewhat confusing.”

cate that the frequency of contradictions in statements about interest rates declined over time. The observed decline in the implied volatility of options on short-term futures also suggests that ECB communication with markets has become more effective (see ECB 2006a).

Other changes also reflect the maturing of the institution (including its data set and models): for example, the ECB began to publish its semiannual staff economic forecasts in December 2000, subjecting internal views to wide external scrutiny. More broadly, the ECB has developed an active dialogue with the public regarding its practices and their evolution. The ECB seminars, conferences, and official participation in outside programs like the ECB Watchers' Conference promote an exchange of ideas with academicians, market practitioners, and others. In the official sector, the ECB also pursues active communication through frequent parliamentary testimony and routine contact with the Eurogroup, Economic and Financial Affairs Council (ECOFIN), and the European Commission.<sup>17</sup>

At least one recent study by Eijffinger, Geraats, and van der Cruysen (2006) compares the level of ECB transparency favorably with that of other central banks.<sup>18</sup> Our own judgment, which coincides with the consensus of interviewees, is that there is no single "best practice" with regard to transparency and communication.<sup>19</sup> Communication is about language and gesture, both of which depend on tradition and history. Effective signaling under constraints requires a thorough understanding of how the signals will be received (which may differ across languages and cultures) and also about which signals could distort the incentives of policymakers and thereby undermine the benefits of transparency. In the words of John Taylor, "More talk does not mean more transparency." At the same time, the ECB's tendency to describe its decisions as unanimous may understate the nature and vigor of important Governing Council debates, thereby diminishing the ability of observers to make an informed judgment about policy and sustaining skepticism about ECB communications more generally.

A key question that arises frequently today is whether central banks should announce an expected path of future policy rates. Ultimately, to maximize the effectiveness of monetary policy, the signals and means of signaling need to be consistent with a central bank's objectives and strategy.

17. Jean-Claude Trichet: "I have to explain regularly and tirelessly all over Europe that I am as frequently in Brussels with the European Parliament as Ben Bernanke and Alan Greenspan appears and appeared before Congress, perhaps even a little bit more frequently. . . . I invited twice a month the President of the college of Ministers of Finance (the Eurogroup) to attend the Governing Council meeting of the ECB. . . . I am, myself, invited every month to attend the meetings of the Ministers of the euro area. Three times a month, there is physical contact between the ECB's Governing Council and the executive branches and the Commission."

18. However, public perceptions of ECB transparency may be less favorable: see Eijffinger and van der Cruysen (2007).

19. Philipp Hildebrand: "The notion that you could somehow hold up the Norwegian model or the Swedish model or the Swiss model as the right model for the ECB strikes me as slightly naïve."

Such announcements systematically reinforce policy goals through rapid market adjustments. At the same time, excessive concreteness that surpasses the ability of policymakers to reliably anticipate future developments can be counterproductive. For these reasons, it is far from clear that publication of an expected future policy rate would be optimal for all central banks (which have different objectives and constraints) or on all occasions for a particular central bank (which may face periods of heightened uncertainty).<sup>20</sup>

The same judgment could be applied to the use of “code words” to signal policy intentions. Codes are imperfect signals at best, and typically relate only to near-term policy prospects, which may be of least importance in the formulation of critical long-run market expectations. Rather, these expectations depend sensitively on the transparency and reliability of the central bank’s reaction function, along with an understanding of the evolution of prices and the economy.

The role of signaling in the monetary transmission mechanism highlights how important it is for central banks to understand markets and their policy responses. Central bankers know that any slavish response to market expectations runs the risk of creating price level or inflation indeterminacy. At the same time, equilibrium in markets requires that the expectations of market participants and central bank decision makers coincide. Consequently, to make their policies most effective, central banks need to understand how markets behave and how to affect expectations without diminishing market incentives for price discovery.

In the case of the ECB, we suspect that the lack of direct financial market experience on the part of most Governing Council members may have complicated this task. The first decade record is filled with outside complaints about ECB communication with financial markets. Much of this criticism underestimates the political constraints under which a multinational organization such as the ECB functions and the challenge of communicating with so many diverse constituencies. Nevertheless, a greater presence of senior ECB leaders with financial market (rather than central bank) experience might have sped the evolution of the central bank’s communications.

### 9.3.4 Data, Models, and Policy Analysis

Over the first decade of EMU, the ECB has made enormous strides in developing data for and models of the euro area economy, as well as advancing the frontiers of policy analysis. In the early years of EMU, the lack of consistent, timely euro area-wide data added sharply to policy uncertainty about the current state of the economy. Even near the end of 2000, for example, published euro area output gap estimates of official institutions

20. For a view calling on the ECB to announce an explicit rate path, see Geraats, Giavazzi, and Wyplosz (2008). For a counterargument from a member of the Governing Council, see Weber (2007).

differed by nearly 1 percentage point, with the Organization for Economic Cooperation and Development (OECD) figure standing at  $-0.3$  percent, while the European Commission published an estimate of  $-1.2$  percent. Moreover, recent readings show very large revisions to these “real-time” estimates—the current OECD measure of the euro area output gap in 2000 is  $+1.2$  percent, while the Commission’s is  $+1.9$  percent.<sup>21</sup> The structural changes induced by EMU added to uncertainty, while the lack of models for the economy as a whole sharply limited the ability of policymakers to be forward-looking.

Perhaps as compensation, the decision-making process at the ECB allocated until recently a significant role to the Chief Economist in setting the stage for policy rate decisions. The likely effect was to enhance attention to the limited supply of timely aggregate data relative to the abundant supply of anecdotes in policy making, helping to narrow the grounds for policy debate. As a result, the “proposal power” inside the Governing Council may have been of greatest importance in the early years of EMU, precisely when the shortage of data and forecast models was most acute.

Today, there are still important gaps in the availability of timely euro area data, although progress depends largely on advances outside the ECB.<sup>22</sup> At the same time, the ECB has developed a forecasting apparatus that is state-of-the-art in the central banking world and—as previously mentioned—routinely publishes its staff projections. In addition, the broad research program of the ECB has reached a status that puts it at the frontier of applied policy analysis alongside the best research efforts of other leading central banks and academic institutions.

### 9.3.5 Euro System—A Constitutional Pact

The Maastricht treaty’s map for the governance of the ECB and the euro system is a complex one. How can the region’s central bankers actually make decisions and divide labor? From the point of view of monetary policy, a key question was whether policy determination would be truly euro area oriented, or if it would reflect some ambiguous compromise arising from the pursuit of national interests? With fifteen NCB governors and six Executive Board members serving on the initial Governing Council, it is natural

21. For comparison, the average of the output gaps in the year 2000 reported in the IMF *World Economic Outlook* of October 2000 (2007) for France, Germany and Italy was  $-1.2$  percent ( $+1.4$  percent).

22. For example, employment data are available in the United States within days of each reporting month, but only seventy-five days after the end of a reporting quarter in the euro area. Similarly, GDP data with breakdowns are available in the euro area at  $t + 65$  days, compared to  $t + 31$  days in the United States. And, in some euro area countries, harmonized index of consumer prices (HICP) flash estimates only recently became available. It is up to the national statistical agencies and Eurostat to change this, not the ECB. For a discussion of plans for improvement, see the report of the Economic and Financial Committee (2007) that was endorsed by the ECOFIN Council.

to wonder whether community interests might have been overwhelmed by national ones. At least one study examined (and rejected) the hypothesis that median voting of Council members sensitive to their domestic inflation conditions accounted for policy patterns in the ECB's early years (see Alesina et al. 2001).

Our interviews revealed unanimity among ECB insiders that country-specific factors were irrelevant in the policy rate-setting process even at the start of EMU. Having feared a greater role for national interests, some interviewees reported reacting with surprise and satisfaction at that time.<sup>23</sup> Others suggested that the long process of preparing for EMU—including joint preparatory work at the EMI—had fostered a broad consensus among euro area central bankers about the objectives and implementation of monetary policy that underpinned the ECB's behavior.<sup>24</sup>

Interviewees also indicated that operational matters resulted in less willingness to don a “euro area hat.” For example, efforts to streamline the euro system—which would affect the locus of some operations and employment—were more likely to inspire national concerns. Perhaps not surprisingly, in 2007 the euro system had fifteen local mints accredited for production of euro notes, compared to only two mints in the United States.<sup>25</sup>

Nevertheless, the euro system has successfully addressed many critical questions requiring a judgment about how to divide labor between the ECB and the NCBs. Monetary policy operations are at the top of this list. Policy is set by the ECB and implemented by the NCBs with their local counterparties using contractual arrangements based on national laws. The ECB lays down the guidelines for open market operations—such as the single list of collateral acceptable for repo—and instructs the NCBs about the size of operations, but the NCBs conduct the operation. Unlike the U.S. Federal Reserve system, there is no single locus (such as New York) for open market operations. Operations coordinated in this decentralized manner require sophisticated information and communication technology that did not exist in the early history of the Federal Reserve.<sup>26</sup>

23. Hans Tietmeyer: “[The decision-making process] was smoother than I anticipated, because I thought that the different traditions and structures of the national central banks could play a diverging role, and that at least some governors could be tempted to feel themselves primarily as representatives of a national area. But especially at the governors’ level, there was a relatively broad-based common feeling from the beginning.”

24. Sirkka Hämmäläinen: “To me, it was quite clear that after those many years of working together it was natural to expect it to be very smooth.”

25. For a discussion of euro note printing, see European Central Bank (2007a). It is worth mentioning that some Federal Reserve District Banks, despite their eighty-four-year historical advantage over the euro system, sustain branch operations that may no longer serve a clear economic purpose.

26. Christian Noyer: “We have a center, but the operations are made in the national central banks. We don’t need to concentrate actions geographically (in contrast to the U.S. example in New York) because we have been born in a time of highly sophisticated telecommunication networks and computer systems, so it’s easy to do that without concentrating the operations.”

## 9.4 The First Decade of Performance

Axel Weber: “I think the success is the high degree to which price stability has been achieved. . . . Long-term inflation expectations have been stable and low and anchored at the level defined as price stability.”

Hans Tietmeyer: “From the beginning, the ECB was seen inside and outside the euro area as independent and credible.”

Fabrizio Saccomanni: “The euro is now considered to be an important currency with a global role.”

Timothy Geithner: “[S]ince the ECB has been setting monetary policy, it has not produced a sustained period of subpar growth; the euro area has not experienced greater volatility of economic growth; and there has certainly not been any erosion of inflation performance. These may not be the only measures of central bank credibility, but they suggest that the ECB is performing well.”

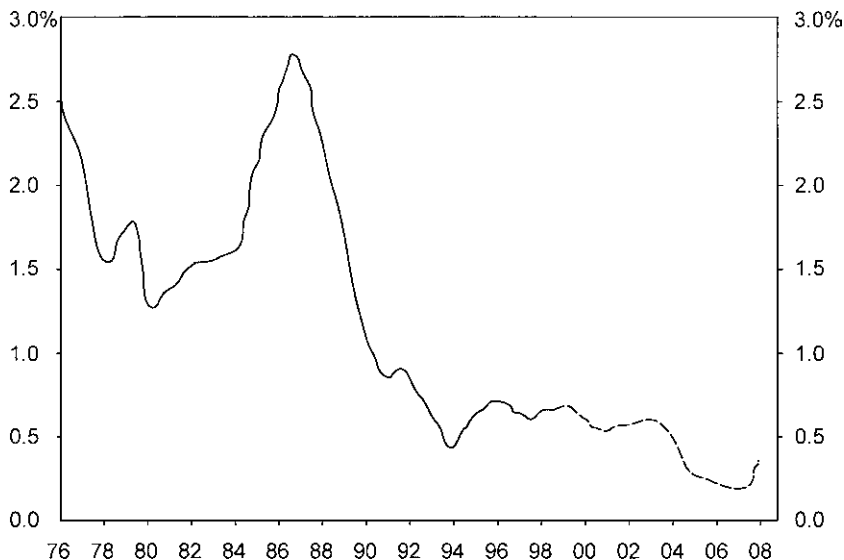
A review of the euro area outcomes in the first decade of the ECB yields a positive appraisal of ECB monetary policy, particularly in light of the extraordinary initial conditions from which policy evolved.

### 9.4.1 Inflation Record

The inflation record is straightforward. Over the period since 2001 (assuming that ECB policy typically affects prices with a lag of about two years), HICP inflation has averaged 2.3 percent, modestly above the ECB’s official target of “less than, but close to 2 percent.” During that period, headline inflation ranged from a trough of 1.6 percent in 2004 to a recent peak of 3.7 percent amid a record oil price shock. For comparison, in the pre-EMU period 1991 to 1998, headline inflation averaged 2.6 percent and ranged from 0.8 percent to 5.0 percent.<sup>27</sup> Even in Germany, which boasts the preeminent pre-EMU inflation track record, inflation has been lower and far more stable in EMU: under the Bundesbank, German inflation averaged 3.4 percent from 1965 to 1998 (with a standard deviation of 3.4 percent), while German inflation since 2001 has averaged 1.8 percent (with a standard deviation of only 0.6 percent).

The stability of euro area inflation can be seen in the broad decline of its rolling standard deviation during the ECB years (see figure 9.1). Other nominal variables, such as GDP, display a similar pattern. This remarkable steadiness is consistent with the evidence of reduced inflation persistence in many countries, including the largest euro area members (see Cecchetti et al.

27. Euro area core inflation as measured by the HICP excluding energy and raw food averaged 1.8 percent from 2001 to 2007, remaining within the 1 percent to 2 percent range in seventy-one of eighty-six months. By contrast, from 1991 to 1998, core inflation averaged 2.9 percent and was in the 1 percent to 2 percent range only twenty-eight out of ninety-six months.



**Fig. 9.1** Five-year moving standard deviation of annual HICP inflation, 1976–2007

Sources: European Central Bank, Eurostat, and authors' calculations.

2008). Yet this phenomenon should *not* be attributed primarily to external factors. Indeed, the treaty's mandate and ECB commitments likely helped to embed this stability in long-term inflation expectations at an early stage.

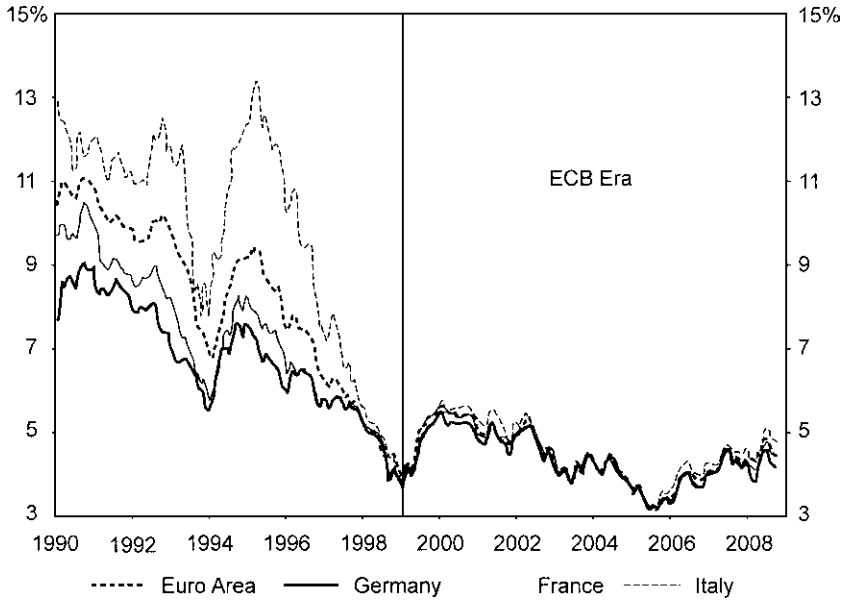
Even prior to EMU, long-term government bond yields had converged to levels consistent with low euro area-wide inflation, rather than to some weighted average of the yields of the high and low inflation countries (see figure 9.2). By the start of EMU, the euro area yield curve also appeared consistent with that of the yield curves of the lowest-inflation countries (see figure 9.3).

This profound market confidence also is evident in the stability of inflation survey data, which has been anchored very close to the ECB's objectives. For example, the ECB's Survey of Professional Forecasters' mean projection of long-term inflation has been stuck, with the exception of a single quarter, in a tiny 1.8 percent to 2.0 percent range since the survey began in 1999.<sup>28</sup> Even the oil price shock of 2007 to 2008 so far has failed to dislodge these expectations, while surveys of long-term inflation expectations in the United States have crept to the highest levels in more than a decade.

In light of the trying economic circumstances of the past decade, the

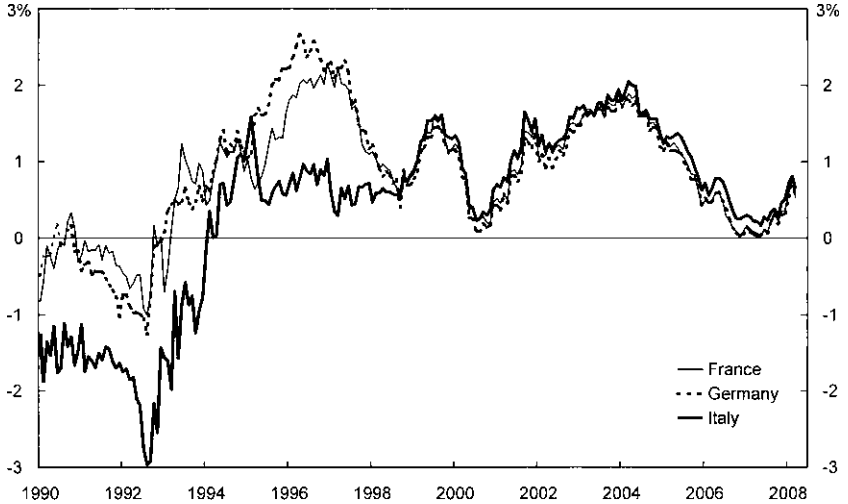
28. Andrew Crockett: "In some respects, the credibility of the ECB could be said to be even greater than that of the Federal Reserve. Inflationary expectations in the United States are further away from the so-called comfort zone of the Fed than European inflationary expectations are away from the ECB's target."





**Fig. 9.2 Ten-year government yields, January 1990–March 2008**

Source: Ecwin.



**Fig. 9.3 Slope of selected yield curves (ten-year minus two-year gov. yields), January 1990–March 2008**

Sources: Ecwin and authors' calculations.

achievement of low and stable inflation in the euro area most likely reflects good monetary policy, not good fortune. Several factors make this assessment compelling. First, since its inception, the euro area experienced large (and occasionally record) price shocks from developments in energy, commodity, and currency markets—not unlike the Great Inflation episode. Second, the economy's persistent rigidities resulted in a low level of potential growth.<sup>29</sup> Third, the loss of country-level monetary independence eliminated a potential remedy for idiosyncratic shocks. Fourth, rather than benefiting from fiscal reforms, the region exhibited fiscal fatigue (partly reflected in the relaxation of the euro area's fiscal compact—the Stability and Growth Pact, or SGP). Finally, the ECB endured repeated interventions by various regional politicians that might have weakened the credibility of a central bank less ardently committed to independence and price stability.<sup>30</sup>

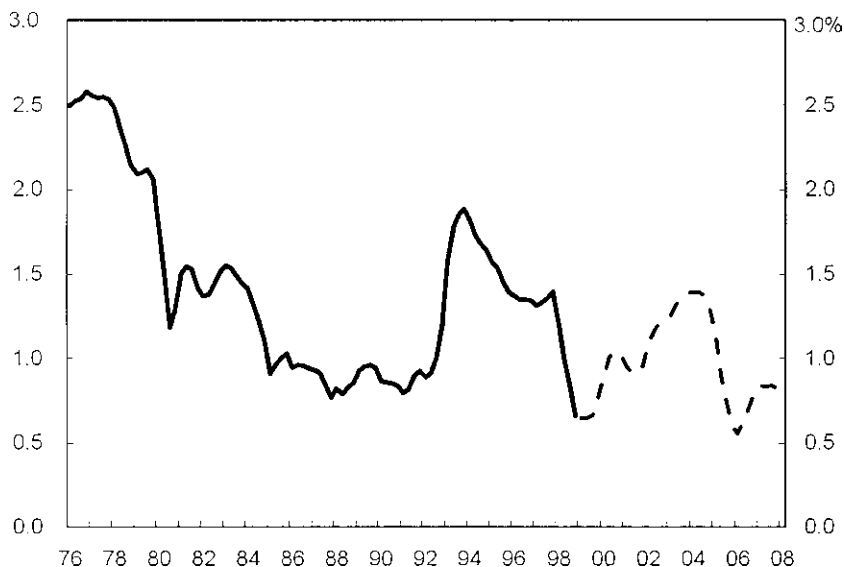
Some outside observers have criticized the ECB for exceeding its inflation objective, and for not resetting its objective in line with actual practice on the occasion of the 2003 policy review (see Galí et al. 2004). During the deflation scare, others suggested that the target was set too low to allow for efficient cyclical and competitive adjustments in some regions without favoring a disruptive decline of prices and wages (see European Economic Advisory Group 2003). Our own judgment is that while the lingering asymmetry of the ECB's objective may not be optimal, in the absence of any credible deflation threat it is unimportant. It seems fair to conclude that the ECB has been very successful—at least until 2008—in keeping inflation stably close to its goal over the first decade. Considering the uncertainties and doubts that preceded the ECB's existence, EMU skeptics must view this achievement as stunning. More important, low nominal bond yields and reasonably stable wage-setting in the face of record commodity price shocks confirm that capital and labor markets have confidence in the ECB's low-inflation commitment.

#### 9.4.2 Dividends of Price Stability

Consistent with the Great Moderation literature, Cecchetti et al. (2008) note that the stabilization of euro area inflation has been associated with a continued low level of output volatility compared to the Great Inflation

29. The following comment of Hans Tietmeyer is representative of views expressed by the majority of our interviewees: "My real disappointment relates to the domestic policies of some national governments, especially regarding inappropriate fiscal reforms and not creating appropriate conditions for more dynamic and flexible markets."

30. On this point, our interviewees were unanimous: on no occasion did the ECB alter policy as a result of strains with European politicians. Lucas Papademos: "My colleagues and I are very attached to the principle of central bank independence. Appropriate monetary policy decisions are best taken within an institutional framework that effectively safeguards this independence. Attempts by political leaders to influence ECB decisions will either have no effect or they may be counterproductive."

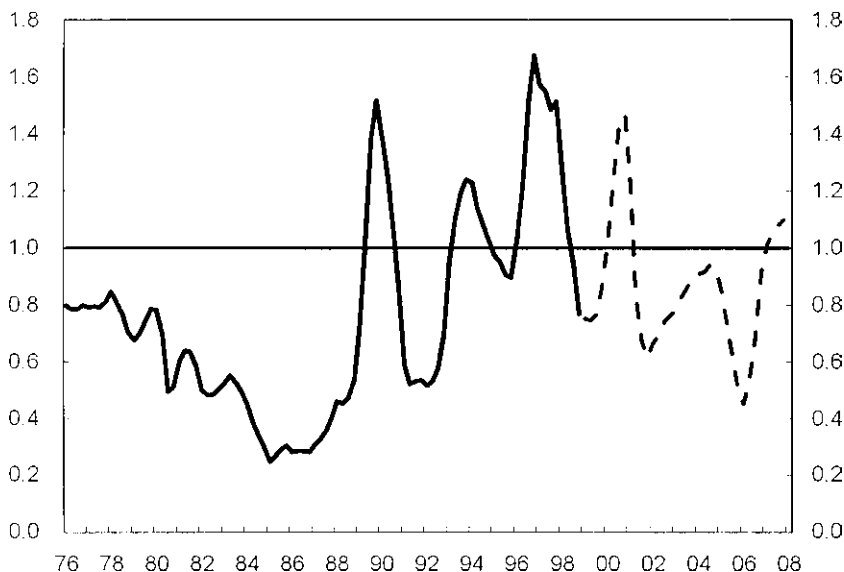


**Fig. 9.4** Five-year moving standard deviation of real GDP, 1976–2007

*Source:* European Central Bank and authors' calculations.

period (see figure 9.4). As just mentioned, the plethora of shocks that hit the euro area economy in this period appears to undermine claims that this outcome is merely a result of good fortune. The largest shocks include the bursting of the global equity bubble, global recession, terrorist attacks, war in Iraq, a deflation scare that triggered unusually low global policy rates, and large currency swings. Yet the low level of euro area GDP volatility compares favorably even with the widely acknowledged U.S. example (see figure 9.5). Under the ERM regime of the early 1990s, large changes in the value of the U.S. dollar had occasionally created stresses across European bond markets and cross-exchange rates that added to output volatility. The single currency regime appears to have counteracted such stresses. We agree with Cecchetti, Flores-Lagunes, and Krause (2006) that improved policy under the ECB shifted the euro area to a better trade-off between the variability of inflation and the variability of output.

By securing price stability, ECB policy contributed indirectly to many other advances in euro area welfare. One example is the progress in capital markets and the financial system. Government bond markets appear to have been largely integrated at a very early stage in EMU. Legal and other obstacles still inhibit the integration of some markets, especially for corporate equities. However, the rapid expansion of markets for corporate bonds and for many derivative instruments over the past decade partly reflected the stable euro area economic environment. The breadth and depth of



**Fig. 9.5 Real GDP volatility—ratio of euro area to United States, 1976–2007**

*Sources:* European Central Bank, U.S. Bureau of Labor Statistics, and authors' calculations.

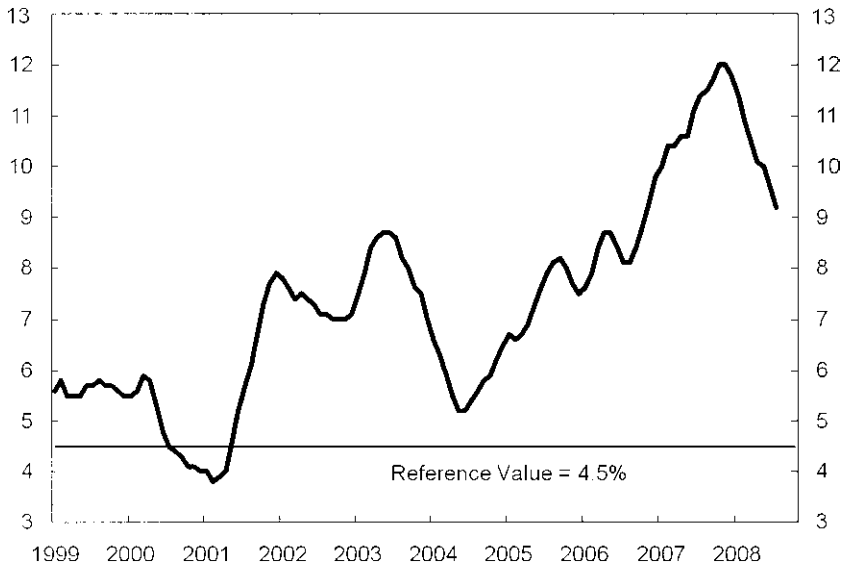
these markets facilitate the efficient allocation of savings in the region. The gradual evolution toward banking integration also contributes to regional efficiency.

#### 9.4.3 Monetary Pillar: Did It Matter?

One issue that may affect future policy strategy is the performance of the monetary pillar in the first decade.<sup>31</sup> Compared to the 4.5 percent reference value for M3 growth set at the start of EMU, M3 growth averaged 7.4 percent since 2000 and exceeded the reference value in eighty-eight out of ninety-seven months (see figure 9.6). Because the overshoot did not prevent the ECB from achieving a high degree of price stability, one may safely conclude that it did not prompt the ECB to become overly restrictive.

From this pattern, it is clear that the ECB's use of its monetary pillar has been far from mechanical. The ECB policymakers, notably Issing (2004) and Stark (2006), have emphasized that the prominent role of money in their strategy aims at underscoring policy's "medium-term orientation," while taking account of the potential links between money and credit growth and asset price bubbles. The ECB staff research (Fischer et al. 2006) discusses

31. Alexandre Lamfalussy's comment is representative of the views inside the ECB in the early days: "I have always been in favor of the two-pillar approach in terms of strategy. I use economic analysis and then cross check it by examining the monetary aggregates."



**Fig. 9.6 Annual growth of M3 (three-month centered moving average), 1999–2007**

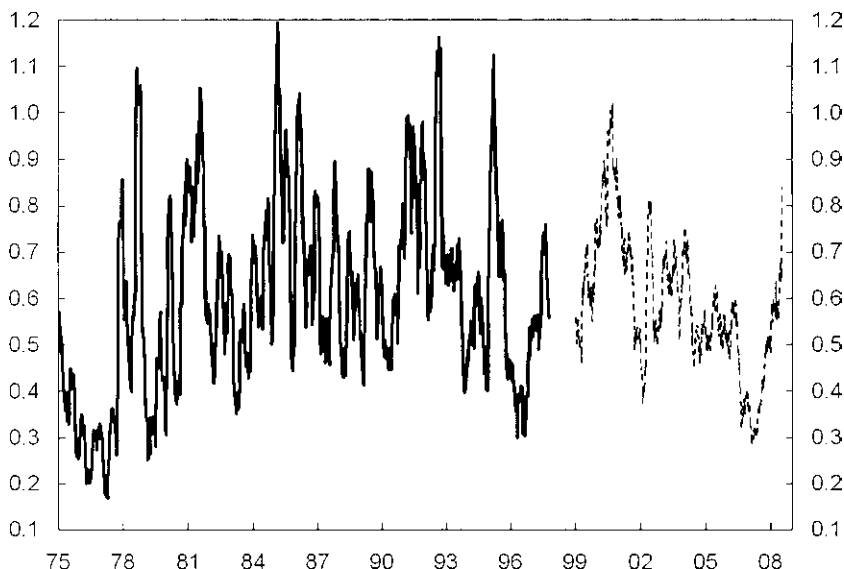
*Source:* European Central Bank.

the complex and evolving analysis that the central bank devotes to monetary developments as a “cross check” for other inflation indicators.

However, the complexity of the procedure—which involves the estimation of underlying trends in monetary aggregates adjusted for portfolio shifts—likely makes any policy response to monetary developments less predictable. Without adjustments to the aggregates, money-based forecasts typically overpredicted inflation, while the adjustments may be large and occur with some time lag. In turn, market uncertainty about the ECB’s response may reduce the effectiveness of policy, because ECB behavior is less likely to be reinforced by market anticipations. For example, Andersson, Hansen, and Sebastyén (2006) found euro area bond markets to be insensitive to news about M3 announcements. To the extent that the ECB actually responded to monetary news, the response appears to have been received in the euro area bond market as an unanticipated policy disturbance, despite the prominent role of the monetary pillar. In this sense, the pillar has yet to be defined in an operational manner that elicits market understanding.

#### 9.4.4 Currency Considerations

The performance of the ECB cannot be divorced from the role of the new currency, which instantly became the world’s second-most important store of value and means of payment and has continued to rise in importance since inception.



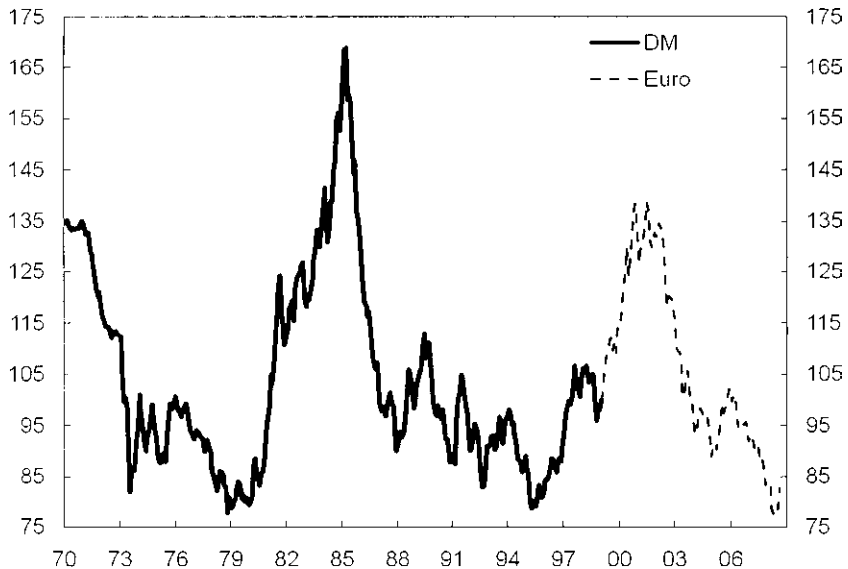
**Fig. 9.7** Three-month moving standard deviation of euro/US\$ and DM/US\$ exchange rates, January 1975–March 2008

*Sources:* ECB, Federal Reserve, and authors' calculations.

The fluctuations of the foreign exchange value of the euro during its first decade of life are surely relevant for future policy strategy. Prior to EMU, some observers expected that the reduced importance of the currency for euro area-wide activity would downgrade its impact on policy, hinting that currency volatility versus the dollar would rise compared to, say, the Deutsche Mark. In fact, there is little direct evidence of increased volatility (see figure 9.7). Taking January 1999 as a base of 100, movements in the real euro/dollar exchange rate have been large, ranging from an index trough of 83 in 2008 to a peak of 139 in 2001, but the order of magnitude of these swings does not appear out of line with patterns in some earlier periods (see figure 9.8).

Broadly speaking, the ECB in its first decade has been as inclined to intervene directly in currency markets as the Federal Reserve (or U.S. Treasury); which is to say, not very.<sup>32</sup> From an operational and international coordination perspective, our interviewees highlighted the flexibility that the ECB demonstrated in joint operations to support the euro in its early years. Yet direct market intervention was rare: multilateral intervention occurred only once (on September 22, 2000), when there was a clear sense that the euro was undervalued. While unilateral intervention may have taken place on other

32. See Bini-Smaghi (2007) for a discussion of euro system intervention policy.



**Fig. 9.8** Inflation-adjusted euro/US\$ and DM/US\$ exchange rates (January 1999 = 100), 1970–February 2008

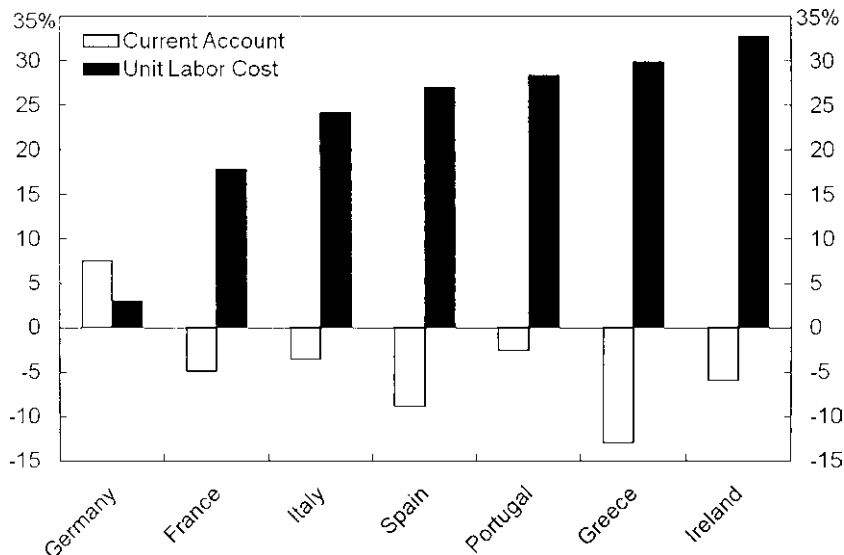
Sources: Deutsche Bundesbank, European Central Bank, U.S. Bureau of Labor Statistics, and authors' calculations.

occasions, we are aware of only one instance (on November 3, 2000) that was reported in the ECB's *Monthly Bulletin*. Verbal intervention was more frequent, but one study viewed early statements by ECB officials as merely adding to currency volatility, with little persistent impact on the exchange rate (see Jansen and de Haan 2003). In recent years, ECB officials occasionally have jawboned in an attempt to slow the euro's rise, but have not capped the climb. In real, trade-weighted terms against a broad range of currencies, the euro has appreciated by about 5 percent from its start in 1999 and by 28 percent from its trough in November 2000.

#### 9.4.5 Disappointments: Outside the ECB

The most frequently expressed disappointments about the euro area in its first decade have nothing to do with ECB monetary policy per se: namely, the lack of structural and fiscal reforms and the lack of concomitant progress toward political union.<sup>33</sup> Many of our interviewees contrasted the European Union's ambitious Lisbon Agenda with the scattered, desultory character of actual supply-side reforms and the frequency of backsliding.

33. An indicative quote comes from our interview with Edward George: "[T]he problem is not the functioning of monetary union in a narrow sense, but the performance of the wider economy given the lack of political consensus that I think you need for successful economic management."



**Fig. 9.9 Selected EMU members: Changes in current account balances (share of GDP) and unit labor costs (percent), 2007 vs. 1998**

*Source:* EU Commission Ameco database.

Some expressed concern that the region's low potential growth would lead observers to blame the ECB because of the need for policy to tighten even at early stages of recovery. Judgments about fiscal policy have been less negative than pre-EMU skeptics feared, but the lack of consolidation in some high-debt countries remains notable, especially amid renewed divergence between several national economies (see figure 9.9). The relaxation of the SGP and the decentralization of the region's fiscal arrangements only add to doubts about coordination and the prospects for future consolidation.

In contrast to what many EMU advocates anticipated, there is little doubt that progress toward political union has not kept pace with monetary union.<sup>34</sup> From the ECB's perspective, this pattern complicates efforts to secure broad popular support. In a democratic society, public backing is critical to ensure the independence of a central bank over the long term. While the Maastricht treaty provides the ECB with a very strong foundation, the ECB lacks the natural constituency that the most credible national central banks typically enjoy, especially when confronted by politicians with a shorter horizon. The ECB's efforts to communicate help to build that popular support, but this

34. Axel Weber: "Regarding disappointments, in contrast to my initial expectation as an outside observer, the creation of EMU did not have a significant impact on further political unification in Europe. The catalytic role of the euro, not just in financial markets but also in the political sphere, was something that I expected to gain some stronger momentum in the first ten years. Looking back, it hasn't."



process may take decades and will almost certainly be less rapid than in a period of speedier progress toward political union.<sup>35</sup>

## 9.5 The Challenges Ahead

Over the next decade, the ECB will face many of the policy challenges common to all major central banks. From time to time, we expect that it will: (a) reassess and refine the strategy employed to secure its treaty-mandated objectives; (b) improve its models of the euro area economy, taking account of structural changes induced by the integration of Europe and by trends such as global economic and financial integration; (c) advance the frontiers of research and central bank practice to understand how asset prices and other financial developments should be integrated into policy decisions; (d) regularly reassess the outlook for price developments and recalibrate its policy stance consistent with its objectives and strategy; (e) manage liquidity as a lender of last resort when crisis threatens; (f) communicate its understanding and its policy thrust to the public at large to foster accountability and make policy effective; and (g) cooperate with policymakers outside the euro area to address issues of mutual interest, ranging from financial stability to exchange rate developments to the operation of official international financial intermediaries. These issues are of great interest, and the ECB likely will make important contributions to global “best practice,” while also benefiting from the successes of other central banks.

In the remainder of this chapter we focus on challenges for the ECB that *differ* substantively from those facing other major central banks. The concerns identified by our interviewees as likely to pose special challenges for the ECB exhibit some variation, but two stand out: (a) enlargement, and (b) the complex framework for addressing financial instability. A variety of other matters received attention, but less broadly. These include the need to develop and secure a popular basis for the ECB, the need to manage a low-growth region facing competitiveness challenges and regional divergences, difficulties of fiscal coordination, and potential conflict over currency matters with ECOFIN, among others. We address each of these in turn.

### 9.5.1 Enlargement

Jean-Claude Trichet: “We are 27 countries in the European Union. In the euro area, we are 15. Of the 27, 25 have no opt-out clause. The challenge is to progressively absorb all the newcomers: none of them has an opt-out clause. At the same time it is imperative to preserve the credibility of the euro area as a whole by strictly respecting the conditions of entry, the Maastricht criterion.”

35. Philipp Hildebrand: “[T]he big challenge for the ECB remains that it does not have a natural (or national) constituency in the population.”

Otmar Issing: “It was extremely important to have an automatic rule which determines who will vote when. That rotation rule is in place and can be applied when the number of members reaches 21. Discussion rules can be changed anytime. New people will find reasonable solutions.”

Lucas Papademos: “As the euro area expands and the number of Governing Council members increases, it may be more efficient to take decisions by voting rather than by forging a consensus as is presently the case.”

Enlargement will affect the euro area and the ECB in many ways. By virtually any metric, it will add to the region’s diversity (whether the focus is on language, culture, or legal systems). From an economic perspective, a twenty-five-country currency area will form the world’s largest in terms of GDP, with a population of about 500 million, compared to around 300 million in the United States. The ratio of per capita incomes between the richest and poorest members would widen to nearly 13 from less than 4, based on recent data (see figure 9.10).<sup>36</sup> The speed of integration of product, labor, and financial markets may quicken, accelerating structural change. And each new euro area member will bring with it a new fiscal agent and a parliament. Among other things, this expansion will increase incentives for free-riding, thereby complicating any constitutional changes that would require unanimity.

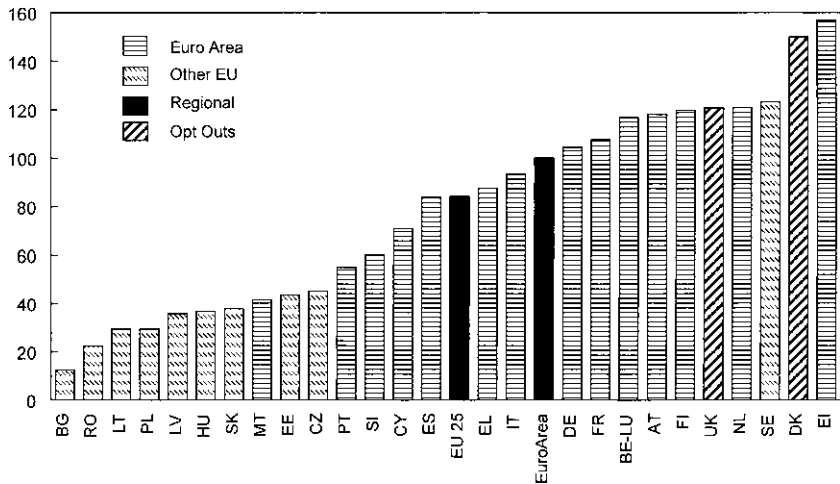
Naturally, the need to assess the preparedness of prospective members will repeatedly revive the issues that confronted the European Council ahead of EMU: What degree of convergence has been achieved, and what is needed to satisfy the treaty’s provisions? Although we did not explicitly pose this question, our interviewees reported no reason to expect that convergence prerequisites would be relaxed in the future.

Against this background, the ECB has established a set of voting rules—essentially a rotation structure for NCB governors that resembles the voting practices of the U.S. Federal Open Market Committee. In this sense, the ECB is well ahead of other political structures in the European Union—including the European Council and the ECOFIN—that also may experience stress as their membership becomes larger and more diverse.

Nevertheless, in the absence of further reforms, enlargement threatens to make the ECB less nimble.<sup>37</sup> The large number of voting parties (capped at twenty-one in December 2002), and the larger number of potential discussants in the Governing Council (which includes nonvoting Governors), will tend to complicate decision making. If increased membership makes policy debates interminable, it may not take long for the Governing Council to

36. This calculation excludes Luxembourg, which has the euro area’s highest income per capita.

37. Philipp Hildebrand: “Making the institution function well as it enlarges will be a very big challenge. As the membership increases, at some point, there will be an inevitable need to look at institutional reform to make sure the organization can remain nimble and effective.”



**Fig. 9.10 European union: Per capita income by country (euro area average = 100), 2007**

Source: IMF.

adopt mechanisms for speeding discussion. Over time, efficiency considerations likely will boost pressures to shift from a “consensus” model to a voting model for making policy choices.<sup>38</sup>

The committee process, which still requires Frankfurt visits by NCB staff to achieve consensus and make decisions outside of the narrow arena of policy rate determination, poses a greater challenge. Innovative approaches that delegate authority (or monitoring responsibilities) to subgroups that do not include all twenty-five national representatives may become more frequent. One past example of such cooperation has been the development of TARGET II undertaken by a subset of ECBs and then distributed to the euro system as a whole.

Yet it remains to be seen whether an increasingly diverse membership will be prepared to delegate authority across a broader set of tasks. How will the enlarged membership affect the consensus on issues such as the quantitative definition of price stability or on the policy strategy? How will ECB decision practices evolve? How will membership of the Executive Board evolve to reflect enlargement? Will it become more difficult to reach consensus on the appointments of top ECB officials? Will trends toward economic divergence for some existing euro area members intensify or diminish as membership rises? How will the difficulty of coordination among twenty-five fiscal agents affect monetary policy? Will a larger number of more diverse

38. The possibility of a future shift toward a voting model was mentioned by more than one interviewee.

members exposed to idiosyncratic shocks raise the chances of a national fiscal crisis, widen market yield spreads, and, in the extreme, lead to a test of the Maastricht treaty's "no-bailout" provisions?

Enlargement will be a particular challenge in the area of communication. Even today, no other central bank faces the task of communicating with the public at large in fifteen different countries. While the presence of NCB governors at the ECB is helpful, it is far from a panacea. As our interviewees observed, speaking to local governments or populations is fundamentally different than communicating with financial markets. As we noted earlier, the lack of synchronization in this effort in the early years of the ECB may have created market confusion on occasion. Regardless of their current cyclical circumstances, diverse national histories may prompt different constituencies to view identical policy statements as accommodative or restrictive. If the longest-run challenge of the ECB is to secure a popular base, as several interviewees suggest, then enlargement only intensifies that challenge.<sup>39</sup>

Against this background, we do not expect the ECB to publish minutes, detail the statements or votes of Council members, or announce an expected policy rate path anytime soon. However, policymakers may choose to consider other means of reporting on policy-related discussions that better reveal the range of Council views without inviting invidious political attacks against individuals. For example, information about the evolving strength or weakness of the policy consensus could affect forward-looking financial markets in a fashion that would enhance the effectiveness of policy.

Of course, the EU itself may expand beyond its current membership of twenty-seven. We expect that new entrants to the EU will wish to join the euro area at an early stage to secure the benefits of its credibility. Consequently, the enlargement challenge is both unique and open-ended.

### 9.5.2 Financial Stability

Jaime Caruana, "When I was going to Frankfurt as a central banker, my role was clear. I had to vote for the best monetary policy for the euro zone. When I participated in financial stability discussions, my role was clear: as the Spanish banking supervisor, my mandate in the Spanish law was to defend the Spanish banking system. I was accountable to the Spanish Parliament. Fortunately, protecting the Spanish banking system was consistent with protecting the European one, but I think that introducing some balance, some European mandate would be better."

39. Beyond enlargement per se, several interviewees expressed concern that politicians and the public at large would forget how difficult life was before monetary union. Ignazio Angeloni: "Over time, I think that people will start forgetting the benefits and the advantages of belonging to the euro. They will forget how difficult it was to manage their own currencies. I am talking about particularly those that had unstable exchange rates. They will forget the times of high interest rates due to currency challenges. And they will start thinking that perhaps without the euro they can be better off. Unavoidably, I think there will be political elements in national politics that will try to exploit anti-euro public opinion sentiments."

Christian Noyer: “We need to have the same rules. Even if we had a single supervision authority, it would not solve the problem simply because there are differences in the regulations. The single authority would have to implement 15 different legislations of regulation. Unifying the rules is certainly the first thing to do.”

Axel Weber: “We need an evolving European structure of banking supervision. When the banks become more international, more pan-European, so will banking supervision. This is an evolution that will become more important in the future.”

Jean-Claude Trichet: “At this stage, what we are calling for is a close relationship—intimate cooperation between the banking surveillance authorities themselves, and very close links with the central bank, including a full transfer of information.”

Our questionnaire (drafted in the spring of 2007) highlights concerns about the euro area’s framework for financial stability that predated the global crisis that began in August 2007. At this writing, that crisis is testing the industrial world’s stability apparatus more broadly, intensively, and persistently than any prior experience in the postwar period, and certainly far beyond what any simulation or diagnostic stress test likely would achieve. As a result, the crisis has revealed important strengths of the euro area stability mechanisms, but has not reduced our unease about vulnerabilities in this framework.

Because these concerns are largely shared by our interviewees, we are confident that the ECB will seek aggressively to approach “best practice” in this area, as it has in other matters. However, continued progress toward financial integration, in the context of a fragmented and complex stability framework, probably makes this goal the most important as well as the most difficult one for the ECB over the next decade. Failure to advance the stability framework—which is a task that goes far beyond the limits of what the ECB alone can achieve—could involve large costs for the region as a whole and could reduce the competitiveness of euro area financial centers.

In the area of liquidity provision as a lender of last resort, recent experience has highlighted important ECB successes. In August 2007, the ECB boosted liquidity supply early and aggressively to counter sharp increases in funding rates as banks turned cautious and alternative private sources of funding shut down. The ECB’s Bagehot-style marginal lending facility (MLF, designed to cap overnight rates in normal times) can be viewed as an automatic mechanism for calming liquidity fears in a crisis.<sup>40</sup> In order

40. Vitor Gaspar: “If you look at the functioning of the ECB’s marginal lending facility and you compare with the prescriptions from Bagehot on the functioning of the lender of last resort, there should be no need for any ambiguity concerning the lender of last resort function. The lender of last resort is simply subsumed within the regular functioning of the operational framework.” See also Gaspar (2006).

to deliver liquidity effectively, the ECB utilized the broad flexibility that it enjoys with respect to assets that it may accept as collateral or acquire outright, including a variety of asset-backed securities.<sup>41</sup> Beginning in December 2007, the ECB also cooperated with other central banks, including playing a role in distributing dollar liquidity to banks in its region.

As term euro rates surged, the ECB was compelled to engage in fine-tuning operations that supplied an extraordinary volume of liquidity, suggesting that intermediaries became reluctant in the crisis to use the anonymous MLF. The ECB's actions also did *not* prevent term money market spreads from widening in a persistent fashion once the crisis began in earnest. Unlike the Swiss National Bank, for example, the ECB did not alter its overnight rate target to stabilize term money market rates. The effect has been a tightening of money market conditions that policymakers did not explicitly seek.

Yet the ECB could have avoided this outcome (by lowering policy rates) if it had wished to do so. The ECB's willingness to tolerate a rise in term money market rates (and to consider *increasing* the key rate on repurchase agreements) highlights the extent to which it has distinguished between the provision of crisis liquidity and the setting of policy rates. Moral hazard concerns still would arise if the ECB appears compelled to compensate for uncertainty about systemic vulnerabilities by generous liquidity provision. Even so, it seems fair to conclude that the ECB's tool kit for liquidity supply has been crisis-tested and satisfies current "best practice" standards among central banks.

At the same time, other, potentially more troubling aspects of the euro area stability framework have been brought to light in this episode.<sup>42</sup> In contrast to liquidity matters—which lie clearly within the ECB's mandate—solvency matters are addressed exclusively by national institutions, which may have different views about what constitutes a systemic threat and about how and when public resources should be employed.<sup>43</sup> The fact that there is no euro area fiscal agent means that burden-sharing across nations would be a challenge should a large (truly European, rather than national) institution become unstable. In many, but not all, euro area countries, the NCB is the banking supervisor, but few NCBs also supervise nonbank financial institutions or securities markets.<sup>44</sup> Rules for supervision are made at the country level, and have not been fully aligned across the euro area despite

41. See European Central Bank (2006a) for a description of collateral rules. We note that the Federal Reserve's liquidity-supply mechanisms have evolved during the crisis to become more like the ECB's both in terms of acceptable collateral and the range of counterparties.

42. For a view that regulatory competition contributed to recent financial excesses, see Tabetini (2008).

43. Several interviewees expressed concern about the difficulty in identifying insolvency.

44. It also remains to be seen how the ECB and an NCB, which implements any lending to specific institutions, would balance the needs for overall monetary control and for liquidity supply to a troubled institution should its requirements be large.

the existence of some common financial directives. It is even conceivable that conflicts could arise between the national mandates of some NCB governors in their role as supervisors and the mandate imposed by the Maastricht treaty in their role as members of the ECB Governing Council.<sup>45</sup>

As our interviewees stressed, there is little or no political will to replace this fractured supervision and crisis management framework with a more centralized one. In fact, it is not even clear that the presence of a single supervisor would successfully resolve the time-sensitive information and coordination problems that are inherent in financial crises.<sup>46</sup> At present, even the largest financial institutions typically still have an identifiable national home, while mid-sized and small institutions usually operate locally and can be monitored by an expert familiar with local conditions and traditions. Finally, no supervisor anywhere has the means to address the costs of insolvency.<sup>47</sup>

Against this background, many interviewees favored a gradual, long-term shift toward greater supranational supervision, particularly as financial integration advances. However, there was a strong practical consensus that, for the foreseeable future, the ECB should aim to help the existing highly decentralized system become sufficiently effective so that it can act as one in a crisis.

Crisis management in a decentralized system is a daunting challenge that will require the cooperation and support of many policymakers—including legislatures—to limit the potential damage to the euro area from a financial crisis. In this context, the ECB has sought to cooperate closely with European supervisors to ensure the timely flow of information to decision makers in a crisis.<sup>48</sup> Even when the supervisory function is performed by an NCB—directly ensuring the euro system’s involvement—the timely flow of information necessitates a well-defined set of procedures and practices that are understood in advance. For example, the central bank’s reputation could

45. In the recent crisis, there was one potential institutional risk that reportedly was conveyed to the ECB only *after* the risk had subsided and shortly before it became public.

46. While there was substantial disagreement among the interviewees over the desirability of a pan-European regulator, even those in favor of consolidation expressed doubts that such an institution would come into existence anytime soon. Several respondents did suggest a certain inevitability in the process. Jaime Caruana: “I stated publicly when I was [at the Bank of Spain] that either we would find a system that works like a one-regulator system in Europe, or we will end up having one regulator in Europe.”

47. Fabrizio Saccomanni “There is obviously great concern by political leaders that they may be confronted with a ‘European’ financial crisis of which they know nothing and for which they might be required to bear a financial burden that would involve taxpayer money.” Andrew Crockett: “It is not clear what would happen in the event that a substantial-sized European financial institution got into life-threatening trouble.” Jean-Claude Trichet. “There is no taxpayer money at the level of Europe as a whole.”

48. Alexandre Lamfalussy: “In crisis management situations, the flow of information is extraordinarily important and there is a natural tendency of each group who possess information to hold it back as long as feasible. That’s instinct: Hand it over only when necessary. This is not helpful, so here we might have a problem.”

be put at risk if an insolvent institution were able to exploit the marginal lending facility (even temporarily) because the ECB lacked knowledge of the circumstances.

In recent years, the ECB has helped prepare for episodes of financial instability by promoting cooperation among supervisors and the central bank.<sup>49</sup> The Committee of Bank Supervisors, which meets at the ECB, is one example. The ECB also has been a party to Memorandums of Understanding (MoUs) with supervisors and fiscal agents that promote cooperative behavior and help clarify responsibilities in a crisis. Also, the ECB has cooperated with supervisors in simulation exercises or stress tests to prepare officials for a crisis. Going forward, the ECB can seek to promote a unified, best-practice approach among supervisors in collecting and assessing information about the institutions under their purview. Such a common methodology—akin to the guidelines and materials developed by the Federal Reserve for the supervisors in its District Banks—would appear to be a prerequisite for efficient information flow in a crisis.<sup>50</sup>

The ECB, like any lender of last resort, has to be concerned lest its preparations and plans for addressing crises prompt moral hazard. Even so, some interviewees thought that the complexity and decentralization of the stability framework favored the development of a “handbook” for crisis response, combined with clarity about the chain of command in a crisis. Agreement on such a structure would require the mutual assent of many parties, because it is not set in law as a euro area standard. Without it, however, policymakers may not know who is in charge. Moreover, the lack of accountability would diminish the incentives to manage effectively. The task of balancing such preparations and crisis flexibility against moral hazard risks is difficult even where the crisis chain of command is clear, but seems even greater where it is not.

Managing a future crisis also could be complicated by differing national legal mechanisms and procedures. For example, euro area members have different practices with regard to deposit insurance, bankruptcy, and even court procedures. There also is no common approach for early public intervention in the case of a troubled financial institution, such as the procedures for “prompt corrective action” in the United States or the proposed “special resolution regime” in the United Kingdom.<sup>51</sup> A credible threat of early intervention creates incentives for financial institutions to guard their capital and thereby limits systemic risks. Early intervention rules also could reduce

49. See the relevant articles in the *ECB Bulletin* (2004b and 2007a).

50. In a recent assessment of the financial stability framework, the euro system concludes that “supervisory convergence is a key objective.” See ECB (2007b).

51. For details of the United Kingdom’s proposed special resolution regime, see Bank of England, HM Treasury, and Financial Services Authority (2008). When asked whether an early intervention scheme was needed in the euro area, Jaime Caruana responded that there is a clear need for “some kind of early intervention system where the rules are clear and you know that you have to act rapidly at the beginning.”



“home-host” strains that may arise when banks compete in other national markets by narrowing the uncertainty of host supervisors about the workout procedures and the availability of capital in a crisis. As U.K. policymakers learned from the Northern Rock episode, the lack of an early intervention mechanism can leave policymakers with a painful choice between acquiescing to heightened systemic threats from a bank run or to moral hazard-inducing bailouts of shareholders, debt holders, and management.

Naturally, enlargement will add to the complexity of the euro area stability framework. Accordingly, the ECB also may wish to encourage prospective new members to implement best-practice rules and procedures in this area as they prepare for accession to the single currency.

### 9.5.3 Other Distinguishing Challenges

Otmar Issing: “What is unique for the ECB is the complex environment. For any central bank, be it the Bundesbank, Banque de France, or the Federal Reserve, the support of the people is crucial. But, the ECB still is a young institution, and the euro area is very complex, not least due to the language and communication problem.

Sirkka Hämäläinen: “There are many signs of weaker political commitment: unwillingness to meet the commitments of the Stability and Growth Pact, attacks on the independence of the ECB, or the lack of measures for structural improvements. Monetary policy needs strong political support to be effective.”

Enlargement and financial stability are not the only issues that are likely to affect the ECB differently over the coming decade. The list of unique challenges identified by our interviewees is substantial, and includes popular attitudes toward the central bank, potential for regional divergences in a low-growth region, coordination with fiscal agents, response to currency disturbances, personnel selection, and operational efficiency. In this section we briefly discuss a few of these.

#### *Broadening the Popular Base*

Before the Maastricht treaty was enacted, critics sometimes spoke of a “democratic deficit” to describe a perceived lack of grassroots support for and involvement in the political (and monetary) integration that European leaders sought to realize. This legacy, combined with the complexity of euro area and European governance, boosts the importance of ECB transparency and accountability. Over the long term, no central bank can operate in a truly independent fashion without a modicum of popular support for its objectives and methods. In the case of the ECB, the broader the popular support, the more its policies are likely to appear credible and resilient (and, as a consequence, prove effective).

As previously highlighted, the ECB uses many means to address its diverse constituencies and to garner support. Going forward, if necessity is the

mother of invention, the ECB is likely to be at the forefront in improving central bank communications, because the challenges that it faces are notably greater and more enduring than at other central banks. As our interviewees emphasized, communication in multiple languages and across cultures and traditions is inherently complex, and will become increasingly so as the euro area enlarges. Some national politicians also may view the ECB as an easy target, because it lacks a national constituency that would raise the political costs of ECB-bashing.<sup>52</sup> At some stage, effective ECB policy will conflict with the short-term interests of particular countries or their policymakers. Reduced momentum toward political integration in Europe also exposes the ECB to potential backlash against policy centralization, even when changes in the economic environment—such as increased financial integration—favor coordinated responses.<sup>53</sup>

### *Suboptimal Currency Area*

Critics of the Maastricht treaty bemoaned the lack of European fiscal and labor market flexibility long before the ECB was established. If anything, the track record of EMU's first decade has resulted in less economic and fiscal divergence than many observers, including some interviewees, had feared. However, risks remain because potential growth is low, labor markets are relatively rigid, and there is little scope for fiscal burden-sharing. Moreover, as Papademos (2007) describes, some countries—including Greece, Italy, and Portugal—exhibit divergent trends in the growth of unit labor costs that appear to diminish their competitiveness. Widening current account imbalances are a symptom of this competitiveness problem (see figure 9.9).

The ECB cannot alter its policy rate for the purpose of limiting economic divergence or to boost growth sustainably above potential. Nevertheless, both divergence and low potential growth add to the strains associated with stability-oriented monetary policy, making ECB policies less popular and less credible.<sup>54</sup> In the extreme, economic divergences can prompt a regional fiscal crisis that might test untried portions of the Maastricht treaty, such as the “no bailout” clause. While such a test currently seems a remote possibility, it cannot be ruled out over the long run.

### *Coordination with Fiscal Agents*

In the first decade of EMU, contrary to pessimistic expectations, there were no fiscal crises, and the excessive deficit procedures that began in recess-

52. Philipp Hildebrand: “Politicians face a relatively low cost for attacking the ECB compared to the cost they would face in attacking a similarly credible national central bank.”

53. Axel Weber: “I think politicians very often forget the merits and the advantages of having independent central banks guaranteeing price stability and have not lived in periods where they see the downside effects of high inflation on the economy.”

54. Ignazio Angeloni: “If [cyclical and inflation] divergence persists, it could present problems. I regard these potentially as political risks, political strains.”

sion mostly have been wound down as deficits narrowed cyclically. However, the willingness of fiscal policymakers to relax the Stability and Growth Pact strongly hints at fiscal fatigue. Despite some consolidation, three countries (Belgium, Greece, and Italy) still have gross general government debt ratios in excess of 80 percent of GDP. More importantly, officials have expressed concern about the threat of fiscal unsustainability in some countries as the euro area population ages.<sup>55</sup>

At this stage, there remains little reason to predict an acute challenge, but it is not difficult to imagine circumstances in which difficulties might arise. For example, the threat of a debt deflation could place an excessive burden on monetary policy to secure price stability without coordinated fiscal support. Achieving coordination among fifteen or more fiscal decision makers (or even among a handful of large-country decision makers) makes the ECB's potential challenge more complex than that of other major central banks.<sup>56</sup>

We view the likelihood of a sustained, open conflict between monetary and *aggregate* fiscal policy as remote. As Sargent and Wallace (1981) famously showed a quarter of a century ago, such a conflict can undermine the inflation credibility even of a resolute central bank. Fortunately, there is little reason to anticipate such a clash. For example, recent Eurobarometer polls suggest that when inflation rises, popular awareness helps underpin the ECB's objective of price stability.<sup>57</sup> And despite evidence of fiscal fatigue over the past decade, peer pressure among fiscal policymakers has helped to limit the kind of post-EMU fiscal slippage that many skeptics anticipated.

Against the background of diverging competitiveness, a somewhat more likely (if still highly improbable) scenario would be a rise of market disturbances caused by the loss of confidence in a (group of) fiscal agent(s). Would such a fiscal crisis also threaten the stability of the regional financial system (say, by weakening institutional balance sheets and the credibility of national deposit insurance schemes)? The notable decline of home country bias in euro area debt after EMU almost surely has reduced "concentration risk" in the financial system (see Issing 2006a). Nevertheless, no central bank can afford to ignore the potential linkages between fiscal and financial instability. Consequently, it would be surprising if the ECB became less inclined to advocate fiscal prudence as it seeks to secure price stability.

55. Of current EMU members, a recent European Commission report (2007) that addresses fiscal sustainability and aging populations cited Greece and Portugal as "high-risk" cases. Only Austria, Finland, and the Netherlands were "low risk."

56. Timothy Geithner: "They never resolved fundamentally what was going to be the framework of discipline on the fiscal side."

57. Asked to name the two most important issues facing their country, the share of persons in the euro area identifying rising prices or inflation jumped to 26 percent in the autumn of 2007 (making it the second item on the list), up from 16 percent a year earlier (and a 16 percent average of the previous three years).

*Exchange Rate Considerations*

The euro depreciated considerably in the early years of EMU. However, the ECB has never faced an exchange rate crisis similar to the one in the United States in the late 1970s: (a) a plunging currency; (b) rising inflation expectations; and (c) sharply weakening long-term financial markets. This may reflect another dividend of the ECB's anti-inflationary credibility. However, over the next decade, it is easy to imagine the combination of a continued unwinding of the large current account imbalances that have characterized the global economy over the past decade and an upward revaluation of currencies in some large emerging economies. Discontinuities in this process could test the ECB's ability to work cooperatively with other central banks to limit disturbances in other financial markets and (thereby) to secure economic and price stability.

The key issues for the euro area will be to clarify who decides currency policy and what circumstances, if any, merit currency intervention. The ECB's track record now provides considerable confidence that these issues will be addressed successfully in the future. But the Maastricht treaty's allocation of authority for setting the currency regime to finance ministers leaves lingering uncertainties.

*Other Matters*

We close by mentioning without elaboration three additional challenges that surfaced in our interviews. First, some interviewees pointed to the loss of political will toward European integration as a potential source of added complexity in matters ranging from enlargement to financial stabilization. Second, there was concern that the generational turnover of leadership at the ECB in coming years will focus attention not only on the competence and diversity of new Executive Board members (and senior staff), but also on the potential for rigidities with respect to country representation. While the treaty's mandate for ECB autonomy is very powerful, turnover also creates a risk that politicians least supportive of the ECB would promote candidates less zealously independent. Third, there was the hope that the pace of progress toward operational efficiency will reveal the ECB's ability to overcome national resistance to productivity-enhancing consolidation (e.g., in reducing the large number of physical mints).

**9.6 Conclusions**

John Taylor: "The biggest success has been to set it up from scratch, to deal with the inherent difficulties of communication and different traditions, and to have a policy apparatus which is basically working well in terms of interest rate decisions, et cetera. That has to be viewed as a major achievement. It's the first time anything like that has been done."

Philipp Hildebrand: “I sometimes have the impression that the ECB has more credibility than it gives itself credit for.”

In reflecting on the first decade of European Monetary Union we are reminded of the story of the *Vasa*, the Swedish warship to which a museum is devoted in Stockholm.<sup>58</sup> In an effort to build a symbol of Sweden’s burgeoning naval power, King Gustavus II Adolphus ordered the construction of a large and elaborate ship. No expense was spared. To accommodate the seventy-two cannons cast for it, the *Vasa* was built with two gun decks rather than the usual one. The result was a massive, top-heavy, and unstable ship that the King nevertheless ordered to set sail on August 10, 1628. The *Vasa* sank almost immediately after encountering its first stiff breeze less than two kilometers from port.

There are two morals to the story of the *Vasa*. First, governments occasionally arrange large, prestigious projects that fail infamously. And second, experts do not like to convey bad news to kings or ministers about their pet projects. In the ECB’s case, the Maastricht treaty ventured where no vessel had gone before, but it has worked well. That success presumably is owed to the design and the crew, not to the lack of turbulence.

Our ECB interviewees rightly express pride and satisfaction in their accomplishment. Literally thousands of people worked diligently for years to make monetary union not only a reality, but a success. It is difficult to find major fault with the operational framework or the monetary policy decisions of the first decade of EMU.

Indeed, with the broader perspective of time, many of the criticisms that have been addressed at the ECB appear ancillary in light of the euro area’s track record of low and stable inflation and reasonably stable economic growth. The ECB focused effectively on price stability, while maintaining its treaty-mandated independence. Critics acknowledge that the two-pillar strategy did *not* prompt the ECB to become overly restrictive for any sustained period, despite persistent overshoots of the monetary reference value. And it is doubtful that ECB goal asymmetry is prompting a sustained rise of long-term inflation expectations, as some observers anticipated.

Naturally, policy strategy, implementation, and communication should be routinely reviewed, and there is always room for improvement. Some outside observers have suggested that the ECB missed a key opportunity in 2003 to make greater progress toward best practice. Our own view is that the ECB leadership has demonstrated an open attitude to proposals for reform—including recommendations in the areas of strategy and communications—provided that the proposals adequately reflect the complex political constraints under which the ECB operates.

Ultimately, with successes come new challenges. For the euro system, our

58. For details of the *Vasa*’s history and the museum, see <http://www.vasamuseet.se/InEnglish/about.aspx>.

interviewees highlighted two: enlargement and financial stability. On the first, we see the constant addition of new countries as a tremendous challenge for both communication and policy setting itself. As the euro area expands, the addition of new constituencies that speak different languages and have different customs and histories will complicate communication further. In addition, the more countries there are, the more likely that real divergence at the national level will arise. Also, dramatically different productivity and labor market performance would place substantial stress on monetary union.

Once everything is said and done, the issue of financial stability seems paramount to us. The key problem is one of information and coordination during a crisis, as well as harmonization of procedures. It is extremely unlikely that Europe will create a supranational supervisory authority to complement the ECB in the foreseeable future. In the absence of such a new organizational structure the majority of interviewees anticipated that the current one would need to work *as if* it were a single entity.

Returning to the accomplishments of the first decade of monetary union, our interviewees were unanimous in their conclusion that the ECB has many more successes than disappointments to its credit. We agree.

## Appendix A

### *Questionnaire*

The following questionnaire was drafted in June 2007 and formed the basis for all of our interviews. In every case, we sent the questionnaire with our initial letter requesting an interview. We clearly stated in that letter that we would be happy to omit any question that the interviewee did not wish to answer. In one case, we discussed the questions with the interviewee in advance and agreed on some changes, which are noted in the footnotes.

#### **I. Policy in the First Decade of Monetary Union**

- a. Thinking back to 1998, what did you anticipate would be the biggest policy challenges? Now, nearly a decade later, what do you think the biggest policy challenges were? How did your policy goals evolve over time?
- b. What were the ECB's most important policy successes and disappointments?
- c. How has the decision-making process of the Governing Council evolved? How do the decision processes under the Duisenberg and Trichet presidencies compare? Has the process been smoother or more complicated than initially expected?<sup>59</sup>

59. For some of the interviewees we substituted the following question: How has the decision-making process of the Governing Council evolved over time?"

- d. On occasion, the relationship between the ECB and the political leaders of selected euro area countries has been strained. How have these developments affected ECB policy determination?

## **II. Policy in the Second Decade of Monetary Union**

- a. Looking forward, what is the biggest challenge facing the euro area over the next decade?
- b. Are the ECB's challenges different from those facing a "mature" central bank?
- c. Communication policy is a work in progress for many central banks. Which of the world's central banks do you believe is at the frontier of best practice in communication policy? What aspects of that central bank's policy would you single out as worthy of emulation elsewhere? How do you see the ECB's communication policy evolving over the next few years?
- d. Some observers express concern about the difficulties facing the ECB in personnel matters. How does the role of nationality in personnel selection affect confidence in the ECB and its governance?<sup>60</sup>

## **III. Financial Stability**

- a. Does the euro area face any unusual challenges in promoting financial stability?
- b. Does the lack of direct responsibility for regulatory and supervisory matters create any obstacle for the ECB in pursuing its financial stability objective?
- c. What is the biggest challenge for policy coordination in a crisis? What legal, regulatory, or behavioral obstacles remain for effective coordination?

## **Appendix B**

### ***Common Themes***

Following is a summary of the themes that emerged from our interviews. For each question, we looked for similarities in the responses of the interviewees. Beyond that, we have used our judgment in creating the list. The following results should not be interpreted as implying agreement or consensus among the interviewees.

60. This question was omitted for some interviewees.

## I. Policy in the First Decade of Monetary Union

### a. Thinking Back to 1998, What Were the Challenges?

Strategy, Instruments, Communications were all open issues  
 Unprecedented experiment with little time to prepare  
 No track record (untested operational framework)  
 Absence of data at the outset  
 Uncertain transmission mechanism  
 Challenge of anchoring inflation expectations and creating credibility  
 Potential conflict between the ECB and the NCBs  
 Worries about fiscal policy and the Stability and Growth Pact  
 Concern that entry of many countries would destabilize EMU  
 Skepticism of external observers that the project would succeed  
 Challenge of creating a virtual currency initially  
 Euro area was not an optimal currency area—one size does not fit all  
 Structural inflexibility in the euro area economies  
 Difficulties created by enlargement  
 Hindsight: Goals were stable; optimal currency area fears were overdone;  
 communication challenge underestimated

### b. Important Successes and Disappointments

#### *Successes*

Rapid establishment of credibility and stable goals (mandate + legacy)  
 Overcame external shocks (not just luck)  
 Major advances in data collection and forecasting  
 Transparent policy strategy, especially the quantitative definition of price stability  
 Excellent track record: low inflation, stable inflation expectations, and low inflation volatility  
 Cooperation between the ECB and the NCBs  
 No major errors in interest rate setting  
 An effective decision-making apparatus  
 Operational success in liquidity provision in crisis and foreign exchange intervention  
 Successfully guarded institutional independence from start  
 Effective international cooperation  
 Rapid money market integration; deep bond market integration  
 Euro has become a leading world currency  
 Consolidation of European banking and financial integration  
 2003 reform: altered communication strategy and use of policy framework  
 The euro yield curve was the best legacy yield curve at start



Avoided deflation panic  
Effective personnel selection

*Disappointments*

No internal disappointments  
Lack of fiscal and structural reforms (thereby sustaining low potential growth)  
Teething problems in communication strategy  
Introduction of coins and notes leads to substantial perceived inflation  
Pace of financial integration was not what had been hoped  
Little impact on political unification that some proponents hoped would come  
Lack of understanding of ECB's role vis-à-vis national governments, the NCBs, and the European Commission  
Inflation sometimes above 2 percent  
Lack of a framework for financial stability  
Some signs of divergence

c. Has the Decision-Making Process Evolved?

No major changes in decision-making process  
Effective decision-making apparatus, including the role of the staff  
Proposal power of Chief Economist at the start  
No national arguments on monetary policy  
Early consensus on the policy strategy  
Eclectic, careful vetting of policy  
Consensus does not mean unanimity  
Evidence of rapid decisions in crises  
EMI prep aided consensus  
Evolution of the communication style  
Less effective cooperation on banking and national economic policy  
Infrastructure decisions more problematic

d. Have Politicians Had an Impact?

Little or no impact of pressure on decisions  
Successfully established and maintained institutional independence  
Easy to resist pressure from one country  
Treaty protects ECB well  
Political debate reflects traditional differences  
Political influences can cause volatility and confusion  
Pressures arise from lack of popular support for ECB  
ECB as a cheap target

## II. Policy in the Second Decade of Monetary Union

### a. What are Biggest Challenges Looking Forward?

Maintaining popular support  
 Multi-national communications  
 Enlargement (the agreed upon voting system will help)  
 Maintain price stability in a credible regime  
 Financial stability  
 Real divergence  
 Fiscal and structural issues  
 Loss of political will (slow financial integration)  
 EU growth trend (competitiveness and dynamics)

### b. Is ECB Mature?

Most problems similar to those of other central banks  
 Enlargement  
 Multicountry  
 Selection of next President and Vice President key  
 Transmission Mechanism still uncertain  
 Financial Stability  
 Federal System/Multiple Fiscal Agents  
 Issues outside conventional monetary policy

### c. Is There Best Practice in Communication?

No “one size fits all”  
 Communication policy is by its nature evolutionary  
 ECB transparency and accountability are high; there is no need for major change  
 Communication is necessarily shaped by history, language, diverse constituency  
 More talk does not mean more transparency  
 Two pillars aided at start, but for how long?  
 Successes: quantitative definition of price stability  
 Press conference as substitute for minutes  
 Not publishing votes promotes “euro area” thinking  
 Would an inflation target be clearer?  
 Enlargement adds to communication challenge  
 Naïve to cite small-country central bank strategy as a model for ECB

### d. Nationality of the Board?

Nationality irrelevant for staffing  
 High standard of personnel achieved

Favorable comparison to other international organizations  
Nationality of Executive Board members is key; need wider rotation  
What happens if United Kingdom enters?

### III. Financial Stability

#### a. Unusual Challenges in Financial Stability?

Greatest contribution to financial stability is continued price stability  
Liquidity provision is a joint ECB/NCB responsibility  
Ex-ante crisis management creates moral hazard  
Bailouts have to be done by national governments with public funds  
Financial regulatory process is in flux with overlapping jurisdictions in Europe, EU, euro area  
Relationship among markets in different countries in flux  
Various committees and MoUs promote cooperation, but the mechanism is complex  
Euro system Marginal Lending Facility follows the Bagehot procedures  
Common collateral framework makes the Lender of Last Resort operate more efficiently  
There remains the danger of perpetuating insolvency through central bank lending  
The key to crisis management is timely information exchange  
Supervision needs to evolve with financial integration  
Burden-sharing challenge rises with financial integration  
Contrast: NCB Governor role in monetary policy versus role in financial stability  
Pragmatic approach: European Secretariat  
Early intervention needed (better incentives for market *plus* reduction of home/host stresses)  
Real test will come with a solvency crisis in a recession  
Decentralization creates a challenge in distinguishing illiquidity from insolvency  
Lack of coordination could threaten competitiveness of European financial centers?

#### b. Lack of Regulatory and Supervisory Authority

Supranational supervisor not necessary—complex coordination is a substitute  
Doctrine: Close relationship between ECB and supervisory authorities  
Exchange of information identified as key  
Requires protocols to aid information flow under stress  
NCBs provide relationship with counterparties  
There may be an evolution toward more supranational approach?

National mandate, culture, practices, law, hinder supervisors from working as one

Political resistance to European supervision

ECB can see unusual borrowing by an institution

Reforms needed not just for institutional design: Crisis handbooks, exercises

### c. Policy Coordination in Crisis?

Multiparty coordination difficult

Burden-sharing not centralized

Long evolution ahead

Greater diversity of circumstances and sophistication

Collateral regime insufficient with insolvency

Euro system lacks a clear New York Fed style liquidity desk

CB as natural leader in crisis (source of liquidity)

## Appendix C

### *Brief Biographies of Interviewees*

We interviewed seventeen high-level current and former officials, the majority of whom were directly involved in the creation of the monetary union. We sent out twenty-two interview requests. Two were declined; two agreed to interviews but we were unable to schedule them; and in one case we received no response.

Following, we provide a very brief biographic sketch of each interviewee. In order to conserve space, we focus on the experience that is most relevant for our purposes. A complete biography of any of these people would run for pages. The date of the interview is in parentheses.

*Dr. Ignazio Angeloni* (September 13, 2007): From September 1998 to December 2002, Dr. Angeloni was Deputy Director General in the Directorate Research at the European Central Bank. Prior to that he was at the Bank of Italy. At the time of the interview, Dr. Angeloni was Director for International Financial Relations at the Italian Treasury.

*Dr. Jaime Caruana* (November 1, 2007): From 2000 to 2006, Dr. Caruana was Governor of the Bank of Spain, during which time he also served as Chairman of the Basel Committee on Banking Supervision (2003 to 2006). Prior to joining the Bank of Spain, Dr. Caruana held various positions in the Spanish Treasury. At the time of the interview, Dr. Caruana was Counselor and Director of the Monetary and Capital Markets Department at the International Monetary Fund.

*Sir Andrew Crockett* (October 30, 2007): From 1994 to 2003, Sir Andrew was the General Manager of the Bank for International Settlements. Prior

to that, he held various positions at the Bank of England. At the time of the interview, Sir Andrew was President of JP Morgan Chase International.

*Dr. Vitor Gaspar* (August 29, 2007): From September 1998 to December 2004, Dr. Gaspar was the Director-General Research at the European Central Bank. Prior to that he was Director of the Research and Statistics Department of Bank of Portugal and Director of Economic Studies at the Portuguese Ministry of Finance. At the time of the interview, Dr. Gaspar was Acting Director of the Bureau of European Policy Advisors at the European Commission.

*President Timothy F. Geithner* (November 16, 2007): Since 2003, Mr. Geithner has been President of the Federal Reserve Bank of New York and Vice Chairman of the Federal Open Market Committee. He also serves as Chairman of the Committee of Payment and Settlement Systems. Prior to joining the Federal Reserve, Mr. Geithner held leading positions at the International Monetary Fund and the U.S. Treasury, where he was Under Secretary for International Affairs from 1999 to 2001.

*Lord Edward George* (January 9, 2008): From 1993 to 2003, Lord George was Governor of the Bank of England, where he worked for his entire career beginning in 1962. At the time of the interview, he was a member of the House of Lords.

*Dr. Sirkka Hämäläinen* (October 9, 2007): From 1998 to 2003, Dr. Hämäläinen was a member of the Executive Board of the European Central Bank. From 1992 to 1998, she was Governor of the Bank of Finland.

*Vice Chairman Philipp M. Hildebrand* (January 28, 2008): Since 2003, Dr. Hildebrand has been a member of the Governing Board of the Swiss National Bank, and was named Vice Chairman in 2007. Prior to joining the Swiss National Bank, he held various positions in private financial institutions.

*Prof. Dr. Otmar Issing* (June 29, 2007): As a member of the Executive Board of the European Central Bank from June 1998 to May 2006 Professor Issing was responsible for the Directorates General Economics and Research. From 1990 to 1998 he was a member of the Board of the Deutsche Bundesbank with a seat in the Central Bank Council. From 1988 to 1990 he was a member of the Council of Economic Experts in Germany. At the time of the interview, Professor Issing was President of the Center for Financial Studies at the University of Frankfurt.

*Baron Alexandre Lamfalussy* (November 6, 2007): From 1994 to 1997, Baron Lamfalussy was the founding President of the European Monetary Institute. Prior to that, he held various positions at the Bank for International Settlements, including serving as General Manager from 1985 to 1993. At the time of the interview, Baron Lamfalussy was Professor emeritus at the Catholic University of Louvain.

*Governor Christian Noyer* (February 27, 2008): Since 2003, Mr. Noyer has been Governor of the Banque de France. From 1998 to 2002, he was

the founding Vice President of the European Central Bank. Prior to joining the ECB, Mr. Noyer held leading positions at the French Treasury and Finance Ministry.

*Vice President Lucas D. Papademos* (November 15, 2007): Since 2002, Dr. Papademos has been Vice President of the European Central Bank. Prior to taking his current position, beginning in 1994, he was Governor of the Bank of Greece.

*Dr. Fabrizio Saccomanni* (November 6, 2007): Since 2006, Dr. Saccomanni has been Director General of the Bank of Italy. From 2003 to 2006, he was Vice President of the European Bank for Reconstruction and Development. Prior to that, Dr. Saccomanni held a variety of positions at the Bank of Italy.

*Prof. John B. Taylor* (January 25, 2008): Professor Taylor is the Mary and Robert Raymond Professor of Economics at Stanford University and the Bowen H. and Janice Arthur McCoy Senior Fellow at the Hoover Institution. He has been a member of the faculty at Stanford University since 1984. During that period, Professor Taylor also has served as a member of the President's Council of Economic Advisers (1989 to 1991) and as Under Secretary of the Treasury for International Affairs (2001 to 2005).

*Prof. Dr. Hans Tietmeyer* (October 9, 2007): From 1993 to 1999, Prof. Tietmeyer was President of the Deutsche Bundesbank. At the time of the interview, he was *inter alia* President of the European Business School, International University, Schloss Reichartshausen, Germany.

*President Jean-Claude Trichet* (December 14, 2007): Since 2003, Mr. Trichet has been President of the European Central Bank. Prior to assuming his current position, he was Governor of the Banque de France starting in 1993, Under Secretary of the Treasury starting in 1987, and Counsellor of the President of the Republic until 1981.

*President Axel A. Weber* (October 10, 2007): Professor Weber has been President of the Deutsche Bundesbank since April 2004. Prior to that he was Professor of International Economics at the University of Cologne and a member of the German Council of Economic Experts.

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## Comment Pervenche Berès

First of all, I would like to thank Cecchetti and Schoenholtz for their in-depth chapter, taking into account that among seventeen interviews, sixteen were conducted with central bankers. Before anything else, let me tell you that I share their general positive appraisal of the first decade of the European Central Bank (ECB), and maybe especially of the last year. I welcome the fact that the euro has brought stability and fostered economic integration in the euro area, even if internal economic divergences have not diminished enough and productivity has not developed satisfactorily.

Reacting on their chapter, I suggest coming back on key issues to be further explored for the discussion, especially concerning the main challenges ahead.

First, I would like to come back to the ECB's operational framework. Together with Werner Langen, from the Economic and Monetary Committee of the European Parliament, I have drafted a report, *EMU@10: The First Ten Years of Economic and Monetary Union and Future Challenges* (Berès and Langen 2008), following the communication of the Commission last spring. The report addresses many elements of this debate; it was voted in ECON and November 2008 in plenary session. I will now discuss the chapter with elements on monetary policy that are developed in our report.

As regards the definition of price stability, the ECB aims at inflation rates of below, but close to, 2 percent over the medium term. We consider that

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