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The ECB's Policy: The View from the Market

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Abstract[*]

Markets have remained sceptical about the ECB's recent and likely future performance mainly for two reasons: Market participants have difficulties understanding the ECB's monetary policy strategy, and the ECB lacks a track record in maintaining price stability that could dispel market scepticism. What could the ECB do to enhance its credibility? First and foremost, they should take no risk with regard to inflation. Any monetary policy mistake causing a breach of the ECB's inflation target will be especially costly during the first few years of the ECB's operation as it would represent a set-back to quickly establishing a good track record in maintaining price stability. Second, the ECB will need to continue its efforts at explaining its monetary policy strategy more clearly to the markets. The widely understood and accepted Taylor Rule could be used to make the ECB's strategy more transparent.

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AN ODD COUPLE

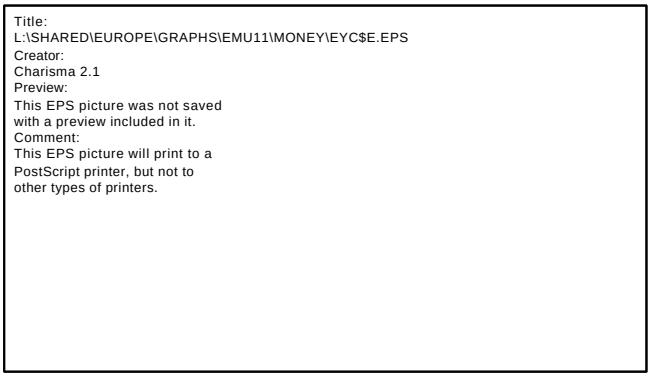
Central banks and financial markets need each other. For instance, commercial banks use the central bank as a source for liquidity, and financial markets look to the central banks for signals on the direction of interest rate developments. At the same time, central banks need the banking systems and financial markets as an important part of the transmission mechanism to influence economic activity and in the event prices. But central banks and financial markets also continuously struggle for dominance in their relationship. Central banks want to guide market rates by determining the costs of central bank liquidity and influencing market psychology. Financial markets, on the other hand, permanently scrutinise central banks as to their ability to maintain price stability and rate their performance by the shape of the bond market yield curves and the external value of the currencies they issue. It is in the interest of central banks to receive good marks from the markets because high credibility reduces the inflation risk premium on interest rates and increases the responsiveness of the economy to changes in the stance of monetary policy. Since financial markets hate uncertainty and surprises, they value highly clarity and consistency in central bank policy. But above all they are impressed by a successful track record in the maintenance of price stability.

How does the ECB fare in the view of financial markets? In the following we argue that markets have remained sceptical about the ECB's likely future performance mainly for two reasons: Market participants have difficulties understanding the ECB's monetary policy strategy, and the ECB lacks a track record in maintaining price stability that could dispel market scepticism. What could the ECB do to enhance its credibility? First and foremost, they should take no risk with regard to inflation. Any monetary policy mistake causing a breach of the ECB's inflation target will be especially costly during the first few years of the ECB's operation as it would represent a set-back to quickly establishing a good track record in maintaining price stability. Second, the ECB will need to continue its efforts at explaining its monetary policy strategy more clearly to the markets. The widely understood and accepted Taylor Rule could be used to make the ECB's strategy more transparent.

THE MARKET VIEW OF THE ECB

Although the ECB has been dubbed "the most independent central bank of the world" and European Monetary Union had a virtually flawless start, many financial market participants still seem to doubt whether the central bank indeed can fulfil its mandate of maintaining price stability. In the course of the year, these doubts have expressed themselves in several ways. After a strong start, the

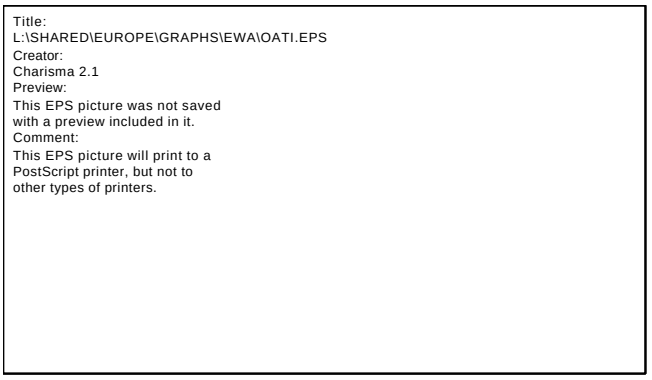
euro weakened significantly during the first half of the year. The main reason for the depreciation was of course market participants' grim economic outlook for Euroland and the associated expectations for interest rate declines at the beginning of the year. In addition, concerns about the political stability in Europe during the time of the Kosovo campaign also weighed on the euro. However, these factors alone are not sufficient to explain the performance of the single European currency. The fact that the euro benefited only little from the end of the hostilities in the former Yugoslavia and reacted only moderately to the rebound in growth expectations for the euro-zone suggests that international investors have demanded a significant risk premium for holding euros. This becomes even more evident when we regard the euro together with the performance of the bond market.



Since the beginning of the year, the Euroland yield curve (defined here as the weighted average of Euroland 10-year bond yields minus 3-month Euribor rates) has steepened by 180 basis points. Part of the steepening was probably caused by the improvement of economic prospects for Euroland and the world at large after excessive gloom and worries about deflation at the beginning of the year. However, the shift in the yield curve coincided with the weakening of the euro, which tends to argue against rising growth expectations primarily causing the rise in long-term bond yields. Rather, the desire to be compensated for an increased risk appears to have added to investors' demands of higher yields on Euroland bonds.

Perhaps the most visible evidence for the emergence of a risk premium on Euroland bonds can be found in the development of the spread between nominal and index-linked French government bonds with a ten year maturity (OAT's and OATi's). In a perfect world, the returns on investments in these bonds are the same when the annual average inflation rate during the maturity of the bonds is identical to the spread in yields (hence the latter is generally known as the "break-even inflation rate"). However, the yield spread is also influenced by

inflation and liquidity risk premia. Nominal bond yields may include an inflation risk premium - which tends to widen the spread - while inflation-indexed bonds may include a liquidity risk premium because of the generally smaller market size - which tends to narrow the spread. Given that more than one factor is likely to account for the spread, it is difficult to infer from it on the absolute size of the inflation risk premium. But some tentative conclusions on the change in the inflation risk premium can be drawn when there is reason to believe that the other factors influencing the yield spread have remained unchanged.



Since the beginning of the year, the liquidity of OATi's has not changed significantly so that we can assume the liquidity risk premium to have remained constant. Moreover, consensus forecasts for inflation have increased only little. At the end of 1998, consensus forecasts saw French inflation at 0.9% in 1999. By September this year, analysts had revised down their forecasts for 1999 to 0.6%, but were then expecting an acceleration of consumer price inflation to 1.1% in 2000. Assuming that changes in the one-year-ahead inflation forecast are a rough approximation for changes in forecasts of trend inflation, we may conclude that inflation expectations increased by about 20 basis points during the first 9 months of this year. Between the introduction of the OATi's last September and the end of January of this year, the yield spread to nominal OAT's eased from 120 basis points to 70 basis points. Since then it has widened again to 180 basis points in September. Based upon the above considerations, perhaps about 90 basis points of the total increase of 110 basis points could be ascribed to the increase of an inflation risk premium.

An especially interesting episode was the development of the spread in April and May. At the end of March, the spread had widened to 110 basis points from the 70 basis points achieved in January. Following the ECB's unexpectedly large rate cut on April 8, the yield spread rose to about 125 basis points by the end of April / beginning of May. The widening of the spread occurred through a rise in nominal and a fall in real yields. The latter movement was probably the

result of significant demand for inflation indexed bonds meeting rather limited supply, which pushed up the price of OATi's. Thus, it seems that the ECB's first interest rate move added to the general market uneasiness about monetary policy in EMU.

WHY ISN'T THE ECB RATED MORE HIGHLY BY THE MARKET?

In view of the ECB's institutional set-up committing the central bank to the maintenance of price stability and guaranteeing its independence from political pressure it may seem odd that financial markets would harbour doubts about its ability to keep inflation low. However, against this stands the ECB's task of conducting a single monetary policy for a politically fragmented and economically diverse economic area, and a monetary policy strategy that needs to take account of the poor quality of data and a high degree of uncertainty about the monetary transmission mechanism. Many financial market participants harbour doubts as to whether EMU will really work and find the ECB's behaviour difficult to judge. Moreover, on the way to EMU politicians bent the convergence criteria and quarrelled over the selection of the ECB's first president. This has rekindled fears about the ECB's ability to resist political interference.

In the discussions of the Maastricht Treaty, even Chancellor Kohl - a fervent supporter of EMU and one of its fathers - thought that monetary union would eventually need to be complemented by political union to make it durable. Many economists agreed, pointing to the need for a strong central budget exerting an equilibrating influence on economic regions of different strength and in an area of low labour mobility due to language and cultural barriers. However, it soon became clear that agreement on political union could not be reached and the idea was silently buried. Without political union, however, monetary union of at most a few European core countries with proven stable exchange rate links only seemed feasible. This view was shattered when in 1996-97 a large number of countries embarked upon a race to meet the entry criteria for EMU and all but one, Greece, managed to qualify. The group of eleven countries, which then in May 1998 committed itself to enter EMU in 1999, could hardly be seen as representing an optimal currency area: it included countries on different economic cycles with different underlying growth rates and varying degrees of economic flexibility. The view held widely before 1998 especially among market participants in New York and London that EMU would never take off changed to the view that, once begun, it would not last long.

On the road to EMU, politics played an important role. Seemingly firmly agreed criteria for the selection of countries were seriously bent for political reasons. Thus, only few participants had debt ratios of less than 60% (and Germany's ratio was even rising on trend), and many countries took one-off measures to squeeze their deficit ratios to the required levels. National considerations seemed to play a very important role in the selection of the first ECB president.

In addition to being sceptical about the durability of EMU and the ECB's independence from political influence, many market participants have difficulties understanding the ECB's monetary policy strategy. The ECB is the only major supra-national central bank existing and it has to struggle with a poor data base as well uncertainty about the transmission mechanism of monetary policy and the stability of the demand for money. Reflecting these uncertainties but also the belief that in the end "money matters", it has opted to pursue its goal of price stability by analysing risks to price stability using a wide set of indicators and by observing a reference value for the growth of the broad money stock (M3). Thus, the ECB's strategy differs from the now well established approach of inflation targeting, as for instance followed by the Bank of England, in that the ECB does not adjust interest rates in order to bring forecast inflation in line with its inflation objective. It also differs from that of the Bundesbank, which in the past at least claimed that it would adjust interest rates in response to deviations of money growth from its target value (though in reality they did not do so). The ECB refuses any thought of reacting mechanically to variations of money growth and emphasises the need to place monetary developments into context. Last but not least, in order to avoid even the appearance of any political considerations entering the thinking of its Council members, it has opted to summarise the proceedings of its meetings in press statements by the President without showing the voting record of Council members.

The ECB understands its strategy to be unique, given the rather exceptional circumstances in which it has to conduct monetary policy. For market participants, however, the ECB's unique strategy is difficult to understand, and hence suspicious. The lack of understanding is often visible in the criticism raised against the ECB's strategy. UK media, notably the Financial Times, tend to criticise the ECB because of its reluctance to come up with a numerical inflation forecast. As a result of that and because of the ECB's refusal to publish minutes similar to those of the Bank of England, so the argument goes, the ECB's conduct of monetary policy lacks transparency. Other observers, mainly in Germany, criticise the ECB for not linking its policy decisions more strictly to money growth.

Not every successful central bank has had a clear monetary policy strategy and a transparent decision making system. The Bundesbank, for instance, was renown for its secretiveness (with minutes of Council meetings published only after 30 years) and, contrary to the Bank's explicit statements, only few believed that the Bundesbank indeed should and was following a monetary target. Moreover, the Federal Reserve Board under Chairman Greenspan is widely seen to follow an opaque approach of looking at everything deemed important by the Chairman and then using a high degree of discretion when making a decision. Nevertheless, these institutions have benefited from a high degree of credibility among market participants - which has led to low risk premia on assets denominated in their currencies - thanks to their impressive track record as inflation fighters. The ECB, however, lacks a track record that could make up for apparent flaws in its monetary policy strategy.

A direct implication of these observations is that European central bankers should take no risk with inflation in the first few years of EMU. After having established an impeccable track record, credibility can be expected to rise and risk premia on euro assets to fall. However, this may take a few years. In the meantime, it is worth pursuing the question whether the ECB cannot reduce the risk premium at a faster pace by helping market participants to understand its strategy better.

A MODIFIED TAYLOR RULE AS A PROXY FOR THE ECB'S STRATEGY

Over recent years, the so-called Taylor rule - a normative interest rate rule for central banks developed by Professor John Taylor of Stanford University - has become a standard instrument in financial markets for analysing central bank behaviour. Because of its simplicity it is easily understood by financial market participants, and because of its (unintentional) ability to explain past behaviour of the Federal Reserve and the Bundesbank, it is widely accepted as a framework for monetary policy analysis. In the following we argue that the Taylor rule can also be used as a reasonable approximation for the interest rate implications of the ECB's monetary policy strategy.[1] Hence, monetary policy analysis using this rule can help to facilitate the understanding of the ECB's actions.

[1] The relationship between a money supply and an interest rate rule was recently highlighted by John B. Taylor, "The Robustness and Efficiency of Monetary Policy Rules as Guidelines for Interest Rate Setting by the European Central Bank." Mimeo February 1999, and J. Hatzius, "The ECB's Likely Pragmatism", Goldman, Sachs & Co. December 1998.

According to Taylor, the appropriate short-term interest rate is given by the following equation:

(1) $i = rer + ie + 0.5 [(dp-dpt) + (y-y^*)]$

with i denoting the appropriate short-term rate, rer the equilibrium real short-term rate, ie the expected inflation rate, dp the actual inflation rate (here in logarithmic differences of the price level), dpt the inflation target, y actual GDP growth (expressed in log differences of real GDP), and y* potential GDP growth (with the expression (y-y*) generally referred to as the output gap). The coefficient of 0.5 in the formula is supposed to reflect an equal weighting by the central bank of deviations of inflation from its target and of actual GDP from the full employment level in its interest rate decisions.

The term in square brackets in equation (1) can be seen as a reasonable approximation of the ECB's first pillar of its monetary policy strategy, which consists of an analysis of the risks to price stability. This analysis includes a review of past and prospective inflation developments relative to the target rate as well as of output developments compared to some underlying growth rate. With inflation exceeding the target and output growth rising above its longer-run sustainable trend, it must be presumed that inflation risks have reached a critical level, justifying an interest rate hike.

But is there a way to bring the second part, the analysis of the money growth relative to a reference value, into equation (1)? Recall that the quantity theory of money equates nominal GDP to the stock of money times its velocity. From this simple equation, the so-called P-Star model has been derived, which relates the long-run price level (P*) to real potential GDP (Y*), long-term velocity (V*), and the stock of money (M).[2] In logarithmic changes:

(2) $p^* = m + v^* - y^*$

where lower case letter denote log changes of variables.

Typically, the velocity of money rises with increases in interest rates (because of higher opportunity costs of holding money). Hence, assume that

[2] This model assumes that the money stock determines the price level in the long run, an assumption not generally accepted by the economics profession. We do not want to add to the debate about the causality between money and prices in the present paper. All we are interested in is to find a more concise way of expressing the ECB's monetary policy strategy. Hence, what matters here is that the ECB has subscribed to the view that money growth causes inflation.

changes in v* are a positive function of the real equilibrium rate rer and expected inflation, given by p*:

(3) $v^* = a\,(rer + p^*)$

Substituting (3) in (2) and rearranging gives:

(4) $p^* = [1/(1-a)]\,m + [a/(1-a)]\,rer - [1/(1-a)]\,y^*$

Assuming that expected inflation ie can be represented by the change in the long-run price level p* and substituting (4) in (1) gives:

(5) $i = [1 + a/(1-a)]\,rer + [1/(1-a)]\,(m-y^*) + 0.5\,[(p - pt) + (y - y^*)]$

Thus, for any given equilibrium real rate rer, the interest rate i rises when the gap between money growth and potential GDP (m-y*) rises, the difference between actual and target inflation (p-pt) grows, or the output gap (y-y*) increases. The first term (m-y*) can be interpreted as the ECB's monetarist pillar in its strategy: an increase in money growth relative to potential GDP growth raises expected inflation and hence tilts the central bank towards an interest rate increase (whereby the strength of the interest rate response depends on the sensitivity of velocity to interest rate changes). The second and third terms represent the direct inflation targeting pillar in the strategy as it is presently practised: an observed rise of actual inflation relative to the target or of actual GDP relative to potential induces the ECB to consider an increase in its interest rate.[3]

For equation (5) to make sense, the parameter a should be positive and less than one. However, this does not represent and implausible restriction. A negative value of a would imply that long-run velocity falls with rising interest rates, which is against all theoretical and empirical insights. A value of zero would imply that v* is constant and coefficients of both rer and (m-y*) in equation (5) would be one. Finally, if a would be equal to one, changes in expected prices p* and velocity would become identical, and equation (2) would no longer be able to give a solution for expected inflation.

[3] The "inflation" and the "output" gap are not independent: a fall in the output gap can be expected to raise inflationary pressures after some time. However, both the Taylor formula as well as the ECB's discussion of risks to price stability focus on developments of the real economy and inflation separately.

WHAT DOES THE TAYLOR RULE SUGGEST?

In the previous section we have argued that the Taylor formula can accommodate monetarist and non-monetarist elements in a central banks' monetary policy strategy. This is perhaps the reason why this formula has been so successful in explaining the behaviour of so different central banks as the US Federal Reserve and the German Bundesbank. In the following, we pursue the question of whether the Taylor formula is also capable of explaining the development of aggregate Euroland short-term rates in the past, and what can be learned from the formula for the interest rate outlook.[4]

In order to simplify matters, we go back to equation (1) to calculate a series of Taylor rates for Euroland. Although this version of Taylor's rule is simple and appealing, its application to Euroland is not entirely straightforward. Obtaining data for expected inflation and the output gap is a relatively easy task: Following conventional practice, we can use actual inflation as a proxy for the former and OECD estimates for the latter, with both series for Euroland calculated as a GDP weighted average of national data. Moreover, since most Euroland central banks other than the Bundesbank have in fact targeted their exchange rate versus the D-Mark during the 1980s and 1990s, we may use the Bundesbank's inflation objective as the inflation target variable for the period until 1999 and the ECB's inflation target thereafter.

More difficult, however, is the determination of the equilibrium real interest rate. In Taylor's formula this rate is assumed to be constant and general practice has been to calculate it from historical averages for short-term interest and inflation rates. But past experience has shown that results can vary significantly depending on the time period chosen for the calculation as monetary policy regimes in many countries have not been entirely stable over time. In the case of Euroland, a change in the real equilibrium rate almost certainly occurred when national monetary policies were merged into a European policy. Hence, the question is not whether but how the real rate has been affected by the regime change.

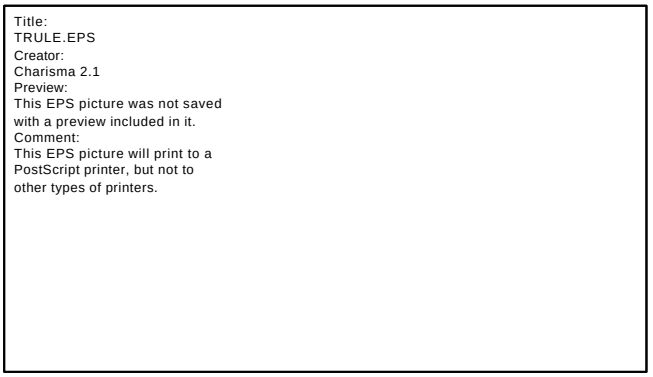
In a recent paper, Gerlach and Schnabel assumed that the real equilibrium rate in Euroland was lowered by an increase in the credibility of monetary policy in those countries, whose currency in the past depreciated against the D-Mark. In order to eliminate exchange rate risk premia, they regressed the average real short-term interest rate for 1982-97 for 13 European countries on a constant and the average depreciation of these countries' currencies against the D-Mark during this period. They then defined the "credibility adjusted"

[4] See also Gert Peersman and Frank Smets, "Uncertainty and the Taylor Rule in a Simple Model of the Euro-area Economy." Mimeo February 1998; and J. Hatzius (op.cit.)

equilibrium real rate as the fitted value of this regression, assuming no depreciation against the D-Mark. In their univariate cross-country regression this is simply the constant, equal to 3.55%.[5]

However, while correction of the historical rate averages is certainly necessary, the approach of the BIS economists is not entirely convincing for two reasons: First, they adjust historical real interest rate data only for the effects of exchange rate changes and hence may miss other effects of the monetary regime shift. Second, their real equilibrium exchange rate is the arithmetic average of country averages corrected for exchange rate effects, giving equal weight to small and large countries in their sample. However, the behaviour of the ECB so far has indicated that they weigh the information from individual countries by the countries' economic size.

In view of these difficulties, we have chosen a different approach to the calculation of the real equilibrium interest rate. First, we assumed that the ECB so far has set actual interest rates correctly for 1999 and that no further rate changes this year are required (though at the time of writing in October 1999 the ECB was clearly considering a rate hike). This assumption appeared reasonable as there were no inflationary pressures visible that would require a correction of the ECB's rate cut from April 8 in 1999. Second, based on our estimates of the output gap and the difference between actual and targeted inflation for 1999, we calculated an equilibrium real interest rate that equates the Taylor rate to actual short-term rates in 1999. The rate satisfying this requirement was 2.25%. Third, using this real equilibrium rate we calculated Taylor rates for past years and 2000, using estimated and projected output gap and inflation data. The result of this exercise is given in the accompanying chart.



As already noted by the Gerlach and Schnabel, the Taylor rate series exhibits a fairly good fit to the actual interest rates, with changes of the latter generally

[5] Stefan Gerlach and Gert Schnabel, "The Taylor Rule and Interest Rates in the EMU Area: A Note", BIS Working Papers No. 37, August 1999

foreshadowed by the former. Hence, it seems appropriate to use the Taylor formula also to come up with projections for future rates. However, with an implied real equilibrium interest rate of 2.25% compared to an historical average of 3.7% during 1978-98, Taylor rates were systematically below actual rates during 1984-98. At first glance, this may raise doubts about our estimate of the real rate, but it is exactly what we should expect. In the run-up to EMU, interest rates converged in a non-inflationary environment to the bottom of the range, indicating a rise in the credibility of monetary policy in the Euroland average as of 1999. By contrast, if we took the historical average of actual real rates in 1978-98 of 3.7% as the real equilibrium rate, the entire Taylor rate series would be shifted upwards by almost 150 basis points. The Taylor rates would be significantly above actual rates as of 1996, indicating that monetary policy was far too loose in 1996-99. By the same token, if we based our calculation of a real equilibrium rate on 3.55%, as suggested by the BIS paper, the Taylor rate series would be shifted up by 130 basis points, with the Taylor rates again above actual rates as of 1996. Since there are no indications of a need for an immediate hike in interest rates by 130-150 basis points, neither approach seems sensible.

If we accept that short-term interest rates at present are broadly appropriate, the Taylor formula suggests that any change in the future depends on likely movements of the output gap and inflation. For the former, we have taken OECD projections of a decline by about 0.25% of GDP (consistent with moderate GDP growth of around 2.5%); for the latter, we forecast a moderate increase to 1.4% from 1.1% this year.[6] With the inflation objective assumed to remain at 1%, the Taylor rate for 3-month money rises by about 0.6 percentage point to 3.3% in 2000 on average. Risks to an interest rate forecast based on the above calculation of a Taylor rate could come from three sides: We may have erred in our estimate of the real equilibrium rate, and we may be wrong in our forecasts for the output gap or inflation.

Given the structural break in the monetary regime of the euro-zone countries at the beginning of the year, the risk of having incorrectly estimated the real equilibrium rate and expected inflation is probably highest. In particular, recent strong money growth could prove temporary - in which case it should be ignored - or it could raise medium-term expected inflation - in which case the ECB should tighten. At present, it is impossible to have a more precise view on this question, and hence both the real equilibrium rate and the expected inflation rate. The risks emanating from errors in the forecasts for the output gap or short-term inflation are important, but perhaps a little better to control.

[6] We can rationalise this forecast as follows: Money growth may well exceed its inflation-neutral level by 1¼% this year, raising the long-run price level by the same amount. Assuming that it will take about 4 years until the effects are fully absorbed, annual inflation could be raised by about 0.3% per year.

CONSISTENCY AND CLARITY VS. NERVOUSNESS AND CONFUSION

The experience of the first nine months of this year suggests that in order to gain credibility quickly the ECB should take no risk with inflation and reinforce efforts to explain its strategy clearly and simply. However, market participants' impression in October 1999 - which can be inferred from the yield curve and Euribor futures contracts - is that the ECB is nervous and confused.

An impression of confusion is created by the apparently highly discretionary use of economic indicators and arguments to justify past or pending rate moves. For instance, in order to explain their concerns about the medium-term risks to price stability, the ECB has recently frequently referred to money and credit growth. In its October Monthly Report, it concluded that "all in all, in line with the medium-term orientation of the Eurosystem's monetary policy, both the rising trend in M3 and high credit growth call for great vigilance on the part of monetary policy at a time of accelerating economic activity." (p.6). It is difficult to reconcile this assessment with the ECB's focus on a reference value for money growth. Since the beginning of this year, money growth has fluctuated between 5.0% and 5.8%, 0.5 to 1.3 percentage points above the 4.5% reference value. In the past, the Bundesbank set fluctuation margins around its money target, which often were as high as 1.5 percentage points. As long as money growth remained in the range, the Bundesbank was not especially concerned. The ECB chose a reference value and not a target coupled with a target range for money growth because it felt that there may be a looser relationship in the first few years of EMU between money growth and inflation than existed in Germany in the past (see January Monthly Report). However, their attitude towards money growth expressed in the October Monthly Report suggests that the reference value is interpreted even more rigidly than the Bundesbank interpreted its targets.

Moreover, the reference to private sector credit growth along with money growth seems inconsistent with any monetarist policy approach. If it is indeed money growth that influences price inflation, credit growth is only relevant to the extent that it affects money growth. Thus, the ECB's emphasis on credit growth as a key variable to be monitored adds to confusion.

An impression of nervousness is created by the ECB's inclination to base moves on fairly thin fundamental developments. Before the April rate cut, the ECB publicly stated that there was no risk of deflation and that monetary policy was not the appropriate instrument to revive a sluggish real economy. Following the cut, the view gained strength that in reality ECB Council members had indeed seen a small risk of deflation. Thus, we may surmise that the rate

reduction was motivated by the desire to hedge against a perceived small risk of deflation. In July of this year, the ECB begun preparing an interest rate increase. However, ECB analyses have not pointed to a significant risk that consumer price inflation will exceed the 2% mark in the foreseeable future. Hence, again the ECB seems to want to hedge against only a small risk that inflation exceeds the 2% mark by an interest rate adjustment. By moving early and decisively in either direction, the ECB wants to avoid being seen making mistakes that could jeopardise their desire to quickly build credibility in financial markets. This is legitimate and understandable. But there is a fine line between a forward looking monetary policy and a nervous reaction to perceived risks. For the time being, the ECB gives the appearance as if they would do the latter.

CONCLUSIONS

In view of the tasks the ECB has been called upon to perform, the conduct of monetary policy in the first year of EMU has been fairly successful. The new monetary regime was introduced smoothly and the ECB has not made gross mistakes. However, it has failed so far to gain the confidence of financial market participants. Much more time will be needed before financial markets will trust the ECB as they have trusted the Bundesbank. Until then, we may have to get used to a somewhat larger risk premium on Euroland financial assets. The ECB can help to reduce this risk premium by patiently explaining its strategy, avoiding hectic interest rate moves, and, above all, establishing an impressive stability track record.

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