The European Central Bank

Two models of central banking

- Two models of central banking after WWII
- *Anglo-French model* versus *German model*
- These models differ with respect to
  - Objectives pursued
  - Relations with government
Objectives of central bank

• In the *Anglo-French* model, the central bank pursues several objectives: price stability, stabilization of the business cycle, employment, financial stability.

• In the *German model* price stability is considered to be the primary objective of the central bank.

• Other objective may be also pursues but only if this does not undermine the primary objective.

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Relations with the government

• *Anglo-French model*
  – Political dependence
  – Monetary policy decisions are subject to the government’s approval

• *German model*
  – Political independence
  – Monetary policy decisions are taken by the central bank without political interference.
Relations with the government

- The German model prevailed in the design of the European Central Bank.
- Note: Since 1997, the Bank of England has operational independence, and price stability is its primary objective; the Government sets the inflation target (2.5% since 1997)

Statutes of the ECB

- Objectives
  - “The primary objective of the ECB is the maintenance of price stability” (article 105)
  - Without prejudice to the objective of price stability, the ECB shall support the general economic policies in the Community with a view to contributing to the achievement of the Community as laid down in article 2. (Article 105(1).)
  - Other objectives such as ‘a high level of employment’ are thus only secondary.
Statutes of the ECB

• Political independence
  – “Neither the ECB nor a national central bank nor any member of their decision-making bodies shall seek or take instructions from Community institutions or bodies, from any Government of a Member State or from any other body.” (Article 107).

Why has the German model prevailed?

• Intellectual development, i.e. the ‘monetarist counter-revolution’
• Growing evidence that countries with independent CBs tend to have lower inflation but not lower growth;
• Strategic position of Germany.
  – In order to accept EMU, the German monetary authorities insisted on having an ECB that gives an even higher weight to price stability than the Bundesbank did.
The ECB: a ‘conservative’ central bank

- ECB attaches greater weight to price stability and lower weight to output and employment stabilization than the rest of society.
- This corresponds to Rogoff’s (1958) notion of ‘conservative central banker’
- This conservative attitude can lead to conflicts

The Barro-Gordon model and optimal stabilisation

- Inflation equilibrium in point A
- Unemployment is at its natural level
- No incentive to create surprise inflation.
- The upward sloping dotted line is the optimal stabilization line (optimal response to shocks to short-term Philips curve).
- Slope of the optimal stabilization line depends on the weight the authorities attach to the stabilization of unemployment.
- With a steep stabilization line authorities stabilize a lot at the cost of a high inflation bias.
- Conservative central banker → relatively flat stabilization line.
How to eliminate the inflation bias?
Appointing a conservative central bank

- The steep stabilization line represents the preferences of the society.
- The flatter stabilization line the preferences of the ECB.
- On average Euroland will have lower inflation without any loss in employment.
- However, there will be less stabilization in the wake of shocks.
- This leads to a potential conflict between the ECB and elected politicians.

How to solve the conflict: first best solution
A ‘target conservative’ central bank

- Suppose target unemployment rate equal to the natural unemployment.
- Then the optimal stabilization line shifts to the right and intersects with the natural unemployment point on the horizontal axis.
- Inflation bias disappears.
- As a result, unemployment is stabilized in the same way for both central bank and society.
- Solution: appoint a central banker who is ‘target conservative’ rather than ‘weight conservative’.
- Svensson (1995): inflation targeting achieves the same result
A new problem: uncertainty about natural unemployment rate

- Initially, target unemployment is at the natural level, $U_N$.
- Suppose a temporary increase in unemployment.
- ECB interprets this as an increase in the natural unemployment rate, and increases its target $U_N$ rate.
- The ECB will not attempt any stabilization.
- This is the same as if the ECB attached zero weight to unemployment stabilization.
- This problem can be aggravated by histeresis in unemployment (i.e. temporary shocks lead to permanent increases in unemployment).
- If the ECB fails to stabilize temporary shocks, they translate into permanently higher natural unemployment.

Is there evidence that the ECB acted as a conservative central bank?

- US Fed seems to have reacted much more to the economic slowdown of 2001 than the ECB.
- But were the economic conditions the same in the US and the eurozone?
ECB does react to movements in output gap
• Thus it gives some weight to output stabilisation
• US Fed reacts more strongly to decline in output gap than ECB
• It appears that Fed attaches greater weight to output stabilisation than ECB
• In this sense ECB is more conservative than Fed
• Note: this is evidence of only 5 years
• It may change in the future

Previous conclusion is not due to different inflation experiences
• Both US and eurozone experienced similar inflation rates
Independence and accountability

- The ECB is politically independent.
- Whenever the government delegates power to the central bank there is a corresponding need to have accountability.
- The reason is that the government maintains its full accountability towards the voters.
- Independence and accountability are part of the same process of delegation.
- The ECB is independent with little accountability for its actions.

Optimal relation between independence and accountability
• The ECB is more independent and less accountable than any other major CBs.
• Accountability is related also to the precision with which central bank’s objectives are specified.
• Most central banks have a wider responsibility than simply price stability.
• The Treaty is vague about the other objectives besides price stability.
• The ECB has interpreted this to mean that it has to pursue only price stability.
• As a result, the ECB has drastically restricted the domain of responsibilities about which it can be called to account.

What could ECB do to avoid conflicts?

• Enhance informal accountability through greater transparency
• Larger openness in the decision-making process
• Inflation targeting promotes informal accountability.
• Having a broader area of responsibility and recognize that there are objectives other than price stability.
The ECB: Institutional Framework

• The Eurosystem it consists of
  – European Central Bank (ECB)
  – national central banks (NCBs) of the EMU-countries

• Governing bodies:
  – Executive Board:
    • President, Vice-President and four Directors of the ECB
  – Governing Council:
    • Executive Board plus the governors of the twelve national central banks.
• Governing Council is the main decision-making body of the Eurosystem.
• It formulates monetary policies and takes decisions concerning interest rates, reserve requirements, and the provision of liquidity into the system.
• It meets every two weeks in Frankfurt.
• Each of the members has one vote (NB: this will change with EMU enlargement)
• There is no qualified voting in the Governing Council of the Eurosystem.
• The members are supposed to vote according to the interests of the Eurozone as a whole rather than according to national interests.

• The Executive Board
  – implements the monetary policy decisions taken by the Governing Council.
  – gives instructions to the NCBs.
  – sets the agenda for the meetings of the Governing Council.
• As such, it has a strategic position and can have a large influence on the decision-making process in the Governing Council.
Is the Eurosystem too decentralized?

- Is the influence of the NCBs in the Governing Council too large so that national interests will tend to prevail?
- In order to analyze this: compute Taylor rule for each central banker
  - Taylor rule computes the interest rates that each of the national governors would desire given the economic conditions in their own country:
    \[ r_t = \rho + \pi^* + a(\pi_t - \pi^*) + bx_t \]
  - \( r_t \) is the optimal interest rate, \( \rho \) is the long-term real interest rate, \( \pi^* \) is the target inflation rate and \( x_t \) is the output gap.

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<tr>
<th>Country</th>
<th>Relative size</th>
<th>Desired interest rate</th>
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<tr>
<td>Germany</td>
<td>0.29</td>
<td>1.22</td>
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<td>Austria</td>
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<td>Finland</td>
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<td>Belgium</td>
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<td>ECB Board</td>
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<td>Netherlands</td>
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<td>Greece</td>
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<td>Ireland</td>
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<td>7.87</td>
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</tbody>
</table>

Source: Inflation: European Commission, European Economy
Output gap: OECD Economic Outlook

Assumptions: \( \rho = 2\% \), \( \pi^* = 2\% \), \( a = 1.5 \) and \( b = 0.5 \).

• Assumptions:
  • Governors are nationalistic
  • ECB-board cares about Euro-wide interests
  • ECB-Board only needs three votes to find majority for its proposal
  • ECB-Board has strategic position despite asymmetries in shocks
  • Country size is measured as percentage of Eurozone GDP;
  • Distribution of votes is the number of votes, ECB has 6 votes

• Today the ECB Board enjoys a strategic position within Governing Council: its interest rate preference is close to median
• In enlarged Eurozone, the ECB Board will loose its strategic position
• Its interest rate preference may be overruled by coalitions of small countries
• Decision-making by concensus less likely
• Interest rate may not reflect average economic conditions in the EMU
The Challenge of Enlargement

• The over-representation of small countries can be reduced in several ways:
• The US Fed formula: all governors participate in the deliberations of the Governing Council but the voting rights are limited to a limited number of governors (e.g. ten) on a rotating basis.
• The IMF formula: small countries group together in constituencies and are represented by one governor.
• Centralised formula: the decision making is restricted to the Executive Board of the ECB. In this formula there is some scope for expanding the size of the Board.

• On 20 December 2002 the Governing Council reached an agreement that combines the first and second formulas.
• The agreement has the following main features.
  – Number of governors with voting rights will be limited to 15. The members of the Executive Board will maintain their voting rights.
  – Governors will exercise their voting rights on a rotating basis. The frequency with which they can participate in the voting will reflect the relative size of their country.
• This proposal has been adopted by the Heads of State
• The reform take effect when the number of Eurozone members exceeds 15
Bank supervision and financial stability in EMU

- Principle of *home country prudential control*
- Principle of *host country responsibility* for financial market stability
- These two principles might conflict in an increasingly integrated market.
- The problem will be compounded during crisis situations
- Centralization of the supervisory and regulatory responsibilities at the European level would be the solution.

Conclusion

- The strong degree of independence of the ECB is not matched by an equally strong procedure to control the performance of the ECB.
- Enlargement creates the risk that the ECB-Board will lose its strategic position and that the interest rate decisions will not represent the needs of EMU as a whole. Change in voting rules is necessary.
- Centralization of bank supervision may be necessary for smooth management of financial crises.