

Transparency and Governance

Centre for Economic Policy Research
Monitoring the ECB 6
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by

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ECB at critical juncture

- **Track record:** inflation persistently above 2%
- **Credibility:** inflation expectations rising
- **Policy rate:** now close to 'neutral', so greater uncertainty about future policy
- **Communication:** markets well groomed for next policy decision, but fail to understand ECB policy further ahead

Need for greater transparency and better communication

ECB track record

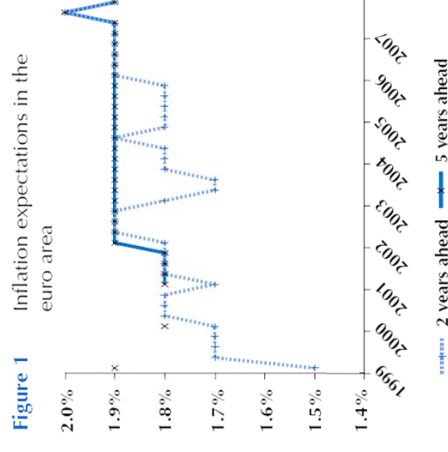
Year	Euro area HICP inflation (annual percentage change)
1999	1.1
2000	2.1
2001	2.3
2002	2.2
2003	2.1
2004	2.1
2005	2.2
2006	2.2
2007	2.1*

* Midpoint of December 2007 Eurosystem staff projection.

Source: Eurostat and ECB, *Monthly Bulletin* (December 2007).

Note: ECB definition of price stability is 0-2% HICP inflation

Euro area inflation expectations rising

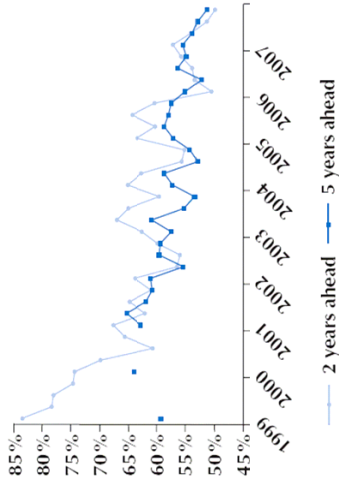


Source: ECB Survey of Professional Forecasters.

2008 Q1 update: 2.0% for 2 and 5 years ahead

ECB credibility drifting down

Figure 2 ECB credibility (probability of euro area HICP inflation within 0–2%)

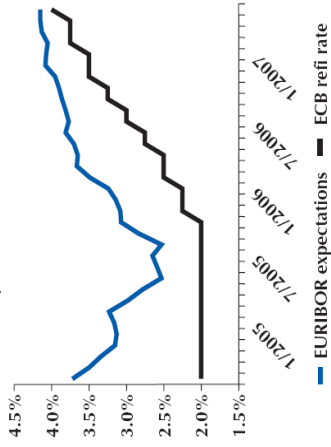


Source: ECB Survey of Professional Forecasters.

2008 Q1 update: 48.7% 2 years ahead, 51.1% 5 years ahead

Markets fail to understand ECB policy further ahead

Figure 4 Three-month EURIBOR expectations for June 2007

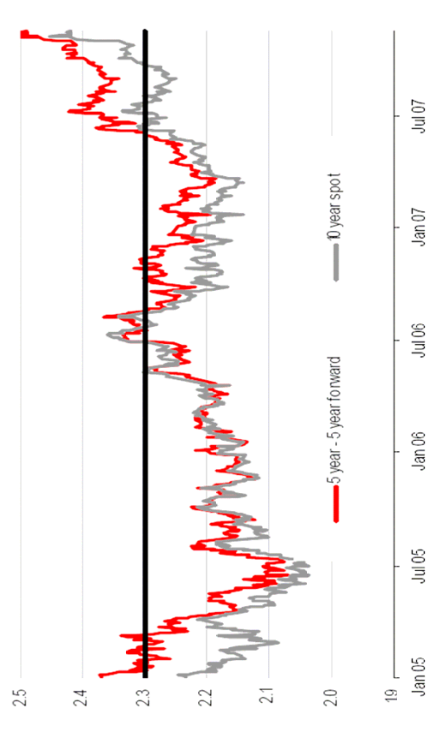


Note: EURIBOR expectations are measured by the implied interest rate on three-month EURIBOR futures with maturity in June 2007.

Source: ECB Statistics Pocket Book.

Market expectations

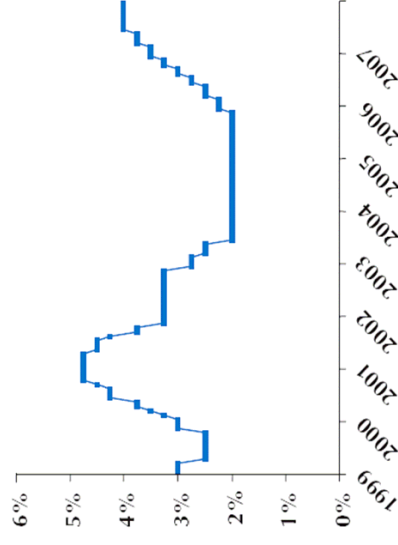
Euro area break even inflation expectations



Source: S&B Economic Research

Where next ?

Figure 3 ECB main refinancing rate



Source: ECB.

Is ECB policy stance currently neutral?

Transparency

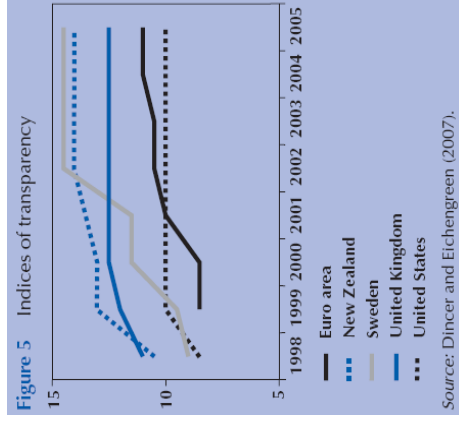
Disclosure of information used for monetary policymaking

- Increases predictability of monetary policy and thus reduces macroeconomic uncertainty
- Gives central bank strong incentive to deliver price stability
 - any wavering in its intentions is soon exposed and penalized by markets through
 - higher long-term interest rates
 - higher wage demands
- Greatly facilitates accountability
 - Easier to evaluate whether performance is attributable to (good or bad) luck rather than skill

ECB transparency improvements

- **Inflation objective:** maintain inflation below *but close to* 2% over medium term (*May 2003 clarification*)
 - Still fuzzy (how close to 2% and over what time horizon?)
- **Monetary policy strategy:** two-pillar strategy clarified
 - “Monetary analysis mainly serves as a means of *cross-checking, from a medium to long-term perspective*, the short to medium-term indications coming from economic analysis” (May 2003)
 - Still ambiguous, but economic pillar appears to prevail in practice
- **Macroeconomic forecasts:** E(S)CB staff projections published quarterly (since September 2004)
 - Still only ranges, no fan charts
 - Still not endorsed by Governing Council
 - Interest rate assumptions based on market expectations (since June 2006), but may not reflect ECB’s anticipated policy path

ECB transparency: An international comparison



Opacity about ECB decision-making

- According to E(S)CB Statutes, Article 10(2):
“the Governing Council shall act by a *simple majority* of the members having a voting right.”
 - President Trichet (ECB press conference, 10-01-2008):
“As you know, we do not vote and have never voted in the past.”
 - Instead, decision-making by “consensus”
- Problem with consensus decision-making:
- Not in line with E(S)CB Statutes
 - Likely to be more inertial
 - Fuzzy concept that gives misleading impression of unanimity

Why publish Governing Council voting patterns?

Lack of unanimity is common among central bankers, so voting records are generally informative.

- Dissenting votes provide information about
 - policy inclination (through direction of dissent)
 - degree of uncertainty (through number of dissents)
- Publication of voting records improves predictability of monetary policy decisions
 - short term: dissenting votes as (leading) indicators of policy bias
 - medium term: balance of votes allows public to better understand ECB policy reaction function

Recommend publication of voting patterns, but not individual votes (to prevent political pressures)

Unanimity about monetary policy decisions

Table 3 Rate of unanimity about monetary policy decisions

Central bank	Committee size	Monetary policy decisions		Unanimity rate (%)
		Total	Unanimous	
Swedish Riksbank	6	60	37	62
Bank of Philippines	7	68	58	85
Czech National Bank	7	122	71	58
Banco do Brasil	9-7*	68	52	76
Bank of England	9	122	54	44
Bank of Japan	9	158	72	46
Bank of Hungary	9-12*	31	13	42
Federal Reserve	12	115	83	72

* The committee size of the Banco do Brasil and Bank of Hungary changed from 9 to 7 and 12, respectively.

Negative correlation between committee size and unanimity rate, so 21 member Governing Council even less likely to be unanimous.

Minutes and policy explanations

Minutes allow peek inside ‘black box’ of monetary policymaking and reveal:

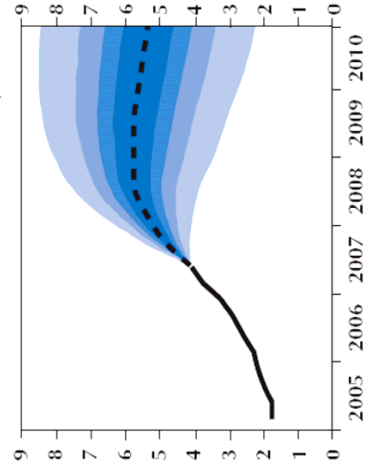
1. Economic information considered for policy decision
 2. Policymakers’ views of economic developments
 3. Discussion of policy options
- Although ECB Monthly Bulletin covers (1), little information about (2) and (3), despite ECB press conferences
- “Introductory Statements” systematically ignore diversity of opinion and counterarguments
 - Q&A sessions suffer from Trichet’s characteristic evasiveness

Communication

- Monetary policy is mainly “management of expectations”
 - Central banks only control short-term interest rates
 - Monetary policy outcomes determined by long-term interest rates and asset prices, which depend on expected future policy rates
- Information relevant for shaping expectations:
 - Macroeconomic forecasts
 - Monetary policy strategy
 - Interest rate path projected by monetary policymakers
- Macroeconomic forecasts and monetary policy strategy insufficient to fully understand monetary policy reaction, so need to publish projected interest rate path

Interest rate fan chart

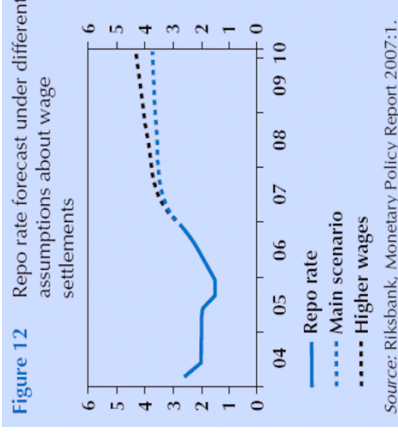
Figure 10 The expected interest rate path from the Bank of Norway



Source: Monetary Policy Report 2/2007, Bank of Norway.

Use of fan chart prevents perception of precommitment and avoids getting “boxed in”.

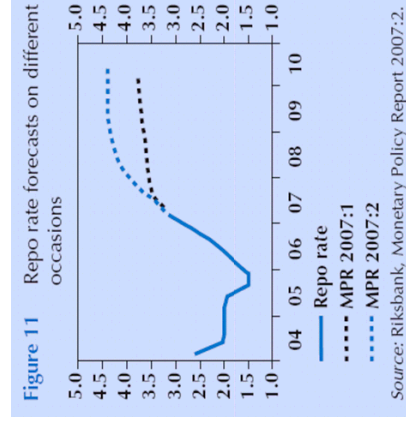
Interest rate paths under different scenarios



Source: Riksbank, Monetary Policy Report 2007:1.

ECB could use scenarios (e.g. ‘high wage growth’ and ‘economic slowdown’) to explicate current heightened uncertainty about interest rate path.

Deviating from interest rate path



Source: Riksbank, Monetary Policy Report 2007:2.

Deviation from interest rate path no problem when central bank explains reasons behind it.

Communication with general public

- Monetary policy delegated to independent central bank with non-elected officials
- To ensure democratic legitimacy, need for
 - Accountability
 - Public support
- Transparency important to achieve accountability
- Effective communication with general public central to maintain public support

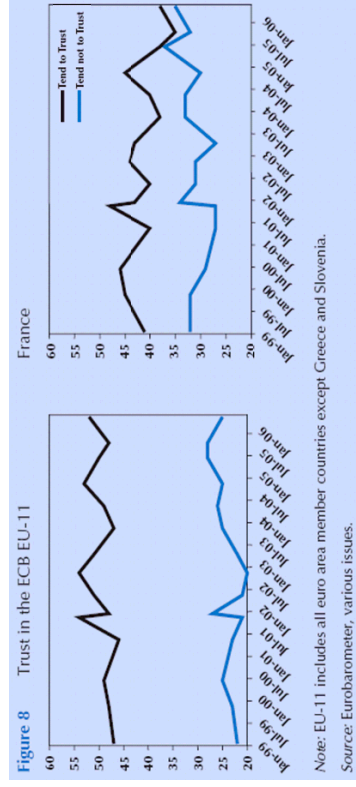
ECB governance

ECB Executive Board is multifunctional

According to E(S)CB Statutes, Articles 11.6 and 12:

- *"The Executive Board shall be responsible for the current business of the ECB"*
- *The Executive Board shall "implement monetary policy" and "have responsibility for the preparation of meetings of the Governing Council"*
- Problematic for selection of Executive Board members
 - Temptation to select members based on their managerial skills
 - But according to Treaty on European Union, Article 109a(2): *"members of the Executive Board shall be appointed from among persons of recognized standing and professional experience in monetary or banking matters"*
- Extensive management responsibilities distraction from preparation and communication of monetary policy

Public opinion about ECB



Politicians in other countries may also be tempted to gain popular support by criticizing the ECB.

Improving ECB governance

- Make ECB president and vice-president responsible for management
 - Encourages delegation to professional managers
 - Allows other Executive Board members to fully focus on preparation and communication of monetary policy
- Make Governing Council meetings longer but less frequent
 - Two-day meetings allow for more extensive discussion of monetary policy and communication strategy

Better governance structure allows ECB to enhance monetary policymaking, transparency and communication.