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INQUIRY BY THE HOUSE OF LORDS INTO:
THE EUROPEAN CENTRAL BANK

UNICE CONTRIBUTION

1) Two-pillar monetary policy strategy:

The Treaty on European Union states the objective of the ECB in the following terms: *"The primary objective of the ESCB is to maintain price stability. Without prejudice to the objective of price stability the ESCB shall support the general economic policies of the Community (…)"*. Furthermore, the ECB defined price stability *"as a year-on-year increase in the Harmonized Index of Consumer Prices for the Euro area of below 2 percent"* over the medium term.

To assess the success of the ECB so far, one has to bear in mind this objective as well as the fact that the ECB, as such, is a fairly new institution. The two-pillar strategy built on the legacy of the ECB's predecessors and is meant to lead to a comprehensive assessment of the economic situation and the long- and short-term trend in prices. This framework has also proved flexible enough to permit some adaptation.

<u>Inflation performance</u>: After 4 years of existence, it seems that the inflation performance of the Eurozone is satisfactory. Indeed, in a period marked by several supply and demand shocks the ECB has succeeded in achieving a moderate inflation outcome. Inflation was 1.1% in 1999 2.1% in 2000, 2.4% in 2001 2.2% in 2002. The latest figure in May 2003 shows a year-on-year increase of 1.9% while expectations for 2004 are below 2%.

<u>Critics of the two-pillar strategy argue that it is too opaque</u>. In particular, for the first pillar, the link between money growth and inflation is strong over the long term (i.e. more than 8 years) but it appears to be much weaker over the short term (less than 8 years). Hence, the second pillar is intended to take into account short-term events as well as the impact of the business cycle. With the prominence given to the first pillar (i.e. the least related to short-term movements), the ECB's decision could appear, at times difficult to explain. In fact, the ECB itself acknowledged that there was a "communication gap". This is important since predictability of monetary policy helps to smooth interest rates fluctuation by leading markets to anticipate and prepare for the decision.

The recent decision of the ECB to put more emphasis on the second pillar in explaining its decisions without abandoning the first pillar is intended to address this issue.

<u>Choice of target</u>: The definition of price stability differs from a proper inflation target in the sense that it is not binding in the short run and aims to shape expectations in the long run. In that regard the ECB strategy is more precise than the one followed by the US Fed (which does not give a quantified inflation target) and less precise than the formal inflation targeting followed by the BoE, for instance, where there is an explicit target and a time frame. Recent work by the IMF, however, tends to prove that all three Central Banks have been successful

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in shaping expectations. Hence, it seems that the most important feature is a credible commitment to price stability.

The weak macroeconomic performance in the Eurozone, particularly in Germany where inflation is at 1%, prompted a debate about the risk of deflation and the appropriateness of the target of less than 2%. The reference to 2% is not uncommon (it was Germany's implicit target and it has been chosen by several inflation targeting central banks). It is intended to target price stability while allowing a low level of inflation that can facilitate relative price adjustments when there are downward price rigidities. The ECB did not clearly state whether there was a lower limit to its target, even though, in its definition of price stability, the ECB refers to "a year-on-year increase" which *de facto* excludes negative inflation. Furthermore, another difficulty for the ECB comes from the dispersion of inflation rates in the Eurozone. While the ECB is in charge of maintaining price stability in the whole Eurozone, low inflation (on average in the zone) coupled with a wide spread could push some members into deflation.

The ECB attempted to address this issue by refining its definition of price stability as "an inflation rate close to 2% but below". It indicates that it does not favour inflation falling too low in any member state. (It must also be recalled that the current weak activity has other causes that monetary policy cannot solve.)

2) The structure and workings of the ECB.

Regarding the structure of the ECB, UNICE does not have a strong view on all the detailed questions. Nevertheless, three principles should be applied. Firstly, the ECB's decisions must be taken in the interest of the Eurozone as a whole. Secondly, the decision-making process must be efficient and transparent. Thirdly, the ECB's independence must be preserved.

From these principles, we can draw the following positions.

For efficiency reasons, we support the decision to limit the number of voting members in the governing council. As long as a rotation scheme can ensure that all sensitivities are represented, the Council is expected to take its decisions in the interest of the Eurozone as a whole and therefore it should not be a problem if not all members can vote at one time.

Transparency is very important both for the efficiency and for the accountability of the ECB. In our view, transparency means a clear effort at explanation of the rationale of ECB's decision. In that regard the two-pillar strategy requires the ECB to provide a more in-depth and comprehensive analysis than inflation targeting.
On the other hand, we do not favour the publication of the votes of individual members. Such a publication could put undue pressure on some individual members in their own countries, particularly if there were a conflict between the country's immediate interest and the Eurozone's interest.

The ECB's independence is one key pillar of the EMU. Hence, this independence must be preserved and the ECB must continue to set the operational definition of price stability. There are several *fora* (including the Macroeconomic Dialogue involving social partners) where the ECB can explain its policy and listen to various stakeholders' remarks, suggestions and even criticisms. The flexible way in which the ECB strategy has been applied suggests that the ECB was able to listen and to adapt without going through a dramatic change that could entail credibility costs, which could be particularly high if it were made in a tense situation.

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