INDEPENDENCE AND CO-ORDINATION – THE EUROSYSTEM

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Abstract

Most outsiders tend to base their analysis of the future of the Eurosystem on the shape of the Federal Reserve System in the US. This paper argues that the US model is inappropriate. It suggests that the Eurosystem is pursuing a different arrangement, where the balance of power in the national central banks rather than in the centre may continue, particularly as the EU expands. This structure affects the relationship between monetary policy and fiscal policy, the one wielded tightly by the ECB and the other by national governments subject to the Stability and Growth pact. The paper explores how the Eurosystem is developing the process of co-ordination between itself and the fiscal authorities. It concludes that this is pushing the Eurosystem towards increasing transparency in order to make its case. This process is simultaneously easing the relationship between the ECB and the European Parliament and between the NCBs and their governments and parliaments.

[*] The views expressed in this paper are personal.

1 The Structure of the Eurosystem

The first year of the Eurosystem has gone successfully in the sense that price stability has been achieved and seems likely to continue for the immediate future despite a rise in headline inflation on the back of the rapid rise in oil prices. Growth of the euro economy has also been much better than expected at the outset aided by expansionary monetary policy. The technical implementation side in wholesale markets and settlement systems with TARGET have been especially successful and fault free. At the same time, however, the Eurosystem has come in for harsh criticism, particularly from the Anglo-Saxon press but also from academics (see Favero *et al*, 2000, for example). The two-pillar strategy for monetary policy, the lack of transparency and accountability and the exchange rate have been the main sources of criticism. In part this has been a problem in communication and in part the result of a learning process as the Eurosystem develops it policies. Quite a lot of the difficulty has occurred because both insiders and outsiders conduct the debate in terms of the structures with which they are familiar. Thus the acerbic debate between Buiter (1999) and Issing (1999) in the pages of the *Journal of Common Market Studies* illustrated that the participants understand different things by the same words, such as 'transparency'.[1]

Tempting though it is to pitch into this controversy, the present paper concentrates on one specific area of criticism, namely, that the structure of the Eurosystem is unlikely to be conducive to efficient or optimal policy making or policy co-ordination, particularly as the number of members expands (Favero *et al*, 2000). Attention has tended to focus on the monetary policy decision-making process itself rather than on the relationships between the national central banks (NCBs) and the ECB. The ECB Governing Council, which is responsible for monetary policy, currently has 17 members, the Governors of the 11 participating NCBs and the 6 members of the Executive Board (EB) including the President and the Vice-President.[2] Over the next decade the EU could expand by another 12 countries and the four current members that have not joined the euro area could do so, making a total of over 30 members of the Governing Council. This would be a large decision-making body by any standards,[3] especially where the subject matter is technical.[4]

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[1] 'Cognitive dissonance' as Issing puts it (p. 504).

[2] The NCBs of all 15 EU member states form part of the ESCB (European System of Central Banks), along with the ECB in Frankfurt but Denmark, Greece, Sweden and the UK are currently not participating in the Eurosystem, which governs monetary policy in the euro area.

[3] Buiter (1999) puts this colourfully: 'A group of 17 is already too large for the serious and productive exchange of views, discussion and group decision-making… A squad of 21 will be quite unwieldy. Thirty would be a mob.'

[4] While under normal circumstances it would appear premature to discuss altering an organisation that has only just started and does not appear to be facing obvious constraints, those seeking change point out that the current IGC represents possibly the only opportunity to change the rules through the Treaty before the EU or the euro zone are expanded. It may be more difficult to persuade people to give up powers they already have than to restrict the powers available beforehand.

In tackling this issue the tendency has been to point to the Federal Reserve System in the United States, where the Federal Open Markets Committee currently has 19 members and suggest that the same procedure where only some of the participants have a vote might be followed.[5] (Only 5 of the 12 Presidents of the Federal Reserve Banks have a vote, all but New York have a vote on a rotating basis only.) Part of the key to these proposals (Favero *et al*, 2000, for example) is that the power of the Executive Board be increased relative to the NCB Governors, perhaps up to the point that they are in a majority.

A change of this sort would have a marked impact on the character and spirit of the organisation. The Eurosystem is not structured in the form of a dominant centre with subordinate branches carrying out allotted tasks. The structure is the other way round with the NCBs in the majority deciding what functions should be most appropriately undertaken at or co-ordinated by the centre and what by the NCBs themselves. Up until recently the ECB staff were largely a secretariat serving a network of committees of NCB personnel. There are currently some 50,000 employees in the NCBs and less than 1,000 in the ECB, although the latter is growing rapidly. Even now the main increase in staff has been to provide the necessary information flows for the Governing Council in its role of running monetary policy.

What is surprising is that the proposals go further than the current position in the United States, which has not only been a single country for over 200 years but has operated its current monetary framework for over 60 years. Currently all 19 members of the FOMC speak in meetings. The Humphrey-Hawkins Report, which sets out the views of the FOMC twice a year, records the forecasts of all 19 members for inflation, GDP and unemployment in order to give a clear idea of the thinking of the Committee. While extreme values are excluded from the computation of the central tendency the exclusion is only on the basis of extremity not on that of who happens to hold the view. It is thus not clear that the FOMC is pushing the boundaries of manageability. Indeed it has been argued (Blinder, 1998) that a little bit of grit in the wheels of monetary policy decision-making might be a good thing as part of the appropriate response to (Brainard, 1967) uncertainty. If we are not sure about how the economy works then the best response to a shock may be caution initially, to avoid adding a further disturbance from inappropriate monetary policy.[6]

It is difficult to foresee the existing members or their governments being keen to agree on a removal of the right even to participate in the ECB Governing Council in the near future in the light of this. However, if some of the members were not have the right to vote, in the interests of improving efficiency, it

[5] Goodfriend (1999) provides a very helpful description of the way in which the Federal Reserve System functions with particular emphasis on the role of the Federal Reserve Banks within it.

seems likely that they too would want to follow the procedure of rotation as each NCB Governor is there in a personal capacity not as a national representative. It would clearly be impossible in such circumstances for some Governors to represent other member states. The hope would be that the particular group of those voting would be reasonable representative of informed opinion.[7]

Inverting the argument, there is not some clear form of polarisation in the FOMC between the Board Governors acting as a group and the Bank Presidents. Votes can cut across the two groupings. Although by tradition the Chairman is always on the winning side, this is not because the other Board Governors always vote for him.[8] It therefore does not follow that in looking for efficiency in decision-making that one should strive for any particular balance between the Governors of the NCBs and the number of members of the Executive Board.[9]

It is clearly going to be difficult to get an agreement that does not reduce the numbers voting substantially, otherwise any efficiency gain could only be limited. In any case it is not currently proposed to open up the monetary chapter in the present IGC on revising the Treaty. It is therefore highly likely that the Governing Council will have expanded at least slightly before any revision could be implemented. Moving away from the current arrangements at an early stage could lead to some volatility. It takes some time for a group to get used to each other and develop the means of working together. By meeting fortnightly (rather than six-weekly like the FOMC) the members of the Governing Council have been able to build this up and develop policy steadily. (The 30th March 2000 meeting in Madrid will be only the 40th gathering of the Governing Council.) As Goodfriend (1999) points out for the FOMC, even with their six weekly meetings, on most occasions economic conditions do not lead to any serious pressure for a change in the settings of monetary policy and hence there is scope for discussion of strategic issues and advance preparation for possible difficulties.

There is thus not a clear match between the behaviour of the NCB Governors and the Fed Bank Presidents. The Governing Council has been deliberately trying to develop a collegial approach. It has not had to vote on monetary policy issues up to this point and has been able to proceed by consensus. No

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[6] There is a long standing debate about the merits of running a relatively stable monetary policy following the observation that monetary policy itself can be a major cause of instability in the economy instead of increasing stability as it intended. See Orphanides (2000) for a recent discussion.

[7] There is therefore no ready analogy with the IMF or other international organisations where countries are grouped into constituencies to make decision-making bodies manageable. While the Governing Council goes out of its way to avoid 'national' inputs to discussions it would be unrealistic to think that Governors are not affected by their history and their home environment. Even if they are not others will still believe that they may be.

[8] It is apparently because of a combination of good argument, persuasiveness, reputation and careful assessment of the prevailing views beforehand (Meyer, 2000).

[9] Indeed in any future arrangement there is no obvious reason why all EB members should have a vote in Governing Council meetings. Only the President and the Vice-President are members of the General Council that includes all 15 NCBs in the ESCB. Perhaps that could be a precedent?

doubt the day will come when matters are so contentious that they have to be put to a vote. However, by the same token the Governing Council is not like the monetary policy committees of most central banks, where the members work together all the time and meet frequently in various groups formally and informally. In many central banks the monetary policy committee are also the executive of the bank and in almost all cases there will be a considerable overlap between the two. In some respects the Governing Council is more like a supervisory board in that they have considerable powers over the ECB's actions only some of which are delegated to the Executive Board. They therefore have a dual role, which the FOMC does not.

In any case the Governing Council can be expected to change its own practices if it finds problems in decision-making. It currently operates with a monetary policy committee with the same sort of composition that develops the information and analyses necessary for Council meetings, with working groups on forecasting, econometric modelling and so on, as necessary. There is considerable scope for these procedures to evolve and it is a choice whether this involves more activity at the ECB or through the NCBs singly or jointly.

A strength of the Eurosystem is that not only are the analytical resources available in the NCBs considerably larger than in the ECB but that this encourages a combination of collaborative and competitive work. There is no means in the system of discouraging different approaches and views as the NCBs have been deliberately constituted independent. One of 'pitfalls' that Goodfriend (1999) identifies for the FOMC, that repeated meetings might lead the members to think alike and hence fail to see a different consequence, is much less likely for the Eurosystem. The NCBs in briefing their Governors are going to be looking explicitly for extra information and analysis that they can bring to bear on the problems and thereby make a contribution to the discussion.[10] The incentives are strong. As Goodfriend (p.10) puts it 'Economic analysis is a great equalizer…argument based on economic reasoning that can be challenged and debated…is ultimately more influential than an intuitive assertion…no matter who expresses it and how strongly it is held.'

The Eurosystem represents a sharing of sovereignty among the participating states because they think that the ensuing single monetary policy will offer net benefits. However, each NCB governor has his own view about how euro monetary policy should be run to the benefit of the whole and uses both the ECB and his own NCB to provide the necessary information for the debate. Particularly since the euro

[10] The other pitfall that Goodfriend (1999) mentions is free-riding. Because of the size of the Committee some participants might feel that extensive preparations for the meetings were not worthwhile, as they could make little personal contribution to a discussion that could be dominated by those with much large resources such as the EB members and the Governors of the larger NCBs.

area is new and lacks data and any track record of established behaviour there is a premium on the exchange of analyses of how it may work. While there has to be a single policy there does not have to be a single view of how the euro economy works.

1.1 *Handling Disagreement*

One of the sources of complaint about the Eurosystem has been about a perceived failure to speak with 'one voice'. This is based on two fallacies. The first is that the FOMC speaks with only one voice. Even the members of the Board of Governors not only hold views that may differ from that of the Chairman but they air those views in public (see Meyer, 2000, for example). The Bank of England's Monetary Policy Committee certainly does not have a single view and from time to time the disagreements are recorded in the published minutes. The second fallacy is that the Governing Council have had much in the way of substantive disagreements in public. Possible differences of opinion, such as that highlighted in Business Week (2000) between Noyer and Issing, are not so much important in themselves but insofar as observers have difficulty sorting out whether the participants are just speaking for themselves or trying to summarise what the Governing Council thinks. The President is the spokesman in the official press conferences after Council meetings. However, monetary policy has to be explained to populations and governments in each of the member states.[11] It is conventional for the NCB governors to do that in their own languages. While they may have a common agreement it is not possible to run press conferences with a script and the specific questions will differ.

In speaking with one voice it is necessary to distinguish between the explanation of the decision, where there should be a single 'explanation' as it is an ex-post description of the collective reasoning, and ex ante discussion of the way in which policy will have to go. The ECB has been fairly circumspect in this latter regard and, if anything, the members of the Governing Council have produced substantially less material then the Fed. The Bank of Finland publishes its own forecast for Finland independent of the joint Eurosystem forecast, which is itself currently unpublished. However, the President has made a commitment to publish forecasts before the end of 2000.

The Eurosystem has the advantage that the Governing Council members are not representatives of their respective countries. The NCB Governors are not required to report on the state of the economies in their own countries at every meeting nor suggest what policy would be appropriate for them. The focus is solely on the euro area as a whole, although most of the statistics and assessments at this stage are built up from the component economies. However, assessing the appropriate policy for the euro area does not mean that the economies should be added together simply with weights reflecting their economic size (Mayes and Viren, 2000). There are strong nonlinearities in the euro economy and the appropriate response of policy. Favero *et al.* (2000) note that the Governing Council might have been putting a high weight on the slack performance of the German and Italian economies when deciding to lower interest rates in April 1998. There is nothing in the published explanations to enable such a conclusion to be sustained or rejected.

What we can see, however, from (Mayes and Viren, 2000, Table 3) is that the short run Phillips curve for the euro economy as a whole is sufficiently nonlinear that it shows very little inflationary impact from closing negative output gaps.[12] Since most conventional measures suggested that the euro economy was operating clearly below sustainable capacity at the time and likely to continue to do so for some time, the policy decision would have been justifiable without putting any unusual weight on Germany and Italy. Furthermore, the decision would not have been upset by placing high weights on the economies that may individually have had positive output gaps at the time, such as Finland. As these countries (Fig. 1), appeared to have below average responsiveness to inflationary pressures, such a different outcome from either equal national or activity weighted assessments would have made sense.[13]

It is therefore difficult to suggest that altering the balance of the voting members of the Governing Council in favour of the Executive Board would somehow make the decision-making more focused on the needs of the euro area as a whole. What Favero *et al.* do argue, however, is that if the European Parliament were to have a greater say over the appointment of the members of the Executive Board *and* the weight of the EB in the voting were increased then this might increase the legitimacy of monetary policy both to the Parliament and more generally. No doubt the European Parliament would favour such an approach. Whether the member states would feel the same way is more debatable. It is also debatable whether this would make the Governing Council any the more accountable for its actions.

While the Federal Reserve has worked out how to record the variety of ex ante views most central banks do not do this. The common practice is to publish nothing except a discussion of published indicators. Those who do publish either produce a single set of numbers or supplement them with simulations or a discussion of 'risks'. Even the Bank of England and the Sveriges Riksbank, which go furthest in discussing the range of possible outcomes in the future do so on the basis of an agreed distribution of

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[11] An analogous role is performed by Federal Reserve Bank Presidents explaining to local audiences (Goodfriend, 1999).

[12] The coefficients were 0.007 (-0.002) on the negative gap depending upon whether Generalised Least Squares (or Seemingly Unrelated Regression) was used for estimation. A 2 standard error interval in the case of SUR covered –0.024 to 0.022.

[13] Mayes and Viren, Table 1, also indicates that Italy and Germany are among the parts of the euro area that are less affected by exchange rate pressure (compared to interest rates) and hence the continuation of the interest rate cut in the face of the decline in the exchange rate could have been justified. This argument also does not feature in any published explanation.

risks.[14] Only a few banks such as the Czech National Bank and the Bank of England record disagreements and voting records. Even very transparent banks like the Reserve Bank of New Zealand and the Norges Bank do not do this.

The Eurosystem is unlikely to be able to operate in the same way as the unified central banks. The Governing Council would not be able to agree detailed texts, especially recording disagreements to go out under its own name unless it were to meet much more often and for longer. Hence published views would either have to follow a US style pattern of a summary of views in numerical terms or the publication of detailed forecasts from the ECB and NCBs, either separately or jointly. In the United States the Board's staff forecasts are published with a 5 year lag.

1.2 *Publishing a View of the Future*

Clearly anything published with a long lag defeats the purpose of helping to inform markets about monetary intentions. Ideally (Mayes, 1998) a central bank is seeking to make itself predictable and credible. If the private sector can assess what the central bank is likely to do in the event of an unexpected shock to the system (or even an expected event) with a substantial degree of accuracy then policy is likely to be less 'costly'. People will take out less 'insurance', holding back from decisions, and will be rather quicker to adjust without adding to inflationary pressure. A credible bank will find that people, when taken together, tend to agree with their assessments of the future for price stability and will expect that the bank will do what is necessary to achieve its objectives.

If the Eurosystem is to become more transparent in this 'ex-ante' sense as strongly recommended by Favero *et al* (2000) inter alia, then it will need to find a means of bridging the gap and providing information on how it sees the future and the way the economy behaves. It is already finding that it has an uphill task explaining that its approach to monetary policy differs from that of inflation targeting (Mishkin, 2000; Svensson and Woodford, 2000). Favero *et al.* explicitly recommend that the euro 11 council of ministers or its equivalent should set an explicit inflation target for the Eurosystem. The Governing Council, however, believes that many traditional inflation targeters appear to put too little emphasis on the role of money in the inflationary process (EMI, 1997). It has therefore emphasised that there are two pillars to monetary policy: a reference value for money and a broad based assessment of price developments.

[14] There is subtle difference in concept between the two banks use of fancharts (Blix and Sellin, 1998). The Bank of England discusses the probability distribution of output' variables such as GDP and inflation while the Riksbank is concerned with the

In practice this is a matter of emphasis. Let us take the example of the central bank that first adopted inflation targeting and is often thought to apply it in its purest form (Haldane, 1995). Although the Reserve Bank of New Zealand's model (Black *et al*, 1997) does not include money, the Bank has also developed separate monetary models whose assessments are taken into account when formulating policy and deriving the forecast.[15] The FPS model is designed to be able to incorporate other models into the forecasting process. Short-run forecasting methods normally dominate structural macroeconomic models over the first few quarters ahead and are hence used by most forecasters.[16] It is very obvious (RBNZ, 1994) that the rise in the monetary aggregates played a strong role in the tightening of policy when other indicators were not suggesting such substantial inflationary pressure.

2 The Structure of Macroeconomic Co-ordination

There were also initial fears that the independent structure of the Eurosystem would make it difficult to co-ordinate macroeconomic policy especially since the arrangements for co-ordinating fiscal, employment and structural policies through ECOFIN and the Euro 11 were so weak (ref). The practice has turned out rather differently. Not only has the Eurosystem responded to perceived weaknesses in the euro economy and run monetary policy rather more loosely than markets expected (as reflected in the decline in the exchange rate) but the process of policy co-ordination outwith monetary policy has been improved with the implementation and report on the Broad Policy Guidelines. Although currently the focus of the non-monetary policies tends to be on actions rather than on outcomes, as the latter are notoriously difficult to measure, a focus of both the Annual Review of Structural Policies and the Implementation of the Broad Policy Guidelines has been on the longer term structural issues, such as pensions and exclusion, that have to be addressed if the long term aspirations for policy are to be achieved.

Again the operation of the Eurosystem is different from many countries own experience, although similar to that in other regimes where the central bank is independent. Policy co-ordination does not occur through the main players sitting round the table and agreeing what to do nor through the government instructing agencies how to act. It is occurring through the Eurosystem setting out how it is sees the needs for monetary policy in the light of the likely developments of fiscal and structural policies. Thus far these discussions have been rather generalised as the Eurosystem is yet to publish its forecasts and simu-

distribution of inputs (such as foreign demand, inflation etc.)

[15] As far as I know the working papers on the monetary models have not yet been published. Variances were certainly large in their 1997 vintages.

[16] It is therefore essential (as Westaway, 1999, points out) for central banks to publish the whole suite of their models if people are to understand how forecasts are put together and how they think the economy may respond to shocks.

lations but they have been remarkably forthright in setting out the difficulties that the governments face (ECB, 2000).[17]

At present the member states have to set out their fiscal and structural plans on an annual basis. These are not only appraised by the Commission under the terms of the Growth and Stability Pact but they are open to peer review through the Broad Economic Policy Guidelines. The Commission's opinions on the balance of fiscal policy can result in recommendations, requirements and ultimately sanctions. Whereas in the other policy areas, providing there has been compliance with the law and it is not possible to bring a case to the European Court of Justice, the remarks can only push the member states towards action by exposing their lack of progress publicly. Ironically monetary policy is the area where 'sanctions' can be applied directly, as it is for the Eurosystem to decide what policy responses are required to maintain price stability without further reference to the member states or any other authority.

As the system develops the map for future monetary policy will become clearer.[18] However, it will always tend to be the case that monetary policy will be more contingent than other policies. This is not because monetary policy is some sense much more uncertain but because of the nature of the decision-making involved. The tax side of budgetary policy is normally only adjusted annually although expenditures can be varied rather more frequently. Structural policy although it can be altered at any time when parliaments are sitting is normally a relatively slow process both in negotiation and in subsequent implementation. The Governing Council of the ECB on the other hand meets fortnightly and could in theory meet in between at short notice. It can (and does) hold meetings by tele-conferencing so there is not even any need to go to a single location. It is therefore possible to change the setting of monetary policy on many occasions during the year and by various amounts on each occasion, as the 25 basis point steps are purely conventional. This, of course, is a common feature of monetary policy the world over and does not distinguish the Eurosystem in particular.

What the Eurosystem, along with other central banks, tries to do is map out for itself what is likely to happen to prices over the coming two or more years. In drawing up that map it explicitly follows the twin pillar strategy of using evidence from the behaviour of monetary aggregates along with more direct methods of assessing likely price developments. The ECB has committed itself to publishing forecasts

[17] Here again is an interesting example of difference in culture. In the New Zealand case the central bank would not have offered an opinion about how government policy should be run even though it was quite prepared to publish fiscal policy simulations. If the central bank were to offer views on fiscal policy then the fiscal authorities would start telling the central bank how they thought monetary policy should be run. When the Governor gave a speech in London at the Institute of Economic Affairs setting out some generalised ideas on deregulation this resulted in a question in parliament. The whole point of independence is to set people a task and then let them use their best professional skills to achieve it. With, in the New Zealand case, full responsibility for those decisions. For the Eurosystem a more active role in the debate appears to be possible.

in 2000 so some or all of this map will become clear during the year.[19] Currently only a few central banks, notably the Reserve Bank of New Zealand and the Norges Bank publish the map as a whole while others like the Bank of England and the Sveriges Riksbank publish most of it. Such a map includes at least three things (i) an assessment of the shocks that are likely to hit the economy over the coming period, including fiscal policy decisions by governments (ii) an assessment of what policy will have to do to ensure continuing price stability over the period (and beyond) (iii) an explanation of how policy is expected to respond if other unexpected shocks occur.

This map therefore is not a single document and certainly not just a short list of forecast numbers (see Mayes, 1998, for a description). It includes documentation of the bank's models, simulation properties and discussion of how they are used in policy formulation. It includes in particular an explanation of the bank's policy 'reaction function'. Very few central banks are prepared to give a clear algebraic representation for this and even those that are, like the Reserve Bank of New Zealand make it clear that this is only a generalised representation not an exact description of precisely what the bank will do on every occasion.[20] It is an attempt to set out the rules that will govern behaviour. If the bank wants to make itself predictable and its policy credible it needs to make that precommitment clear and believable. The Eurosystem's currently published map is consistent with a huge range of policy reactions and commentators (Business Week, 2000; Favero *et al.*, 2000, for example) are pushing it fill in a lot more of the data.

Here the US example is interesting because the map is fairly well understood (Business Week, 2000) and yet much of it is non-quantitative. There is no explicit target. There is no explicit agreed single view of how the US economy works although models are published. Even the forecast and the discussion of risks is fairly generalised. There is certainly no specified reaction function although outside commentators have managed to find quite good representations of behaviour, such as the well-known Taylor rule (Taylor, 1993). Criticism of the efforts of the Eurosystem in the light of this US approach might seem a little harsh. The Eurosystem is at least rather more explicit about its objective. This discrepancy in attitude shows the advantage of having a long track record and indeed the benefits of having had the same spokesman (Chairman) for well over a decade. It is clearly unrealistic to expect the Eurosystem to produce such a clear map in as many months.

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[18] Although as Issing (1999) and Vickers (1998) point out it will never be crystal clear; some eventualities will not be covered.

[19] Issing (1999, p.514) appears to associate forecasts with a major input to the second pillar only. Here forecasts are viewed as the outcome of the forward look derived from the assessment and weighting of the two pillars together.

[20] The RBNZ's reaction function as set out in FPS is to move policy so as to bring forecast inflation into the middle of the target range for the average of quarters 6 to 8 ahead. While the model takes the definition of middle literally the bank has made it clear (Mayes and Razzak, 1998) that this is a softer definition in practice involving a range of values round 1.5% inflation. Policy will remain unchanged if the forecast without a reaction does not go outside the range.

Ironically just publishing strings of numbers that emanate from the Eurosystem's models could be not just rather uninformative but positively misleading if they are not crucial information that is believed and used by the decision-makers in the Governing Council. A single forecast track, if it is based on unrealistic assumptions and using a simplified model, will not show us much of the map. Producing a single track based on assumptions of unchanged monetary policy can be particularly unhelpful. Under most circumstances it will be a counter-factual as we do not often observe constant policy settings for such long periods nor do people expect them. However, more importantly it will tend to show policy failing to achieve its objective, whereas what people want to know is how the bank sees policy succeeding (Tarkka and Mayes, 1999). The counter-factual will tend to be inconsistent with itself as people base their price expectations on what they expect to happen, which will include how they expect the bank to react. If they really believed monetary policy setting would be constant then their expectations of inflation would change.

What tends to happen in practice in these circumstances is that the forecast becomes a hybrid because some of it is on the basis of the most likely outcomes and some on the artificial assumption of unchanged policy. Hence if a second simulation is run, which includes a reaction by policy in order to maintain price stability, it will tend to show policy having a relatively muted effect. This does not increase the credibility of policy's ability to counter other unexpected shocks particularly large ones. The generally recommended solution (see Tay and Wallis, 2000, for example) is to present one's best guess of the likely outcomes including the reaction of policy as basic track for the forecast and then show how unexpected shocks would cause both inflation and policy to react. This could be in the form of a probability distribution, following perhaps the lines of the Bank of England or Riksbank fan charts discussed above or specific alternative scenarios as used by the Bank of Finland and the Norges Bank *inter alia*.[21]

In assisting policy co-ordination the Eurosystem needs to illustrate to general sorts of cases. It needs to show what the impact of different external forces, such as foreign interest rates or growth, since the Commission and the governments of the member states may have different views about what is likely and hence have a different basis for their own calculations. They need to be able to make the assessments comparable. Secondly they need to know what effect the Eurosystem expects from changes in the policy variables that governments themselves control. Thus for example the Broad Economic Policy Guidelines need to take into account the likely reaction of monetary policy to any changes they suggest.

[21] There are other possibilities. The Bank of England also publishes fan charts showing what it thinks would happen if policy were to follow the implicit path that can be derived from the term structure of interest rates.

Achieving this does not mean that the whole map has to be printed out on every occasion. Normal practice is to discuss different events as time passes and to update the general picture when there is something new to say. Thus the Eurosystem only produces full forecasts at six monthly intervals. The ECB publishes a monthly Bulletin that can be used to provide updates about how policy reacts and the press conferences after Governing Council meetings can be used to announce changes in view if the Governing Council thinks that forecasts have become too out of date to be useful. If this were not sufficient the Eurosystem has control over what it chooses to publish.

The key feature of the map is that it is a guide to likely future policy in the context of an uncertain world. In other words it reflects the difficult realities of actual decision-making and seeks to make the central bank's reactions as transparent as possible. No central bank can commit itself either to maintaining current monetary conditions or to following some explicit path in the future come what may. It can only commit itself to following a predetermined strategy.[22] The crucial aspect is that the explanation is 'ex-ante' not 'ex-post', to use the terminology of Favero *et al.* (2000) – it explains where policy is seeking to go rather than just where it has been.

Although this approach may differ from a corporatist bargaining one where the central bank agrees to follow a particular approach to monetary policy if governments follow a particular approach to fiscal policy and wage bargainers can credibly commit to specific outcomes, it does not constrain it. The difference is that the central bank lays its cards on the table. This pushes governments to lay their cards on the table as well and this is precisely how the Growth and Stability Pact works. It is government plans that are evaluated and commented upon not merely the outcomes after the event. Fiscal authorities thus also constrain their actions, not just for a single year but in the medium and longer terms as well.[23] The credibility of these constraints will vary. In a democracy new governments may be elected with a commitment to alter previous plans. Uncertainty is also reduced for wage bargainers, however (de)centralised the system.[24]

Co-ordination is always difficult when the different policies take different lengths of time to affect the same variables. Structural policy can be the slowest acting, except insofar as people try to anticipate its impact in order to gain a competitive advantage. Monetary policy is also well-known for its 'long and

[22] Issing (1999, p.517) sets this out neatly: 'The very purpose of a monetary policy strategy is to provide a clear and coherent framework to structure information and the decision-making process internally and to explain monetary policy decisions externally.'

[23] The New Zealand equivalent is the Fiscal Responsibility Act of 1994, which appeared after the new monetary arrangements had been operating for 5 years.

[24] As Kilponen *et al* (2000) point out, the creation of the euro area moves wage bargaining in the area as a whole more towards the centre of the Calmfors-Driffill (1989) 'smile' as the more centralised national bargainers no longer control the whole of the area to which monetary policy applies.

variable lags'. Thus while it may be much easier to change the setting of monetary policy, as it does not require legislation to be passed through parliament, nor any extended periods of consultation or implementation, monetary policy still needs to be set well in advance if its main impact occurs one or two years into the future. It therefore has to anticipate some of the faster acting policies and events, such as fiscal policy and wage bargains. The neat revelation of each party's hand may not therefore adequate co-ordination and the balance of policy may not turn out to be optimal. Nevertheless it is not clear that other co-ordination schemes will be able to achieve better allocations or more credible pre-commitments.

This same map that helps co-ordination will provide much of the information that the media, European Parliament and national parliaments want in their assessment of monetary policy and of the ECB, NCBs and the Eurosystem in achieving the objectives laid down in the Treaty. By trying to reduce the costs of monetary policy by making itself more transparent and predictable the Eurosystem is at the same time reducing many of the recent sources of criticism. Full forward-looking explanations of policy intentions and expositions of the views of the policy makers, even to the extent occurring through the Humphrey-Hawkins testimony in the US, will provide a substitute for the 'minutes' of meetings that some seek.[25] Even the structural suggestions for reform are likely to take more of a back seat if current decisions become better understood. There is always a tendency to blame the structure if one does not like the answers it delivers.

Concluding remark

With the Eurosystem only just a year old in full operation, some commentators have been demanding substantial changes in its structures and operations. In part these stem from observing differences between 'home' systems and the new Eurosystem. They also reflect the fact that Eurosystem is still building up its procedures and understanding of the euro economy and cannot therefore be expected to move straight to the maturity that other central banks have spent many years developing. Not only is the legal position of the Eurosystem somewhat different from that of other central banks but the organisational environment in which it works is also rather different, with 11 governments subject to much more limited constraints on their behaviour than is common in other single currency areas.

As the Eurosystem moves to publish its 'forecasts' later this year, this may go a long way to providing the transparency that many are looking for, not just for financial markets and the media but for member state governments and the Commission in trying to set the guidelines for fiscal, employment and struc-

[25] Of course, some aspects, such as voting records, will remain untouched, but except for issues of individual accountability this may prove little drawback.

tural policy and the European Parliament in trying to assess the Eurosystem's performance as well. The irony is that the motivation behind these steps is not to answer the critics but to try to provide the basis for more credible monetary policy that the Eurosystem is seeking to achieve in order to maintain price stability more efficiently. By becoming more predictable and better understood the Eurosystem will help stabilise private sector price expectations on its target of price stability and hence find its task easier. At the same time governments in the euro area will find they can co-ordinate their macroeconomic policy plans more readily with monetary policy. If a by-product of these changes was that the Eurosystem received a better press this would no doubt afford them just a little pleasure as well.

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Fig.1 **Responsiveness of inflation to positive (y>0) and negative (y<0) output gaps EU countries 1987-98** (Source: Mayes and Viren, 2000)