

REVIEW

Flaws in the Design of the Eurosystem?

Paul De Grauwe

University of Leuven.

Padoa-Schioppa, Tommaso, *The Euro and its Central Bank: Getting United after the Union*. Cambridge, MA: The MIT Press, 2004, ISBN: 0-262-16222-9.

de Haan, Jakob, Sylvester Eijffinger and Sandra Waller, *The European Central Bank: Credibility, Transparency, and Centralization*. Cambridge, MA: The MIT Press, 2005, ISBN: 0-262-04226-6.

Sinn, Hans-Werner, Mika Widgrén and Marko Köthenbürger, *European Monetary Integration*. Cambridge, MA: The MIT Press, 2004, ISBN: 0-262-19499-6.

The creation of the euro was a major historical event in the process of European unification. Not more than 15 years ago few people in Europe believed they would experience a common currency in their lifetimes. Economists, more than the general public, were extremely sceptical about the prospects for such a currency in Europe.

Despite the general scepticism, the euro is with us. In many respects it is a great success. The European Central Bank (ECB) has managed to keep inflation low and to create solid expectations that it will remain so in the future. Money and bond markets in the eurozone are almost fully integrated. Although the equity markets and the banking sectors have a long way to go to achieve full integration, the dynamics towards such integration seems unstoppable. Bankers, investors and wealth owners in the eurozone have much to be pleased about.

The general public, however, is not amused. The financial and monetary successes of the euro have not been translated into high growth and low unemployment. On the contrary, since the start of the euro in 1999, the gap in the growth and employment performance between the eurozone and the other EU countries has increased. The favoured official reaction to this disturbing phenomenon has been to shout that 'it is all structural, stupid'. The eurozone is underperforming because of structural rigidities. Although there are certainly structural problems in Europe, the structural rigidities story is not a satisfactory explanation. After all, prior to the start of the euro, the eurozone countries suffered from the same rigidities. And yet, in those days, the gap in the growth and employment performance of the eurozone countries with the rest of the EU was smaller, if it existed at all.

Could it be that there are flaws in the design of the eurozone and of its major institution, the ECB? This question, although not formulated in the same explicit way as here, looms large in a number of recent books about the eurozone and its central bank. Let me start with Tommaso Padoa-Schioppa's *The Euro and its Central Bank*, a highly readable and informative book written by an insider who is fully versed in academic discussions and analyses. So much so that his analysis of the 'impossible trinity' (the impossibility of reconciling fixed exchange rates, free capital mobility and monetary independence) has become part of standard textbooks in international economics.

Padoa-Schioppa is certainly not an iconoclast. On the contrary, having contributed to the creation of the ECB, he defends the performance of that institution with great verve. In his defence of the ECB he even goes so far as to claim that 'in the field of monetary policies perfection is already within reach' (p. 169). An extraordinary claim that only a man of the stature of Padoa-Schioppa can make without inviting ridicule. There are other, to my taste, too idyllic descriptions of the workings of the Eurosystem. One such description concerns the Governing Council of the Eurosystem. This is called a 'wisdom-based' collegial system in which its members do not pursue national interests but only care about how to achieve the common interest. If this is so, it is surprising that its members have not unanimously condemned the practice whereby an Italian member of the ECB Board has to be replaced by another Italian, a German member by a German, etc. Until we hear the protests against such nationalisms, the story of the Governing Council being a 'wisdom-based' collegial system will be believed by few outside the Governing Council.

These observations, however, are only sidetracks in Padoa-Schioppa's main line of reasoning. This is that much of the eurozone is unfinished business. The Eurosystem is not only concerned with monetary policy, it is a full-fledged central bank with a whole spectrum of activities, functions and

interests. And here much remains to be done. The present institutional setup for ensuring financial stability is mostly a national affair, and the question arises as to whether it will be effective in managing a crisis. National payments systems are still in place and national central banks have kept most of their national prerogatives (with the exception of the conduct of monetary policies). Streamlining and further centralization of these central bank functions will be necessary. Finally, and most importantly, the eurozone is unfinished business because of a lack of political union. In the last chapter of his book, Padoa-Schioppa describes with great eloquence how a monetary union must be embedded in a political union to work well and to be sustainable in the long run. It is worth quoting a few sentences from the conclusion: 'It is true that central banks have struggled for years to free the printing of money from the influence of politics (. . .). It is equally true that the present independent status of the Eurosystem is exceptionally strong in this respect. However, only superficial thinking could view the lack of political union as strengthening the central bank and making it freer to fulfill its mission. It would be unfortunate if independence were to be confused with loneliness' (p. 180). And Padoa-Schioppa goes on: 'Ultimately, the security on which a sound currency assesses its role cannot be provided exclusively by the central bank. It rests on a number of elements that only the state, or more broadly, a polity can provide'.

The fact that monetary union was started without the existence of a fully fledged political union is considered by some to be a serious flaw in the design of the monetary union. Not so for Padoa-Schioppa who prefers to think that 'the decision to move ahead with the euro in advance of political union contains an implicit commitment to the completion of the polity'. What if this commitment is not honoured? Padoa-Schioppa does not pursue this question. It may be better not to do so, as the answer would be very disturbing for the future of the eurozone.

Certainly the absence of a political union has had the unfortunate effect during the economic slowdown since 2001 of putting all the burden of macroeconomic management in the eurozone on the shoulders of the ECB. This contrasts very much with the United States where we have seen that both the central bank and the federal government have used their respective instruments to stabilize the business cycle. In the absence of a euro-wide fiscal policy, the ECB was indeed a very lonely institution. There can be little doubt that the absence of a political union is a serious design flaw in the European monetary union that will have to be remedied to guarantee the long-run survival of the eurozone.

Are there other design flaws in the system? The book of Jakob de Haan, Sylvester Eijffinger and Sandra Waller provides for a detailed account of the institutional design of the ECB. It is less wide in scope than Padoa-

Schioppa's book, but it compensates for this with a detailed and illuminating analysis of the ECB as an institution.

There is first the difficult balance between independence, accountability and transparency of the central bank. The authors present us with a careful analysis in which they blend their own original research. There is no doubt that the ECB is independent and that this is a desirable feature of any central bank. The ECB scores less well in the field of accountability. This can be compensated for, however, with transparency. The authors provide evidence that the ECB indeed scores well in a transparency index that gives points to the amount of information central banks disclose. At the same time they show survey evidence indicating that market participants do not perceive the ECB to be transparent. How can this discrepancy between measured and perceived transparency be explained? The authors stress two possible factors: the lack of harmony in public statements of the members of the Governing Council and the monetary policy strategy of the ECB. This leads to two other potential flaws in the design of the ECB.

The size and the composition of the Eurosystem's decision-making body (the Governing Council) are certainly problematic. The Governing Council is too big. There can be little doubt about this. There has been interesting work recently on the optimal size of committees (by Anne Sibert,¹ for example) suggesting that while committees are better suited to process complex information than individuals, the benefits of committee decision tend to wither away with size. Committees larger than ten members become unwieldy and inefficient. The Eurosystem's Governing Council now numbers 18 members and is quickly going to exceed 20 when new member states join the eurozone. The reform in the voting procedure that will come into play when the Eurosystem will number more than 15 countries will not solve that problem. The Governing Council will be too big, creating an environment in which it will be difficult to come to decisions and in which the large number of participants in the decision-making process will increase the probability of contradictory communication to the markets.

Then there is the monetary policy strategy of the ECB. This strategy has been widely criticized. The authors repeat this criticism. The ECB's monetary policy strategy is flawed for several reasons. First, it defines the inflation target to be 'below but close' to 2%. Many economists have argued that this target is too low, and that its asymmetric definition is asking for trouble. By announcing that the inflation rate should be below 2%, the ECB is creating a credibility issue where this is unnecessary. The reason is that it

¹See Sibert, A. (2005), 'MPC Design: Individual and Collective Reputations', Paper presented at the workshop 'Central Banking by Committee', Nederlandsche Bank, Amsterdam, November 2005.

is difficult to keep the inflation rate within a narrow band below 2%. In fact the rate of inflation of the eurozone has been above 2% most of the time. As a result, the ECB is put on the defensive in having to explain why inflation is above 2% so often. If it had chosen 2% as a midpoint target it would have spared itself the embarrassment of having to explain why it failed to meet the target. It would also come closer to the best-practice policies followed by many central bankers.

Second, the ECB's monetary policy strategy puts a lot of emphasis on erratic money stock numbers to guide its policy actions. The privileged position given to the money stock numbers that rarely signal underlying inflationary pressures creates another credibility problem. For much of the time the growth rate of M3 has been above the reference value announced by the ECB. For example, in the period 2002–03 the yearly growth rate of M3 was about 8%. Monetarists, reminiscent of Milton Friedman's notorious predictions, forecasted that this would inevitably lead to an upsurge of inflation two years later. It did not happen. Inflation moved in a flat band between 2% and 2.5%. This will not surprise other central bankers who abandoned monetary targeting long ago, after finding out that in a low-inflation environment, money numbers are very bad predictors of future inflation. In insisting on putting emphasis on money growth the ECB creates a needless and self-inflicted credibility problem, having to tell the market one day that the numbers should not be taken seriously, while the other day (e.g. in December 2005) having to argue that these numbers are important and that is why it is increasing the interest rate.

All this adds to confusion in the market and helps to explain why the ECB is perceived to lack transparency, despite the fact that it discloses a lot of information.

One of the most discussed conditions for ensuring a well-functioning monetary union is absence of asymmetric shocks. Since Mundell's path-breaking analysis, it has been well understood that countries which face asymmetric shocks and which lack the flexibility to deal with them should think twice about joining the monetary union. The 12 members of the eurozone have done their homework about this prior to entry and decided that asymmetric shocks would not be a problem. They are now in the union, and one would think that this Mundellian analysis has become purely academic. Not so. The issue pops up again in many ways. It pops up in Jakob de Haan, Sylvester Eijffinger and Sandra Waller's book when these authors analyse the tension that exists between the centralized nature of the ECB's policies in an environment of divergent economic conditions. The same theme is taken up in Hans-Werner Sinn, Mika Widgrén and Marko Köthenbürger's edited book, which is a conference volume bringing together a rather diverse set of papers on European Monetary Integration.

The reaction of many economists about asymmetric shocks in a monetary union is to throw their hands in the air and to shout that there is nothing one can do about it. This is not the position taken by Daniel Gros and Carsten Hefeker in their contribution to the conference volume. These authors argue that in an environment of asymmetric transmission of monetary disturbances the common central bank should not restrict its information set to euro-wide aggregates but should also use country-specific information in the formulation of its monetary policies. This advice goes counter to the official position of the ECB who has been arguing that it should only use the euro-averages of inflation and output growth.

It is not easy to dispute Gros and Hefeker's analysis. After all, it seems always better to use more rather than less information, at least if the additional information promises to improve the effectiveness of monetary policies. In a way, taking up the theme of design flaws, the proposal of Gros and Hefeker can be interpreted as a way to improve the design of the Eurosystem given that this system has to operate in an environment with many asymmetric features. It seems logical to use country-specific information in such an environment.

Curiously, there is a lot of resistance against this idea. One often-heard argument in Frankfurt is that the eurozone should be seen as one integrated economy, very much like the United States is. In this view, it does not make sense to use regional or national information in deciding about the best possible interest rate for the area as a whole. This argument is based on fiction; the eurozone is not an integrated economy. It is better to face this truth rather than to deny it. Once one accepts it, it is much easier to be pragmatic about the issue and to use country-specific information.

The power of the argument is stronger than one usually suspects. Let us take the example of Italy today (in 2006). Since the start of the euro, Italy has experienced a large loss in its competitive position relative to other eurozone countries. This cumulative loss could now amount to 20%. This loss of competitiveness puts a strong deflationary drag on the Italian economy, increasing unemployment and making fiscal consolidation extremely difficult. Italy will now have to go through a period during which it forces its inflation below the eurozone average inflation rate so as to regain competitiveness. As the ECB targets an inflation rate of 2% this means that the Italian inflation rate will have to be below 2% for quite some time. Even if it succeeds in bringing its inflation to 1% a year it will take Italy more than a decade to restore its competitiveness. The deflationary pressure that this will introduce in the Italian economy for a long period of time is likely to lead to social and political repercussions that can bring Italy's membership in the union into danger.

The ECB can alleviate the problem by redefining an inflation target that is less strict than the one it has defined. After all, a 2.5% or 3% inflation target is nothing to worry about. I know of no single economic theory that says that the difference between inflationary heaven and hell is to be found between the numbers 2 and 3. It is unlikely that the ECB will heed this advice, however. Yet it may be the right thing to do if one wants to sustain the eurozone in the long run in an environment where trends in competitiveness are likely to diverge regularly.

There are many other interesting chapters in Hans-Werner Sinn, Mika Widgrén and Marko Köthenbürger's book. Fabrizio Coricelli, Alex Cukierman and Alberto Dalmazzo analyse the link between conservativeness of the central bank and economic performance in a monetary union when shocks are asymmetric. They argue that the welfare loss, because of asymmetric shocks, can be compensated for by a greater conservativeness of the common central bank. Hans-Werner Sinn and Holger Feist study the redistributive effects of the introduction of the euro on the seigniorage revenues of the participating central banks. It turns out that the German Bundesbank is the big loser. Gerhard Illing develops a bank crisis model and analyses issues related to the lender of last resort function of the central bank.

Finally there is an illuminating chapter by Christopher Sims, who introduces a distinction between two types of central banks. There is a type-F bank like the US Federal Reserve System whose balance sheet is perfectly hedged. Assets and liabilities are expressed in the same currency (the dollar) leaving almost no risk of balance sheet problems. Put differently, the assets held by the Federal Reserve (US treasury securities) are fully convertible at par into high-powered money. There can be no default of the central bank as long as the US government does not default. The budget constraint of the central bank and the government is one and the same thing. This contrasts with the type-E central bank like the ECB. The latter is characterized by the fact that the risks of assets and liabilities do not match, because a substantial part of the assets are foreign currency assets. As a result, part of the bank's assets are not convertible at par into high-powered money. The budget constraints of the central bank and of the different national governments are very different. In this sense the balance sheet of the ECB is not fully backed by the power of the state.

We have come full circle. The European monetary union is a remarkable achievement. Yet it also remains fragile because of a number of flaws in its design. The most important one is the absence of a full political union which includes a Central European government with the power to spend and to tax, and which is independent of national governments. Such a government is the only institution that can fully back the ECB. Its absence is a flaw in the

design of the system that will have to be fixed. It should be clear, however, that it will be very difficult to do so. There is a general 'integration fatigue' in Europe so that it is doubtful whether the European population wants to fix this flaw in the design of the Eurosystem.

The other flaws in the system can be dealt with more easily, although some may still turn out to be difficult to tackle. In particular, some can only be fixed by a further transfer of sovereignty, a difficult task. For example, it will be important to reduce the size of the Governing Council, but this will require some countries to give up their seat in the Council. Resistance against such a move is likely to be fierce.

Other flaws can be fixed more easily as they require nothing more than common sense. I have in mind the Monetary Policy Strategy of the ECB that can and will be improved on. These easy fixes will smoothen the operation of the Eurosystem. They will not be sufficient, however, to guarantee its long-term survival.