

Sarkozy on the ECB: Right intuition, wrong target

Francesco Giavazzi

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Sarkozy repeatedly criticised the European Central Bank during the campaign; his intuition was correct but his aim was off. By forcing the ECB to be more transparent and accountable, he would contribute to improving monetary policy in Europe.

During his electoral campaign, Nicolas Sarkozy repeatedly criticised the European Central Bank. Since becoming President, he has kept quiet, but he obviously remains sceptical of the Frankfurt institution. As on many other issues, Sarkozy's intuition is correct, but he is aiming at the wrong target. What is flawed with the ECB is its lack of transparency, not its interest rate decisions.

Implying that the ECB stands in the way of growth and jobs in Europe is wrong. In the twenty years that preceded the start of the monetary union, the US economy created 32 million new jobs, the euro area countries – a region of about the same economic size – only half that number. Since the Euro was introduced, the number of jobs created in Europe and in the US was exactly the same – about 18 million each. Productivity growth is where Europe has fallen behind the US, but there is nothing the ECB can do to speed up productivity.

By directing his criticism to the right target, the bank's lack of transparency, Sarkozy could greatly contribute to improving monetary policy in Europe. It is now well understood that good monetary policy requires delegation of the power to set interest rates to an independent central bank. But a democracy can only accept such a delegation if the central bank is accountable, that is if its decisions can ex-post be carefully scrutinized: by Parliament, by the general public, by the press, by academic economists. This is why central bank transparency is the lynchpin of central bank independence.

But seriously scrutinizing a central bank which does not fully reveal its analyses and its decision-making processes is impossible. Thus a central bank that is not entirely transparent cannot be held accountable, and in a democratic society it will sooner or later lose its independence. The members of the ECB Board of Directors could testify in the European Parliament every week, rather than four times a year: this would not help improving their accountability if the bank's analyses and decision-making processes remain secretive.

The most successful central banks in the world have understood the important link between transparency and independence and have become glass houses. The data that are presented to the committee responsible for setting interest rates are available on the banks' websites. The banks' forecasts are clearly explained in an 'Inflation Report,' and the committee takes direct responsibility for such forecasts, adopting them as their own. Since it is impossible to decide the appropriate level of today's interest rate without having a view on the path that policy rates should follow in the future, these committees also publish their expectations for such a path. The opinions that are in competition while the committee deliberates – and such competition is the sign of a healthy debate – are clearly explained in the minutes of the meetings.

Decisions are always taken with a vote, and the vote of individual committee members are public information, thus reducing the risk that peer pressure prevents individuals from voicing their disagreement. The Riksbank, the Bank of England, the central banks of Canada, Norway, New Zealand (and many others) work like this, and constantly strive to improve their transparency. The publication of interest rate forecasts is the latest step in this quest for transparency. The Riksbank and the Norges Bank already do it. In the Bank of England, which does not yet publish such forecasts, there is a lively and open intellectual debate on the merits of taking such a step.

The ECB is miles away from all this. The Governing Council, which is the committee responsible for setting interest rates, takes no responsibility for the forecasts produced by the bank's staff. If they turn out to be consistently wrong, the Council's members cannot be held accountable; they can simply blame the staff. The deliberations of the Governing Council are secret. We don't even know if a vote is taken, let alone how each Council member voted. Nobody knows whether different views were discussed, or which arguments were made for and against a decision. We know, for instance – because often rumours pierce through the ECB's thick walls – that during the past year two camps have confronted each other in the Council. One favours raising interest rates relatively fast, the other favours gradualism. Gradualism prevailed, but what were the arguments for and against it? Without knowing them, it is impossible to decide whether the view that prevailed was correct. Jean Claude Trichet, the bank's president, has the habit of pre-announcing an interest rate move one month ahead of the Council's decision. Does the rest of the Council agree? Again, rumours indicate that on at least one occasion some members protested, since on the day of the meeting they were presented with a *fait accompli*. Moreover, Trichet's hints resemble the presages of the Delphic oracle – one has to interpret them looking for a change in the nuance of an adjective. Just try showing the bank's statements to your smartest friends and see what they can make of them.

Last November, the ECB convened the world's best monetary economists in a conference whose purpose was to openly discuss the bank's monetary strategy. Tangible tensions emerged during the conference – among the bank's staff, and between the staff and some members of the Board – on the role that monetary aggregates should play in deciding the appropriate level of interest rates. The academics and the market practitioners present had the clear impression that these important issues are rarely openly discussed inside the bank and that, at least in this case, it was dogma rather than reason that rules the institution.

Very few members of the ECB Governing Council have private sector experience. They are mostly old "central bank hats", nurtured in a culture that assumes central bankers know better and markets should be kept guessing. They are at least 10 years behind the curve in modern central banking practices.

The observation that the Federal Reserve is not much more transparent is a very weak defence. First, it is not true. The minutes of the Federal Open Market Committee are made public a few weeks after each meeting. These meetings are also taped and the tapes are made public with a few years' delay – a practice I personally do not encourage since tapes, contrary to minutes, have the effect of killing any lively debate. Chairman Bernanke is actively working to improve the Fed's communication. In fact he has said that this is one of his priorities. And even if the Fed does not become very transparent, why should the ECB follow a (bad) example rather than those of the Riksbank and the Bank of England?

If Nicolas Sarkozy aimed at the right target and used his authority to force the ECB to be more transparent, he would greatly contribute to improving monetary policy in Europe. By forcing the bank to create the conditions for becoming seriously accountable, he would also take a subtle revenge at those who, even inside the ECB, accuse him of undermining the bank's independence.