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CAN A LESS BORING ECB REMAIN ACCOUNTABLE?

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Highlights

- Until recently, there was widespread agreement that central banks should focus on one objective: price stability. On this basis, an intellectual apparatus was developed that put the emphasis on transparency and predictability. As the governor of the Bank of England once said, central banks were proud to be boring.
- In the crisis, central banks haven't been boring. In the wake of the crisis a new consensus is emerging, calling on central banks to take more responsibility for financial stability. They will have to participate in macro-prudential supervision. But(a)0(v)1hpi(vi)0(B)20()16.1((u)19.1d1(tial s)14.2(u)-ie)2

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ACCOUNTABILITY AND TRANSPARENCY in central banking were defined and promoted as objectives at a time when central banks around the word thought their mission was to be predictable, guarded and conservative – "boring", as Mervyn King, the governor of the Bank of England, aptly said in 2000[1]. Indeed, in recent decades the trend has been for central banks to become more independent in order to credibly focus monetary policies on price stability. This clear focus and independent mandate have gone hand in hand with greater transparency and accountability of central bank action.

Yet, since the crisis started in 2007 and especially as it has evolved into a global shock of historic proportions, central banking has become anything but boring. Central banks have *de facto* taken on a much enhanced role and have successfully contributed to limiting the consequences of the financial crisis. The ECB in particular emerges from the last two years as a greatly-strengthened institution that has been Tw[(in)17.1(s)6.0 1s th greank acf

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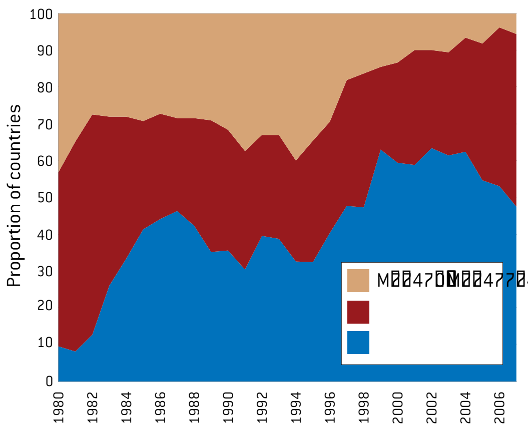
Proportion of countries
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influenced by this approach, although it always fell short of adopting it.

Inflation targeting is a sophisticated strategy. Contrary to what is commonly believed, it does not target the current rate of inflation, but the central bank's own inflation forecast. This forecast is conditional on all available information, including the current (and possibly future) monetary stance. The transparency of the rule is ensured through publishing both inflation forecasts (frequently accompanied by their standard deviation) and the models and assumptions used to prepare them.

This strategy has two significant advantages. First, it ensures a high degree of transparency and predictability of monetary policy because the central bank has one primary objective and communicates in real time on how likely it is to reach its objective within a given time frame. Second, it combines the advantages of a rules-based policy with reliance on a wider set of information that is traditionally associated with the discretionary approach[4].

This recent trend has indeed further enhanced transparency and accountability in central banking. Eijffinger and Geraats (2006) quantified these effects, defining transparency as "the extent to which central banks disclose information that is related to the policymaking process". They even distinguish between several types of transparency as seen in Table 1.

By the late 2000s central banking around the world was therefore converging on a model characterised by high degrees of independence, specialisation (on the price stability objeas og7.8(s)23(as.

which are far from fully understood at this stage.

Perhaps a good starting point is the 'Tinbergen rule', which states that an institution needs as many policy instruments as there are policy objectives[6]. The past trend towards specialisation was very much an application of this rule: in a nutshell, the central bank was given one objective, price stability, and was in control of one instrument, the short-term interest rate[7].

If an institution has more than one objective and only one instrument, or more generally more objectives than instruments, it must engage in trade-offs across objectives – which is precisely what the monetary policy framework, developed over the last few decades, tried to avoid. Trade-offs complicate accountability and transparency as the institution needs to rank equally desirable

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BOX 1: MACROPRUDENTIAL RECOMMENDATIONS OF THE DE LAROSIÈRE REPORT

In October 2008, the European Commission President requested a group of high-level experts to prepare a report on the future of financial regulation and supervision against the background of the economic crisis. This report, published in February 2009, contained a host of recommendations regarding the micro-prudential regulation of financial institutions and products at the European level. However, it recognised that these steps will need to be complemented by better macro-prudential supervision, taking into account that apparently independent micro-risks can be highly correlated because of system-wide and macro-economic linkages. As a result, excellent micro-prudential regulation may fail to detect the build-up of ene34p oa16.1(e)2 0(d m)18.1(a)19.1(c)14.2(r)16.1(

QUESTIONS FOR THE FUTURE

The preceeding analysis raises a number of questions, which can be summarised as follow:

a) Should the definition of the ECB's objectives be amended to give more weight to financial stability? If not (assuming the treaty language can accommodate the increased weight likely to be given to it in practice), where and how should the objective be defined in a way that facilitates the monitoring of the central bank's performance? Should financial stability be considered part of the 'general economic policies' that the ECB should support? Or should financial stability be considered a condition of lasting price stability?

b) If the central bank is to give more weight to financial stability, what are the implications for the assignment of monetary policy to the primary goal of price stability? Does it mean that the central bank should be able to trade-off short-term price stability for longer-term financial stability, in other words to set the interest rate at a level that is higher than what is required to achieve price stability over the usual forecast horizon? Or should the central bank err on the side of caution? How should such decisions be communicated and how should central bank accountability be ensured?

c) When pursuing financial stability, how can the ECB as an interest-rate setting institution take into account the variety of situations within the euro area? Do serious threats to financial stability in some countries or markets justify reacting more aggressively, implicitly giving them more importance than justified by their quantitative weight?

d) How much discretion should there be in the management of countercyclical regulatory instruments? Should action be based on rules, or should there be room for discretion, at least during a learning phase?

e) How does the ECB intend to manage the risk of increased competencies coupled with the increasingly political character of its decisions ultimately undermining support for its independence?

f) Can the ECB be held accountable for the achievement of financial stability although it is not fully in charge of the corresponding instruments, and the responsibility for implementation is left to the regulatory and supervisory agencies?