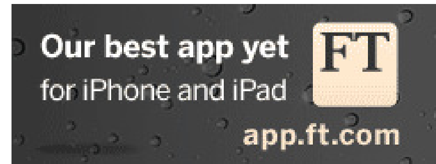

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Worry about the euro; not price stability

By assigning to the European Central Bank the task of "defining and implementing the monetary policy of the Community", the EU Treaty implicitly considers that there should be only one monetary policy for the entire euro area. Yet, looking at a variety of indicators – from short or long term interest rates on a wide variety of assets to the flow of money and credit to the private sector – it is difficult to conclude that monetary conditions are currently uniform across the union.

The central bank typically implements its monetary policy by setting the rate of interest at which it lends to the banking system. Such a rate, which influences asset prices and affects the savings and investment decisions of the private sector, is determined with a view to achieve price stability. A key assumption underlying this operational framework is that financial markets are efficient and support a smooth flow of funds across the union. In other words, the transmission mechanism of monetary policy is expected to be stable and predictable.

This assumption is currently far from being satisfied. The euro area financial market, in all segments and maturities – including the very short term money markets – does not function properly, as banks deposit their excess liquidity with the central bank instead of lending to other banks. Cross-border banking flows have dried up. Households and firms across the union borrow at rates which depend more on the respective sovereign risk — just look at Spain, today, for example — than on their intrinsic creditworthiness. Interest rate decisions made by the central bank are not able to affect monetary conditions in the desired way in a large part of the euro area.

There are two ways to address the issue. The first is that the central bank

adopts measures aimed at circumventing the prevailing disruptions to the transmission mechanism of monetary policy. Over the last two years the ECB has taken several actions in this direction, such as the provision of unlimited long term refinancing to banks, at a fixed rate. These measures have been effective, at least for some time, and there is probably room for more, but the transmission mechanism of monetary policy has remained impaired.

The second way is to repair the transmission mechanism. But who's task is it? Central bankers tend to think that the responsibility lies primarily with national governments and supervisors, given that the malfunctioning of the financial markets is mainly due to the heightened banking and sovereign risk. Governments, on their part, contend that they have already taken strong actions, and have committed to more, but markets are too slow to recognise progress. Only the central bank has sufficient firepower to push markets towards a sustainable equilibrium.

Both are right, to some extent. But there can be no viable solution without actions being taken at the same time by governments and the central bank, each in their own field of competence. In allocating responsibilities, the euro area can build on the experience gained by the International Monetary Fund in dealing with crises for over 40 years. First, strong conditionality is needed to ensure that governments consistently implement their adjustment programs over time. Second, liquidity has to be provided in sufficiently large amounts so as to catalyse private financial flows and convince market participants that the system is stable.

To be effective, the solution requires confidence and trust between the policy authorities. The central bank has to be reassured that the conditionality adopted by the member states is sufficiently stringent, lasting and irreversible. In this respect, the experienced which followed last Summer's ECB's intervention in the secondary market for Spanish and Italian government debt has left a sour aftertaste. Governments, on their side, have to be reassured that the tough measures that they have committed are supported by the provision of sufficient liquidity to guarantee success over time. To be sure, the fiscal adjustments which are currently being implemented have little chance of succeeding unless the interest rates prevailing in these countries are rapidly brought down more in line with the rest of the euro area. This can hardly be done without the direct involvement of the central bank.

The strategy is successful if market participants are convinced that policy makers stand ready to do all that is needed to solve the crisis. Communication is key, and needs to be consistent with this requirement. In this respect, focusing on what the central bank should not do or does not intend to do, rather than what it might eventually do, if necessary, in order to address the problem, can be counter-productive. For example, repeatedly raising concerns in the public about the size and the risks of the

central bank balance sheet, about the dimension of the cross-border payment imbalances (Target2 balances) or about the limited ability of monetary policy to solve all problems may fuel doubts among market participants about the determination of the monetary authorities. In a fiat money system, even the slightest doubt that the central bank may face constrains in ensuring the convertibility of the currency can fuel bank runs and generate financial turmoil.

The euro area crisis may have reached a point in which it can hardly be resolved unless the policy authorities are determined to take bold actions. This may require that the member states further strengthen their policy commitments, concerning in particular the structural reforms aimed at improving competitiveness and growth, and make these commitments irreversible, consistently with their membership of the euro area. It also requires that the central bank takes more drastic measures to ensure that there is a single monetary policy throughout the euro area, consistently with its mandate. Price stability is not in danger right now. The euro might be.

The writer is a visiting scholar at Harvard's Weatherhead Center for International Affairs and a former member of the ECB's executive board

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