

The ECB monetary policy: Choices and challenges

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Received 15 May 2006; received in revised form 21 August 2006; accepted 6 December 2006

Available online 16 January 2007

Abstract

This paper analyses the European central bank (ECB) monetary policy over the period 1999–2006, with a special emphasis on the recent years. The first part of the paper underlines the *declared* goals, decision variables and procedures, as can be inferred from various speeches of Jean-Claude Trichet, the President of the ECB. These statements are then weighted against the data, mainly through estimates of possible ECB interest rate rules. While in many respects the bank has performed reasonably well, several issues may be raised, mainly because the inflation objective has not been reached during the last period and monetary developments are not in line with economic stability. Policy recommendations follow, built on a renewed monetarist tradition: the reduction of the weight of real activity in the conduct of monetary policy, while further emphasising money *via* a money growth intermediate target.

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JEL classification: E52; E58; F01

Keywords: Monetary policy; ECB; Euro area; Taylor rule

1. Introduction

A fruitful debate on monetary policy processes, whatever the central bank under scrutiny, needs to unveil the variables that affect the banker's behaviour, and analyse how these variables affect such behaviour. This is a crucial endeavour to get an understanding of any consistent (or inconsistent) decision-making process, to evaluate this process and to make policy recommendations.

Economists often resort to linear models of the interest rate determination in order to describe the essentials of a central bank's monetary policy. Yet, in day-to-day decision-making, central bankers follow a rather pragmatic approach in formulating their policy decisions. They take into

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consideration a variety of variables and even “hunches” that are not necessarily captured by simple rules. Hence, the necessity to carry out not only a quantitative but also a qualitative analysis of the central banker behaviour.¹ By considering both the quantitative and the qualitative analyses one gets a better view of a central bank’s monetary policy framework and is able to use these analyses as a basis for policy proposals.

One objective of this paper is an attempt at unveiling the ECB decision-making process, building upon both a qualitative analysis and an empirical analysis of its main monetary policy decisions. From these analyses we infer an evaluation of the ECB monetary policy and propose policy reforms which, we believe, would enhance and sustain over time the bank’s credibility as well as improve its role and achievements as a “money watcher”.

The qualitative analysis is conducted by studying the public statements and positions (press conferences and speeches) given by the President of the ECB, Jean-Claude Trichet, speaking for the governing council of the central bank. The quantitative analysis seeks to extract from the data the basic responses of the ECB to main macroeconomic variables; this extraction process enables us to compare the empirical results with principles deduced from the qualitative analysis. The quantitative analysis is conducted essentially via estimates of interest rate rules, be they in the existing literature or our own new estimates.

Following this introduction, Section 2 presents a qualitative analysis of the European central banker’s behaviour, as inferred from his policy statements. Section 3 pursues this analysis through a discussion of the art of central banking and the credibility building essential to a new central bank. The empirical analysis is developed in Sections 4 and 5; first by evaluating the existing literature, second by a set of new estimates including the most recent period. Section 6 is devoted to further evaluation and discussion of the ECB policy process and to propositions for institutional and policy reforms. Finally, Section 7 concludes by highlighting our key points.

2. European monetary policy in action: a qualitative analysis

This section aims to unveil the different variables that seem to come into play when the ECB determines monetary policy in the euro area, and the qualitative role that such variables play in this determination, as can be deduced by reviewing the official statements of the President of the central bank.²

2.1. *Inflation and inflationary expectations*

No doubt, inflation and inflationary expectations of private agents are the core variables influencing practical monetary policy choices in the euro zone. A typical Trichet’s quote: “It is of the essence (of monetary policy) that the increase in the current inflation rate does not translate into inflationary pressures over the medium term and to ensure that inflation expectations remain firmly anchored at levels consistent with price stability.”³

¹ Furthermore, Heinemann and Ullrich (2004) have shown that these qualitative analyses do convey relevant information about monetary policy making.

² The references are essentially the *Press Conferences* given by J.C. Trichet after each meeting of the Governing Council over the year 2005 until July 2006, and the *Reports to the European Parliament*. When other references are used, they are explicitly mentioned.

³ Private agents’ expectations are not easy to grasp (they may be captured by the yield gap between standard and inflation-indexed bonds), and are extremely volatile. Keeping them under control is possible only if private agents have trust in their central bank.

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