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European Central Bank versus euro

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IN THE past few months, the European Central Bank (ECB) has been soundly criticised and blamed for the sharp decline in the euro. Many analysts lament that if only the ECB and its President, Mr Wim Duisenberg, was as powerful as the Federal Reserve Chairman, Mr Alan Greenspan, the euro would have fared much better. But what are the real reasons for the euro's fall?

Much has been made of the fact that the ECB has not used its independence effectively. We must, however, remember that the ECB -- while on paper is the most independent central bank -- has been under pressure right from its formation due to the constant interference by Europe's politicians. The election of Mr Wim Duisenberg as President in 1998 was itself a messy affair. The French pressed hard for the appointment of their candidate, Mr Jean Claude Trichet. They had to yield when most other Euro zone members backed Mr Duisenberg, widely perceived as Germany's candidate. Mr Duisenberg, after his appointment announced that he was getting old and would resign mid-way through his eight-year term. That Mr Trichet would succeed him seemed to be the implicit message. The manner the ECB's governing council was selected was also cause for concern. Instead of going by merit, a quota system was used to accommodate the interests of different member-countries.

During the euro's early days, the statements of the German finance minister, Mr Oskar Lafontaine, created much confusion. Mr Lafontaine pressed for lower interest rates as Germany was going through a severe recession then. The ECB would probably have reduced interest rates on its own, but did not budge. Here, the ECB seemed to be taking a leaf out of the formidable and highly independent

Bundesbank's book.

Only after Mr Lafontaine resigned a few months later, did the ECB cut interest rates from 3 per cent to 2.5 per cent.

Even two years after the euro's launch, it cannot be said with a high degree of conviction that European politicians have decided to mend themselves. They have been voicing their opinions in public, holding the ECB responsible for euro's fall. For instance, during September-October 2000, Mr Duisenberg came under tremendous pressure as the euro plunged below $.84. When it went up briefly at one point of time, there was even speculation, that it was the result of Mr Duisenberg's decision to resign. French politicians in particular, continued to fish in troubled waters, asking the EC president to quit.

Mr Valery Giscard d'Estaing, a former French president remarked: ``I have always thought the ECB's first president should be a man whose international monetary authority would be immediately recognised. Whatever be the personal merits of Mr Duisenberg, it was a casting mistake.'' A surprising criticism of a man who had been in charge of the Dutch central bank for 15 years. It must be recalled that the Netherlands maintained a band of only 2.25 per cent against the mighty Deutsche Mark when all others withdrew into the safety of a 1.5 per cent band within the European Exchange Rate Mechanism, following the currency crises of 1992 and 1993.

People are comparing the ECB with the Federal Reserve, that has been far more aggressive in cutting interest rates over the past three months. It is the primary function of a central bank to control inflation, and if the ECB feels this is not the time to reduce interest rates, why blame it? Moreover, there is no guarantee that a cut in interest rates will automatically boost growth.

In the last few years, the US dollar has attracted huge investments. For many European companies, strategic investments in the US have made sense. But despite brave talk, Europeans have struggled to restructure their economies. It is one thing to cut interest rates (the Euro Zone members all cut their interest rates to 3 per cent just before the Euro was launched) and reduce the budget deficit. But it is quite another to deal with micro-economic issues.

For instance, it is no secret that Europe's labour markets are very rigid. Firing workers is expensive in countries like France and Spain. When the famous British retailer chain, Marks & Spencer, recently decided to pull out of France, the reactions from French politicians were shameful to say the least. The French Prime Minister, Mr Lionel Jospin, remarked: ``The logic of profit must not be exercised to the detriment of employment.''

Unemployment benefits are so generous that many people are effectively out of the workforce. Consequently, structural unemployment has continued to rise. Many labour unions are politically affiliated. This makes labour-management negotiations a complicated and long drawn-out process. While things are changing, the level of transparency and shareholder orientation is far lower than in the US. European companies barring exceptions such as Nokia have also not shown the capability to innovate. And setting up new companies is far easier in the Silicon Valley than in Europe. Due to all these reasons, the dollar has gained in credibility at the euro's expense.

In today's global forex markets, statements by central bankers or direct intervention have little impact. What matters most is expectations. For the euro to go up, market sentiments need to improve. And for this to happen, politicians in Europe should get down to some serious work. They need to allow their companies to restructure themselves and make the labour market more flexible. They need to create conditions that allow sick companies to close and new companies to be formed quickly. Ultimately, it is microeconomic factors rather than the actions of a central bank that boost the competitiveness of an economy. And a currency is nothing but a proxy for an economy's competitiveness.

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