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EU Central Bank Faces Rocky Start

The Challenging Quest for 'One-Size-Fits-All' Interest Rates

By Alan Friedman
International Herald Tribune

ROME — The greatest challenge for the future European Central Bank will be to set a "one-size-fits-all" interest rate for much of Continental Europe. But even some of the biggest boosters of the planned single currency at finance ministries and central banks worry that it might get off to a rocky start.

Putting together a central bank that represents as many as 11 countries and is able to overcome barriers of language, culture and economic tradition will not be easy. But then making sure that politics do not intrude on sensitive financial decisions will be even tougher.

During the first days of May, when European Union leaders decide which countries will launch the euro on Jan. 1, 1999, they will also have to name the president of the new central bank and agree on exchange rates among the various currencies destined to be merged into the single currency.

The potentially volatile and politically controversial environment in which the new European Central Bank will have to operate was evident over the weekend as Greece announced plans to devalue the drachma by 14 percent and pursue a tough austerity program as part of a bid to join the European Union's exchange-rate mechanism and ultimately, the single currency.

Ireland, meanwhile, angered its exporters by revaluing its own currency to prepare for its participation in the euro.

The central bank, which is to be fully operational by the end of this year, will be of crucial importance as the guardian of the euro, setting interest rates that will affect Europeans in a broad range of ways, from steering overall economic growth to influencing mortgage rates paid by homeowners.

Its most formidable challenge will be trying to decide rates for a large number of countries with different business cycles, different electoral calendars and different levels of growth and unemployment.

Negotiations over the choice of the president of the new central bank have already deteriorated into political horse trading between Bonn and Paris, triggering resentment among other nations that fear that the two leading European economies will exclude them from other key decisions.

"The big difficulty," said one senior European central bank official, speaking on condition of anonymity, "is that you may have some countries in a strong recovery phase and therefore needing higher interest rates to keep inflation at bay, while others, especially those with depressed regions and high unemployment, will need lower rates in order to stimulate growth."

"The risk," the official said, "is that you set a rate that is right for Europe, but not right for each region."

David Marsh, director of European research at Robert Fleming, a London bank, said: "In a vast area with disparities in economic growth, it will be hard for the European central bank to come up with a one-size-fits-all interest rate."

The view of government officials who are preparing for the euro is more optimistic, although none wanted to be quoted by name in this article.

"What we will do is look at Europe-wide developments and set interest rates to cover a broad area," one official said. "If the Fed can do it in the United States, why shouldn't we be able to do the same?"

But Carl Weinberg, an economist at High Frequency Economics in New York, said: "Monetary policy after the launch of the euro is going to be imprecise, inefficient, and misguided. They are going to learn by doing and with other peoples' money."

The fierce political jockeying surrounding the choice of the central bank chief is another problem. The battle pits Germany and France, with Bonn backing the Dutch central banker Wim Duisenberg, and Paris still fighting an uphill battle on behalf of its own central bank governor, Jean-Claude Trichet.

Economists say a similar fight could emerge over the selection of the other five members of the executive board. The Maastricht treaty does not offer guidance on how to fill the banks' key slots, except to say the terms may be either four or eight years. But already, there is much behind-the-scenes maneuvering by France, Germany and Italy — the Continent's three biggest economies — to guarantee that they have key places at the top table.

Might some of the central bank's board members hew to a more nationalist than European line on interest rates when they report to the new headquarters in Frankfurt?

"There is always the risk of a politicization," said Julian Jessop, an economist at Nikko Europe in London, but "this should not be too great a risk because most European central bankers are remarkably tough inflation fighters and they should be able to work well together."

But critics note that European commissioners who arrive in Brussels do not always shed their national perspective and politics as they are supposed to.

Many senior European officials and economists say that even if the choice

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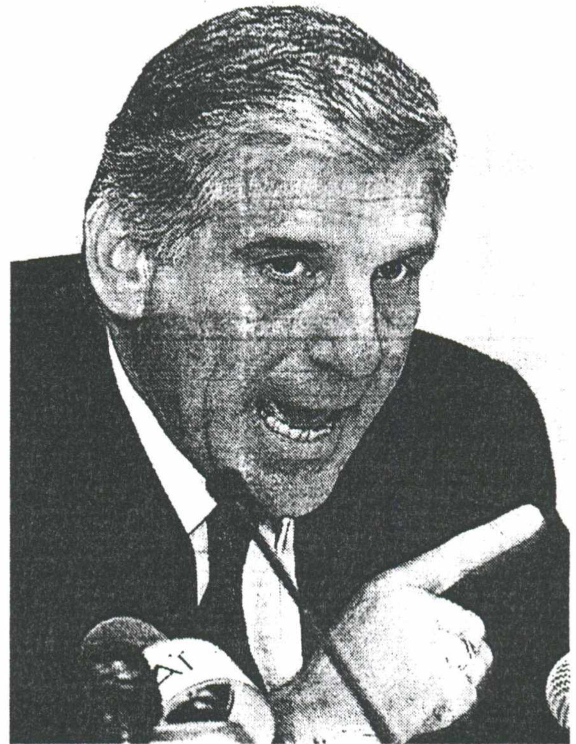

George Karachalis/Reuters

Finance Minister Yannos Papantoniou explaining to journalists Sunday why low inflation allowed Athens finally to devalue the currency.

Greece Unveils Austerity Plan in Bid to Join EMU

Compiled by Our Staff From Dispatches

ATHENS — The Greek government announced Sunday that it was embarking on a three-point economic austerity plan, one day after it devalued the drachma by 14 percent to rejoin the European Union's exchange rate mechanism.

The EU devaluation, which also included a 4 percent drop in the value of the Irish punt, came as the bloc prepares to decide in May which countries will join its economic and monetary union, scheduled to start in January.

Greece is the only country among the 15 EU nations whose debt, budget deficit and inflation rate are all too high to join the planned single EU currency, the euro, at its inception. Athens said the revaluation would pave the way for it to join by 2001 instead.

For Ireland, the revaluation of the punt, which has been buoyed by last year's 8 percent growth in gross national product, will help it adopt the euro at a rate that will not fuel inflation.

Finance Minister Yannos Papantoniou of Greece said a policy of a strong drachma had led to low inflation, allowing Athens finally to devalue the currency. "We could only do it now because only now inflation has fallen to an extent that we have been accepted by our partners in the European Union," he said. "As soon as it was possible, we did it."

The drachma joins the exchange rate mechanism with a central rate of 357 drachma to the European currency unit.

Athens announced plans Sunday to sell off a 49 percent stake in 11 state-run businesses, cut public spending and reform the labor and welfare system in an economic austerity program aimed at preparing the country to join the euro in 2001.

Among the companies Mr. Papantoniou said would be semi-privatized are the telecommunications giant OTE.

The government also planned to cut 200 billion drachmas ($690 million) from public spending by the end of 1999, with most of the cuts coming from capital investments, and to reform the labor market and the state welfare system, he said.

"This is a good thing" for Greece, said Steven Bell, economist at Deutsche Morgan Grenfell in London. "We expect the government to pursue a tight monetary and fiscal policy." He added that he expected Greek long-term bonds to rise after ERM entry.

Some analysts were not convinced by the Greek move.

Ioannis Protopapadakis, vice president of Santander Investment in Athens, said that it would not be enough to avoid further depreciation of the drachma.

The Irish currency, meanwhile, will be revalued to 0.796 Ecu. It was trading in a band centered on 2.41 Deutsche marks. *(AFP, Bloomberg, Reuters)*

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of key executives at the European Central Bank is not politicized, the hardest part is still to come: the transition from theory to practice.

After the central bank starts operations, finance ministers will also have to make sure that the Stability Pact — the accord that calls for members of the single currency to apply peer pressure on each other to keep budget deficits low — does not create a situation in which individual governments are unable to compensate for recession or high unemployment by raising spending.

"My concern," said Alison Cottrell, chief European economist at PaineWebber in London, "is not with the central bank, but with the politicians."

"If a single institution sets a single monetary policy for a broad block of countries," she added, "that makes the need for flexibility on the fiscal side crucial because you will have varying needs in various countries."

Ms. Cottrell and even some officials doubt that the stiff penalties for countries that exceed the Maastricht deficit targets will ever be imposed.

"Forget the stability pact," said one European central banker. "It is a toothless pact. Can you imagine European governments really putting sanctions on each other, knowing the same could happen to them?"