Duisenberg's Lesson for The ECB

Stop worrying about the financial markets.

Wim Duisenberg, *first president of the European Central Bank (1998–2003).*

BY MELVYN KRAUSS

It is almost two months now that the European Central Bank ruled out the possibility that eurozone interest rates would be going to zero. Then, that possibility was hedged at the last meeting of the ECB's Governing Council.

Who knows what will happen? The ECB's attempt to manipulate market expectations in a constantly changing economic environment is causing it to lose credibility at a time when confidence in financial institutions already is severely shaken.

It doesn't have to be this way. The ECB should take a page from Wim Duisenberg's playbook (itself strongly influenced by German Bundesbank practices). The former ECB president did not plan his monetary policy moves months or even weeks in advance, much less announce them in public. He would wait until the last minute—then make up his mind.

Even though he has left the scene, Duisenberg's way of running Europe's monetary policy has turned out to be particularly relevant for today's volatile economic environment.

The pioneering Dutchman cared little for what markets thought, according to his close associates. Preparing markets for interest rate moves was what former Federal Reserve chairman Alan Greenspan did—and he would have none of it.

Occasionally, Duisenberg even would purposely wrong-foot markets to keep them off balance. He told me so himself. It wasn't that the first ECB president was hostile to markets (though they would grow hostile to him)—he just wanted to maintain a maximum amount of freedom for the Governing Council to act.

After all, circumstances change—the economy and the Governing Council can be moody and hard to predict. Duisenberg was a consensus politi-

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cian, who understood that consensus inside the Governing Council could be a variable thing.

The ECB's decision to raise interest rates by 25 basis points last July is a classic example of what can go wrong when the ECB pre-announces its interest rate moves.

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But rather than lose face, the ECB went through with an obviously bad policy move—raising rates in a deteriorating economic situation.

This was not a wise choice and raised serious questions in the market about the judgment of ECB policymakers. In fact, since last June, there has been a noticeable decline of ECB credibility in the markets.

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European interest rates rose when the rate increase was pre-announced last June. A surprised market believed the Bank even though many thought the hike to be a crazy move.

But when a press leak from ECB offices, hinting that interest rates either would not be cut or cut only a small amount, appeared on the front page of London's *Financial Times* a week before last January's meeting, contrary to what one would expect, market interest rates actually went down, not up.

The market had more faith in the economic data than the ECB's market guidance—and it was right. The common wisdom in the markets today is, "Follow the data," not the ECB leaks.

But the ECB apparently still has not learned its lesson. It continues to pre-announce ECB monetary moves even though the current economic environment is one of "anything can happen and usually does."

At a recent press conference, for example, ECB leadership strongly hinted there would be a further rate cut in March of 50 basis points. That's quite precise—a lot can happen in a month. What happens if the data deteriorates to the point where the Governing Council wants to cut interest rates by 75 basis points?

Why does the ECB keep pre-announcing when it has itself said the only thing that matters for its monetary policy decisions is the economic data, and that after all is public information?

Let the markets figure it out for themselves without the distraction of ECB leads. It will be better both for the markets and ECB credibility, especially in frenetic times as these.

At a time when central bankers increasingly are being accused by Europeans of causing the global financial crisis, the ECB must come up with a new *modus operandi* to prevent further damage to its credibility. For inspiration, the Bank need look no further than the practices of its first president. ◆