CENTRE FOR EUROPEAN REFORM
NEW IDEAS FOR A NEW EUROPE

HOW TO REFORM THE EUROPEAN CENTRAL BANK

Jean-Paul Fitoussi and Jérôme Creel

CENTRE FOR EUROPEAN REFORM

about the CER

The Centre for European Reform is a think-tank devoted to improving the quality of the debate on the European Union. It is a forum for people with ideas from Britain and across the contintent to discuss the many social, political and economic challenges facing Europe. It seeks to work with similar bodies in other European countries, North America and elsewhere in the world.

The CER is pro-European but not uncritical. It regards European integration as largely beneficial but recognises that in many respects the Union does not work well. The CER therefore aims to promote new ideas for reforming the European Union.

Director: CHARLES GRANT

ADVISORY BOARD

PERCY BARNEVIK.......... Chairman, AstraZeneca
CARL BILDT.......... Former Swedish Prime Minister
ANTONIO BORGES.......... Former Dean of INSEAD
NICK BUTLER (CHAIR).......... Group Vice President for Policy Development, BP p.l.c.
LORD DAHRENDORF .... Former Warden of St Antony's College, Oxford & EU Commissioner
VERNON ELLIS.......... International Chairman, Accenture
JOHN GRAY.......... Professor of European Thought, LSE
LORD HANNAY.......... Former Ambassador to the UN and the EU
IAN HARGREAVES.......... Professor of Journalism, Cardiff University
LORD HASKINS OF SKIDBY.......... Former Chairman, Northern Foods
FRANÇOIS HEISBOURG.......... Chairman, Geneva Centre for Security Policy
CATHERINE KELLEHER.......... Visiting Research Professor, US Naval War College
FIORELLA KOSTORIS PADOA SCHIOPPA.......... President, Istituto di Studi e Analisi Economica
RICHARD LAMBERT.......... Former Editor, Financial Times
HANS LEUKERS.......... Former Chairman, Berlin Stock Exchange
DAVID MARSH.......... Partner, Droege & Comp. AG
DOMINIQUE MOÏSI.......... Deputy Director, Institut Français des Relations Internationales
JOHN MONKS.......... General Secretary, Trades Union Congress
DAME PAULINE NEVILLE-JONES.......... Chairman, QinetiQ p.l.c.
WANDA RAPACZYNSKI.......... President of Management Board, Agora SA
LORD SIMON OF HIGHBURY.......... Former Minister for Trade and Competitiveness in Europe
BARONESS SMITH OF GILMOREHILL
PETER SUTHERLAND.......... Chairman, BP p.l.c. & Goldman Sachs International
ADAIR TURNER.......... Vice Chairman, Merrill Lynch Holdings Ltd.

Published by the Centre for European Reform (CER), 29 Tufton Street, London, SW1P 3QL
Telephone + 44 20 7233 1199, Facsimile + 44 20 7233 1117, info@cer.org.uk, www.cer.org.uk

© CER OCTOBER 2002

★ ISBN 1 901229 34 3

How to reform the European Central Bank

Jean-Paul Fitoussi and Jérôme Creel

ABOUT THE AUTHORS

Dr Jean-Paul Fitoussi is a Professor of Economics at the Institut d'Études Politiques de Paris, and also President of the Observatoire Français des Conjonctures Economiques, an institute dedicated to economic research and forecasting. He was previously the economic adviser to the former French Prime Minister, Lionel Jospin, and a professor at the European University Institute in Florence. Since 2000, he has been an expert for the Committee on Monetary and Economic Affairs at the European Parliament.

Jérôme Creel is a research officer at the OFCE. He holds a PhD in Economics from the University of Paris-Dauphine. His most recent publications include articles on the Stability and Growth Pact, *Journal of Economic Integration*, September 2002; and on the consequences of the East Asian crisis for the policy mix in Europe, *Journal of Macro-economics*, forthcoming 2003.

ACKNOWLEDGEMENTS

The Centre for European Reform would like to thank Odey Assset Management for supporting this publication.

Established in 1991 by Crispin Odey, Odey Asset Management Limited is Europe's longest-established long-short equity fund manager. For more information, please visit www.odey.co.uk.

Contents

About the authors

Acknowledgements

1 **Introduction** 1

2 **Macro-economic policy-making in the eurozone** 11
Budgetary policy
Monetary policy
Economic policy co-ordination
An unchanging framework?

3 **The European Central Bank in action** 19
ECB policy in 1999-2002
The ECB and the Federal Reserve
The ECB: the new Bundesbank?
Credibility and transparency

4 **Reforming Europe's economic policy framework** 43
The future of European monetary policy
Europe's optimal policy mix

5 **Conclusion** 67

1 Introduction

Although the drive to build a new Europe after the Second World War was largely political, there were also sound economic reasons for pushing European integration forward. Deepening economic ties meant that Europe's economies were becoming increasingly inter-dependent. The European Community was set up as a means to manage this inter-dependence within a broader political context.

This pamphlet explores one aspect of this process, namely macro-economic policy. More precisely, it deals with monetary policy – the power to set interest rates and influence exchange rates – and fiscal policy. It will look at how macro-economic policy is made at the European level and how the two policies, monetary and fiscal, interact. The right mix can boost growth while the wrong mix can stifle it. Economists refer to this as the search for an optimal policy mix. This pamphlet assesses the institutions in charge of Europe's macro-economic policy according to two criteria: their effectiveness and their democratic credentials.

A federal economic government?

Economic sovereignty is an integral part of the nation-state. But the member-states of the EU have decided to pool some of their sovereignty at the supranational level to manage better the deep economic integration that has ensured Europe's economic success over the last 50-odd years. The EU's economic sovereignty has three main elements: the European Central Bank (ECB), which draws up and implements Europe's monetary policy; the Stability and Growth Pact (SGP), a mechanism for supervising the fiscal policies of the member-states; and the European Commission's directorate-general for competition policy (DG Competition), which oversees industrial policy. In economic terms, the EU has thus adopted some of the

characteristics of a federal government. It has a monetary authority, a ministry of industry and the equivalent of a junior minister to oversee budgets. In other policy areas, however, the EU still functions as a confederation of nation-states, most importantly in foreign policy, defence and security. It does not have a finance minister with the power to draw up budgets. The EU budget is tiny compared with the national budgets of the member-states, and the member-states determine its use rather than the EU's supranational elements, such as the European Commission. The EU is thus a federation in some respects and a confederation in others. Nevertheless, the people of Europe rarely think of the EU's economic institutions as a federal government, perhaps because they are run by independent agencies rather than politicians.

The different parts of the EU's economic government vary in their status and power just as they do in national governments. The 'junior minister for budgets', that is to say the commissioner for monetary affairs, does not have executive powers. His brief is to make the SGP function efficiently by monitoring national budgets. But he also has huge political influence through making his findings public and proposing recommendations for national fiscal policy. These recommendations form the basis for decisions by the Council of Ministers, the EU's executive body, about a member-state's fiscal policy. The 'industry minister', the competition commissioner, possesses legislative, executive and judicial powers. Like ministers in national governments, these two members of Europe's economic government can be forced to resign by parliament, although the powers of the European Parliament in this respect are much more circumscribed than those of most national legislatures. The ECB, Europe's monetary authority, has a powerful role that is sketched out in the EU's treaties but which it is free to interpret. It cannot be stripped of its functions, nor is it directly accountable to any political institution. Most significantly, perhaps, there is no head of government to co-ordinate the actions of Europe's different economic institutions.

Europe's economic 'constitution' was devised and approved according to the democratic processes of the governments and parliaments of all 15 member-states. But this does not mean that Europe's economic government is set in stone. The EU's institutions and processes, especially in the area of macro-economic management, are relatively new and incomplete and in many ways unsatisfactory. This means that any assessment of the EU while it is evolving, this one included, is somewhat artificial. Is it fair to reproach a child making its first tentative steps for not striding boldly ahead? How can we criticise a building that is still under construction? Europe's integration process is uneven: every step forward can either lead to another step or might block progress elsewhere. Any snapshot of the EU has to take this underlying dynamic into account.

DG Competition plays a crucial role in Europe's economic government. By pressing for structural reforms, it helps to remove obstacles to competition and free trade. Nevertheless, we deal with competition policy only in passing, since it is not traditionally considered an instrument of macro-economic policy. Competition and macro-economic policies are certainly linked. They complement each other insofar as structural reforms are both more effective and more politically acceptable in a favourable macro-economic climate. Conversely, the success of macro-economic policies depends to a very large extent on the structural context in which they are conducted. However, some economists argue that the two policies are substitutes. Different economic theories propose either one or the other as the best way to boost economic growth and attain full employment. Europe is witnessing a heated debate between those who advocate higher budgetary spending to boost economic activity, and those who believe that only liberalisation of labour and product markets can ensure Europe's competitiveness and economic prosperity.

Any assessment of the EU's economic institutions depends on which position one adopts in this debate. Those who believe that macro-economic and competition policies are complementary tend

to have a broad vision of the European policy mix, stressing that monetary policy, budgetary policy and structural reforms are highly inter-dependent. This inter-dependence requires close co-operation and co-ordination, perhaps even centralisation under the aegis of a European government. The view that the two policy areas are substitutes – more liberal in outlook – fits more neatly with the current structure of European economic government. The ECB's strong independent position and the constraints of the SGP are bound to weaken the EU's policy-making powers, which are concentrated in the Council of Ministers. Competition policy, or deregulation, will thus become the tool of choice for driving economic integration forward.

This, however, has wide-ranging implications for the way the EU member-states organise and govern themselves. While many governments have been moving towards more liberal economic policies, they are rarely – if ever – prepared to give up sovereignty over their macro-economic policies. It is the dynamic aspect of European integration that has underpinned the transfer of economic sovereignty to European institutions. But it is also this dynamic aspect that is probably at the heart of the debate about Europe's 'democratic deficit': the fear that the growth in the EU's powers and competences is not matched by growth in its democratic checks and balances. There is nothing wrong per se with Europe's nation-states subordinating their policies to the EU. This is an inherent part of any process of unification. However, the fact that EU policies are essentially determined in a democratic vacuum not only goes against Europe's political tradition but also poses a threat to its economies. The EU is a strange political animal. Governments agree on rules that restrict them in using their national sovereignty. But then they oppose the emergence of sovereignty on a higher, federal level in the name of national sovereignty. This gap is at the root of Europe's 'democratic deficit'.

The EU's impending enlargement further highlights its institutional weaknesses. The EU is unwieldy enough as it is, although its current

15 member-states are a fairly homogeneous group, at least compared to those countries that are now queuing to join. With up to 28 members, the EU may well become ungovernable – unless it restricts itself to being a single market in which federal authority is limited to ensuring free trade and competition between businesses, as well as monetary stability. This would be an EU that is very close to the vision of economic liberals. But it would be an EU scorned by those who want to strengthen the nation-state to prevent any further erosion of autonomous economic decision-making and levels of social protection. Unless the EU moves swiftly to create credible and effective institutions at the federal level, monetary union will add to this trend. It will reinforce economic and financial integration, and the resulting competitive pressures will restrict the room for national economic policies even more. The logic of Europe's economic 'constitution' is thus to push the continent towards an increasingly liberal economy, through EU institutions that do not have a choice in this matter. They have the power to increase the intensity of competition within the single market, but not to reduce it.

In an integrated international economy, with a single currency but without an overarching political authority, the traditional tools of national economic management become blunt. Since governments can no longer steer the economy, adjustment to economic shocks has to rely on movements in the relative prices of goods and labour. This, according to economic theory, can only happen if the markets for goods and labour are fully liberalised. Europe's drive towards liberalisation and structural reforms, pushed by the ECB and the Commission, is thus the flip-side of its chosen model of monetary integration. However, further liberalisation of labour markets and the scaling back of established systems of social protection runs the risk of widening the gap between rich and poor. Is that what most European citizens want? And even if they want it now, what if they change their minds at some point in the future? Will we be able to implement an alternative vision?

The criteria of democratic legitimacy

Democratic legitimacy should be at the heart of any evaluation of public policies. However, there is an inherent tension between the two principles underlying the system of western liberal democracy: on the one hand, individualism and inequality (the principle of the market) and on the other hand, the public sphere and equality (the principle of democracy). A constant struggle for compromise is therefore inherent in western democracies. This struggle is productive as it enables the system to evolve steadily. In contrast, systems organised by a single organisational principle, such as Soviet central planning, are inflexible. They tend to suffer strains until they finally break down.

While the tension between different values is healthy, even necessary, there is normally a hierarchy that ensures that democratic concerns take precedence over economic ones. However, policy-makers now tend to employ purely economic criteria to assess policies and reforms. This is a mistake. Dan Usher, the US political scientist, has proposed a set of alternative criteria: is the policy in question likely to reinforce democratic support, or to weaken it? And will it bind a population more closely to the prevailing political regime, or alienate it? If ever there were doubts about the validity of these democratic criteria, the recent rise of the far right in Europe should have eliminated them. How can reform policies work if the people do not support them? Can people be made to live and act contrary to their wishes in the name of the principle of economic efficiency? Democracy implies a hierarchy in the relationship between political and economic systems. Societies choose the economic system they want and not the other way round.

And yet the relationship between democracy and the market is more complicated than that. As Usher remarks: "In one way or another all societies should decide who will be rich and who will be poor, who will command and who will obey, who will do those jobs generally considered desirable, and who will do those considered undesirable."[1] Yet entrusting the distribution of wealth and jobs to

democratic coalitions can result in instability, which could undermine the very foundations of democracy. Political scientists refer to this dilemma as the 'faction problem'. Any given coalition can undo the work of another coalition, since a minority faction can achieve a majority by offering certain members of the current majority a better position if they switch sides. Only political regime change can break this potentially endless cycle.

[1] *Dan Usher, 'The economic pre-requisites of Democracy', Columbia University Press, 1981.*

Non-political channels of change and decision-making – what Usher refers to as 'equity' systems – are therefore crucial for the survival of a market democracy. The free market is such a channel (other examples are the social economy or merit-based systems). Generally, an 'equity' mechanism must fulfil two conditions: it must be feasible and universally acceptable. Feasibility is a question of degree. If market forces fully determine the distribution of income and wealth, then there is no place for political intervention and thus for democracy. At the other extreme, if the distribution of, say, 80 per cent of national income depends on the outcome of the next election, individuals will have such strong incentives to get involved in politics that the democratic system will grind to a halt. Therefore, the system works best if the distribution of a significant part of national income depends on non-political channels. How significant will in large part be determined by what is acceptable for the majority of citizens concerned.

The ascendancy of the far right in recent European elections could be a sign that our system – which is moving more and more towards 'pure' economics, while eroding democratic decision-making – is becoming less acceptable. The predominance of market forces and growing competition between national economies ties governments' hands with respect to state intervention and the redistribution of wealth. This erosion of national autonomy is not accompanied by the creation of decision-making powers at a higher, federal level. Instead, market efficiency is taking over from democracy as the main steering device. In other words, ongoing changes to our

'equity' systems are no longer the result of political decisions but rather of external factors, such as growing competitive pressures.

Although democracies have the big advantage of being flexible, they are not prone to radical change. Their constitutions usually ensure gradual evolution, allowing them to adapt to new circumstances. Efforts to reduce this flexibility, by handing over decision-making to a set of fixed rules, drawn up in accordance with the doctrines of the day, do not guarantee progress. Europe's main challenge is to move from a rule-based system of government to a system founded on freedom of choice. In other words, Europe must become more pragmatic.

The European Central Bank and the Stability Pact

In line with the above discussion, we attempt to evaluate the EU's rules and institutions for macro-economic policy – the European Central Bank and the Stability and Growth Pact – according to two criteria: effectiveness and democratic legitimacy. We focus mainly on the ECB but also discuss the SGP, not only for the sake of being comprehensive, but also because monetary and fiscal policies are so closely interlinked. Perhaps one of the driving forces behind the SGP was the desire to restrict the strategic interaction between them, in order to make the ECB's task easier. In the first part of the pamphlet, we discuss the institutional framework for monetary and budgetary policies within the eurozone, as well as their co-ordination. Co-ordination is problematic because of a major institutional imbalance between an independent and unaccountable central bank, and a plurality of budgetary authorities constrained by the SGP.

The reason why Europe's macro-economic policy is so hotly debated is because its consequences are so far-reaching. If well managed, it will encourage job creation and economic growth. In the context of rapid technological change, the right macro-economic policy mix can help to move an economy to a higher and less inflationary growth rate, and facilitate the implementation of structural reforms. But bad macro-management can block improvements in living standards, aggravate unemployment and stall reform efforts.

Current economic thinking gives monetary policy, rather than fiscal policy, the most active (and reactive) role in the stabilisation of economic activity and thus in the pursuit of employment, growth and inflation targets. The ECB, as the institution in charge of monetary policy, therefore bears a heavy responsibility. The second section of this pamphlet will try to assess the ECB's performance to date, using the criteria of efficiency, credibility and transparency. We will put our findings into context by comparing the ECB's performance with that of the US Federal Reserve, the Bank of England and the German Bundesbank. We arrive at positive conclusions – the ECB's monetary policy has been generally appropriate, given the prevailing economic circumstances. Contrary to widespread perception, ECB policy has been less restrictive than the Bundesbank's would have been under similar economic circumstances.

But in terms of credibility and transparency, there is room for improvement. Even if the debate surrounding these issues is still in its infancy and our suggestions are of a tentative nature, we do feel secure in our view that the ECB's (self-imposed) 2 per cent limit for medium-term inflation is too restrictive. By the end of 2002, the ECB will probably have missed its target for the third year out of the four it has been in operation. This clearly undermines the Bank's credibility and should be rectified.

Our reform proposals in Chapter 4 reflect the concerns of the first two chapters of this pamphlet. The EU should strengthen the ECB's political accountability by giving the European Parliament the right to define the ECB's main objective of 'price stability'. The EU's eastward enlargement threatens to cause gridlock in the ECB Governing Council, the decision-making body that contains the ECB Executive Board and the national central bank governors of all eurozone countries. Our preferred option would be for the heads of state and government in the European Council to nominate directly a certain number of national central bank governors to sit on the ECB's Governing Council. Alternatively, a selection could be made

through rotation, with some permanent seats reserved for the largest eurozone economies. We also put forward reform proposals for the Stability and Growth Pact. Although the SGP's theoretical foundations are dubious and its political implications deeply troubling, it should not be scrapped altogether as this would worry the ECB and could lead to a sub-optimal European policy mix. We suggest a thorough overhaul of the Pact that takes into account both cyclical factors and public investment in the definition of public deficits. Thankfully, in September 2002 the Commission put forward proposals along these lines. Since it would fall upon the European Council to determine which kind of spending counted as investment, this new rule would in fact give the EU a role in directing national spending towards European priority areas.

2 Macro-economic policy-making in the eurozone

The 1991 Treaty of the European Union, known also as the Maastricht treaty, is the foundation for most of Europe's economic institutions, including the European Central Bank. The Amsterdam treaty of 1997 added the Stability and Growth Pact and the whole system came into force on January 1st 1999 with the introduction of the euro. According to the treaty:

> *The Community shall have as its task, by establishing a common market and an economic and monetary union and by implementing common policies and activities, to promote throughout the Community a harmonious and balanced development of economic activities; sustainable and non-inflationary growth ...; a high degree of convergence of economic performance, a high level of employment and of social protection ...* (article 2).

Despite the reference to employment, article 3A indicates that the signatories regarded combating inflation as their priority:

> *[The action of member-states] shall include the irrevocable fixing of exchange rates leading to the introduction of a single currency ... and the definition and conduct of a single monetary policy and exchange rate policy the primary objective of both of which shall be to maintain price stability and, without prejudice to this objective, to support the general economic policies in the community, in accordance with the principle of an open market economy with free competition ... (article 3A).*

Moreover, the treaty sets out the preconditions for entry into economic and monetary union (EMU), the so-called Maastricht criteria (article 109J). These conditions required applicant countries to demonstrate their ability to follow certain rules of sound financial management, including keeping their fiscal deficit below 3 per cent of GDP and their national debt below 60 per cent of GDP.

Budgetary policy

Although individual member-states remain in control of budgetary policies in the eurozone, they are constrained by the rules of the SGP as laid out in Council regulations (1466/97 and 1467/97) and a Council resolution of June 17th 1997. The first regulation requires member-states to publish every year a medium-term stability programme, containing economic forecasts as well as fiscal targets. While the level of revenue and expenditure is at the government's discretion, the programmes must enshrine the medium-term objective of either a balanced budget or a budget surplus. The Council of Ministers, which scrutinises the programmes, can make recommendations to countries which deviate from their targets. This process is intended to improve the transparency of the budgetary process and reinforce the supervision of economic policy established by the Maastricht treaty.

The second regulation turns the Maastricht criteria requirement to keep budget deficits low into a permanent fiscal constraint for eurozone members. It adds procedures for determining 'excessive' deficits and imposing sanctions. If a national budget deficit exceeds 3 per cent of GDP, the Commission draws up a report about the public finances of the country in question. On that basis, the Council of Ministers decides whether the deficit is deemed 'excessive'. This will usually be the case unless it results "from an unusual event outside the control of the member-state concerned", most notably a "severe economic downturn", defined as real GDP falling by 2 per cent a year or more. If the member-state is judged to have run up an excessive deficit, it will be asked to bring it under control in the

following year. If it fails to do so, it may be required to pay a non-refundable deposit of 0.2 per cent of its GDP plus a tenth of the value by which it has exceeded the 3 per cent limit, up to a maximum of 0.5 per cent of GDP. This deposit can be converted into a permanent fine if the deficit remains above the limit after two years. Another possible sanction is to suspend the operations of the European Investment Bank in the country concerned.

This procedure is not automatic, however. The Council decides about the existence of an excessive deficit by a qualified majority vote (including those countries that are not eurozone members). It also has some leeway. It can, for example, accept that the country in question is suffering a severe downturn even if GDP contracts by less than 2 per cent – although there is a non-legally binding commitment not to do this if GDP falls by less than 0.75 per cent. The Council also has discretion over policy recommendations to countries with an excessive deficit and in imposing fines. Any decision requires a two-thirds majority, although only among eurozone members and excluding the member-state in question.

Monetary policy

Monetary policy is the responsibility of the European System of Central Banks (ESCB), which consists of the European Central Bank (ECB) and the 12 national central banks. Three separate bodies run the ESCB:

★ The Governing Council formulates the eurozone's monetary policy. It consists of the governors of the 12 national central banks and the six members of the Executive Board of the ECB. Formally, the Governing Council takes decisions through simple majority voting, with each member having one vote and the ECB president having the final say in case of an equal split between the other members. In practice, the Governing Council has always taken important decisions by consensus.

★ The Executive Board is responsible for implementing the Governing Council's decisions. It consists of the ECB president, the vice-president and four other officials, appointed by the European Council after consultation with the European Parliament and the Governing Council. The ECB president is chosen for eight years by the national governments of the member-states.

★ The General Council comprises the president and the vice-president of the ECB and the governors of all the national central banks of the EU member-states, including those not in the eurozone. It supervises stage 2 of the European Monetary System (EMS), which co-ordinates monetary co-operation between the eurozone and the other member-states of the EU.

The principal objective of the ESCB is "to maintain price stability" (article 105 of the treaty). The ECB and the national central banks are independent from both national governments and the European Commission and cannot receive instructions from either (article 107). Neither national central banks nor the ECB are allowed to 'bail out' fiscally irresponsible governments. They cannot lend money to governments ("grant overdraft facilities or any other type of credit facility in favour of public authorities") or buy government debt (article 104).

The ECB presents an annual report to the European Parliament, the European Council and the Commission. The president of the ECB appears before the European Parliament four times a year. However, unlike in the US for example, where Congress has the power to alter the statutes of the Federal Reserve, the European Parliament has no legal clout over the ECB. Moreover, the Governing Council's meetings are not public and minutes are to be published with a 16 year delay. Since formally the ECB is subject to rather minimal requirements of transparency, only the Bank itself can initiate a move towards more openness.

Economic policy co-ordination

The EU has two bodies for economic policy co-ordination, Ecofin and the Euro Group. Ecofin is one formation of the Council of Ministers, involving the economics and finance ministers. In addition to the usual Council tasks, it may also issue economic policy recommendations to individual member-states (article 103 of the treaty). Although the Euro Group, consisting of the finance ministers of countries in the eurozone, is an informal, consultative body, it has been crucial for enhancing economic policy co-ordination within the eurozone. The Euro Group's main tasks are to promote the exchange of information about economic trends and policy decisions that may affect other member-states; to monitor macro-economic trends and budgetary developments; and to explain national labour-market policies. The Euro Group thus contributes to the development of a long-term macro-economic strategy, which is decided upon by Ecofin.

Further (informal) economic policy co-ordination takes place within the Governing Council of the ECB, which is attended (without voting rights) by the rotating president of the European Council, and a member of the Commission. Conversely, the president of the ECB attends those parts of the meetings of the European Council that relate to the ESCB (article 109B of the treaty). These arrangements are in line with the call of the 1997 Luxemburg Council for a "continuous and fruitful dialogue between the Council and the European Central Bank, involving the Commission and respecting all aspects of the independence of the ESCB".

An unchanging framework?

A stark imbalance currently impedes economic policy co-ordination in the eurozone. Monetary policy under the auspices of the ECB has a clearly defined mandate, namely price stability. Fiscal policy, on the other hand, remains the responsibility of the individual member-states – fiscal federalism is making little headway – and its goals are not defined in the EU treaties. The

only 'positive' instrument of co-ordination is the broad economic policy guidelines – non-binding recommendations for fiscal policy drawn up each year by the Commission, and adopted by Ecofin. The Stability and Growth Pact, on the other hand, is a 'negative' instrument of co-ordination in that it simply restricts governments' freedom to act.

The EU's budget warning to Ireland illustrates the deficiencies of EU policy co-ordination. In February 2001 the EU finance ministers (excluding their Irish colleague) publicly counselled the Irish government to "redress the inconsistency of the 2001 budget with the broad economic policy guidelines" that had been adopted by the Council in June 2000. Although the warning had no legal force, it showed that EU policy co-ordination is backward-looking rather than pre-emptive. It also revealed a very narrow reading of the SGP. Although strong growth had allowed Ireland to run a sizeable budget surplus, the EU finance ministers were worried that expansionary fiscal plans for 2001 could lead to economic overheating. Irish inflation averaged 5.3 per cent in 2000, exceeding both the ECB's medium-term target of 2 per cent and the European average in 2000 of 2.1 per cent. However, the dangers emanating from Ireland's inflation to the eurozone were small, as the Irish economy accounted for a mere 1.5 per cent of the total GDP of the euro-11 area in 2000. Moreover, the economic downturn in the larger member-states, such as Germany and France, in 2001, was likely to help reduce inflationary pressures in the Irish economy, which is heavily reliant on exports to the eurozone. Indeed, inflation fell to an average of 4 per cent in 2001, and the discussion about potential economic overheating dried up. Nevertheless, the public reproach was very controversial in Ireland, and some commentators claimed that it contributed to the Irish 'no' on the Nice treaty in the referendum later that year.

The ECB was not directly involved in this exercise of policy co-ordination. Rather, by reprimanding Ireland themselves, the

eurozone governments had stolen a march on the ECB, which is usually quick to condemn lax government spending. But the episode nevertheless serves to illustrate the complex interaction between the ECB and national policy-makers. The different actors sent back and forth their incompatible messages, like in an on-going game of chicken:

> *"I shall raise interest rates because you are not doing enough to tighten your budget."*
>
> *"That is not true. Look, I am reprimanding another government to convince you of the contrary."*
>
> *"Sorry, not credible. Your adjustment efforts are clearly slipping."*
>
> *"But my economy will go into recession!"*
>
> *"Had you listened to me in the first place, you would now have enough room for manoeuvre to counter the slowdown."*
>
> *"Had you cut rates more forcefully when inflation was still low, I would not have this problem now."*

And on it goes. This fictitious dialogue illustrates the difficulties experienced by the 14 partners responsible for economic policies (the ECB, the eurozone governments and the Commission), in their efforts to achieve an optimal policy mix.

3 The European Central Bank in action

Assessing the ECB's performance is unusually difficult, because both the Bank and the context within which it operates are so new. There is no historical precedent. Nor are there any criteria against which to judge a monetary policy that has been designed for a group of states, which are closely integrated but fall short of a federal structure. One does not need to be an economic expert to appreciate that monetary policy is much more complicated in this novel situation. There are technical difficulties – eurozone statistics are far less reliable as a basis of policy decisions than national ones – and political ones, in particular the preponderance of national interests over any sense of a common destiny. European governments still tend to Europeanise their problems and nationalise their successes.

Any evaluation of the ECB's first three years in action has to start with the fact that the worst fears of the single currency's opponents have not materialised. Economic growth has not been stifled by a soaring euro. If anything, the ECB's policy has stimulated economic growth, since real interest rates have been much lower than during the low-growth period of 1991-97. Nor has the euro's weakness generated a significant rise in inflationary pressure. Against this background, the ECB's monetary policy appears as effective as, if not more so than, the monetary policies of the EU's national central banks that preceded it. This positive assessment is the context for the more critical comments that are to follow. Although the ECB has done well, there is room for improvement, especially since it is still a young institution that may have a lot to learn from its own mistakes. In the following, we discuss the

relevance of the ECB's monetary policy and evaluate the credibility of its actions.[2]

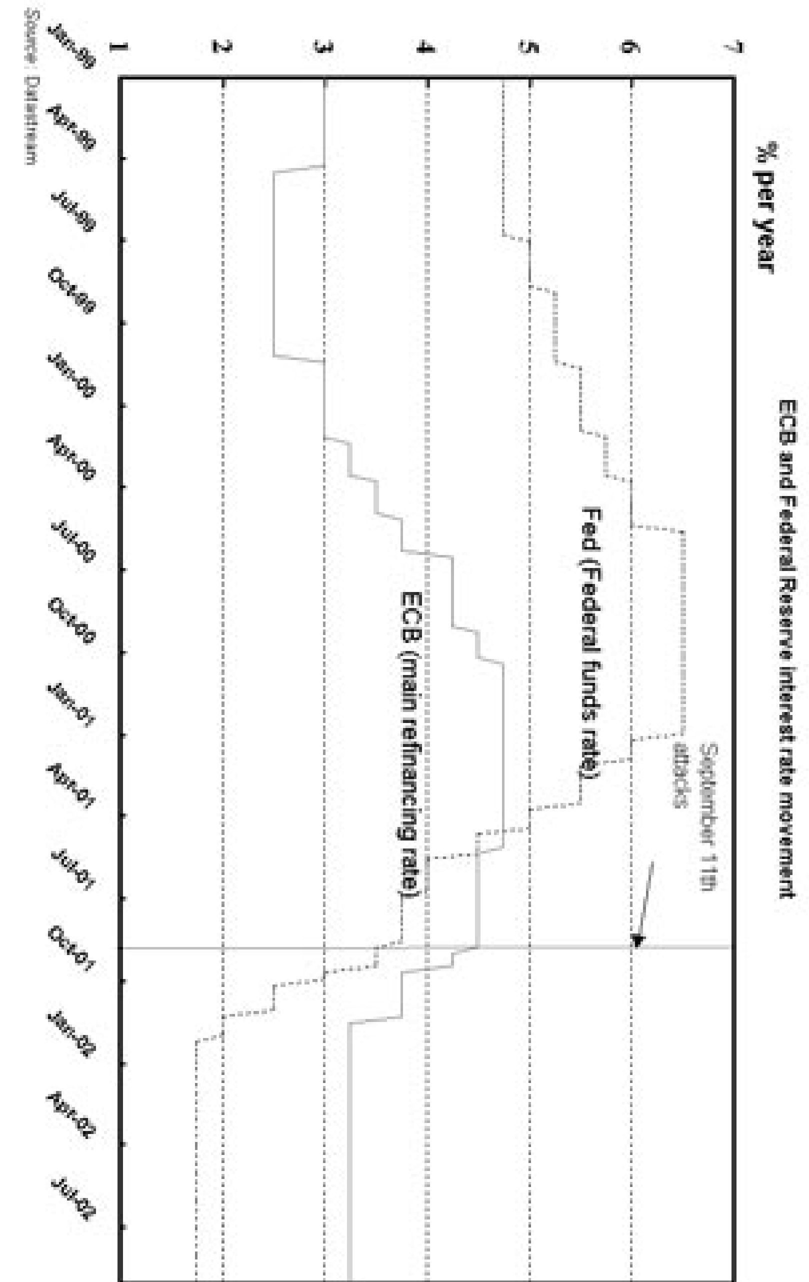
[2] *Our assessment draws heavily on J Creel and J Fayolle, 'La BCE ou le Seigneur des euros', and 'La Banque centrale et l'union monétaire européenne: les tribulations de la crédibilité', Revue de l'OFCE, March 2002.*

ECB policy in 1999-2002

In the course of 1999 the ECB skillfully steered the European economy through the global economic turbulence that followed the Asian crisis. It proved vigilant to the dangers of deflation (falling prices) and thus confounded its critics who had feared that its 'asymmetric' inflation target would lead to a deflationary bias in European monetary policy.[3] However, despite the ECB's efforts to clarify its strategy and objectives, traders and commentators did not give it the benefit of the doubt. The ECB has not communicated well with the markets, which have generally perceived its decision-making as overly cautious.

[3] *The ECB defines its target of 'price stability' as inflation of less than 2 per cent over the medium term, which does not rule out zero inflation or falling prices (both of which can be harmful to growth).*

For example, despite recession fears in 2001, following the sharp slowdown in the US in late 2000, it took the Bank until May 2001 to reduce its main refinancing rate by a quarter of a percentage point. The ECB did not cut rates again until the end of August 2001. The ECB's decision to make small and irregular interest rate cuts suggested it lacked a clear strategy. Faced with intermittent bursts of inflationary pressure, the ECB decided to err on the side of caution and failed to prevent a slowdown in the European economy in 2001. It was only after the terrorist attacks of September 11th 2001 that the ECB decided on a more decisive rate cut of half a percentage point. But it then put rates on hold again until November. The ECB's inaction was thrown into sharp relief by the decisive and consistent approach of the US Federal Reserve, which cut interest rates twice immediately after September 11th, each time by a full percentage point, and continued to pursue this policy thereafter (Graph 1 opposite).



Graph 1

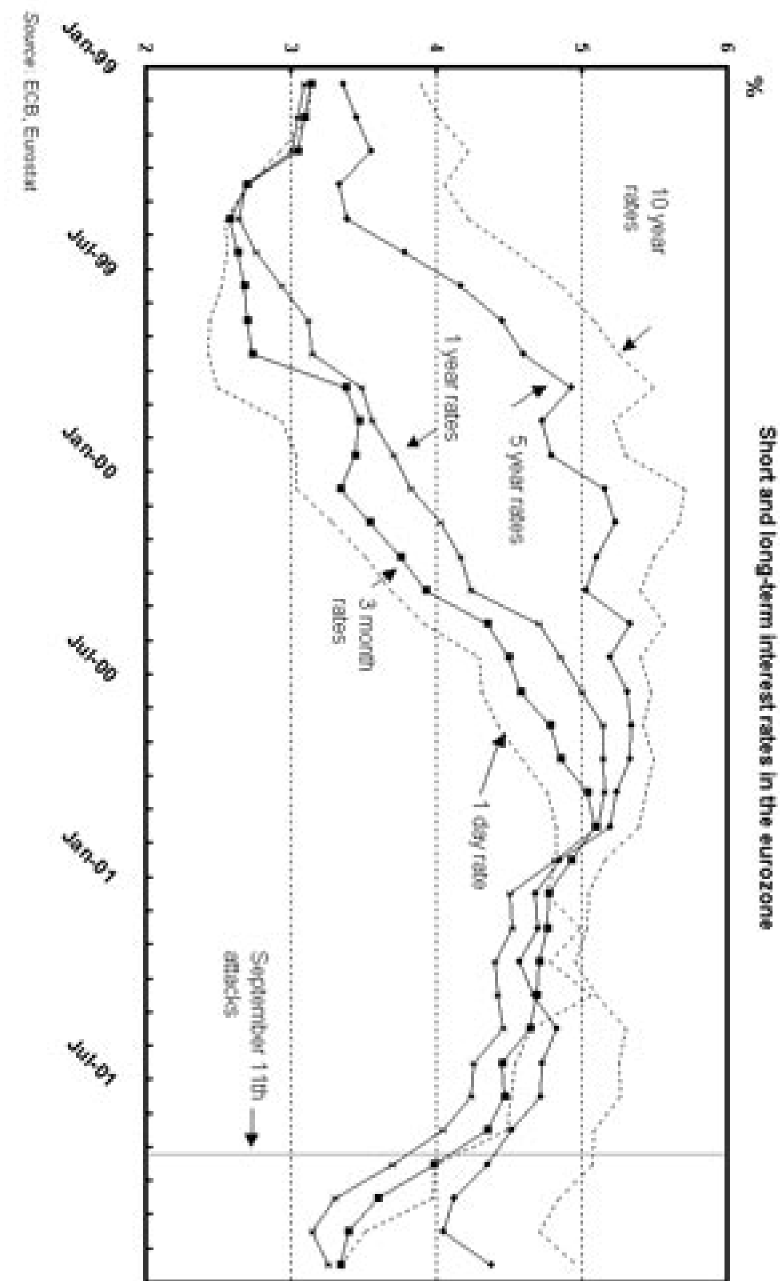
Bearing in mind the difficulties of assessing the ECB's monetary policy on the basis of only three years of evidence, we can distinguish four distinct phases since 1999:

- ★ From the launch of the euro in January 1999 until the autumn of 1999, the ECB's monetary policy was rather loose, in response to the recessionary threats emanating from the Asian crisis. The key refinancing rate, set at 3 per cent at the introduction of the euro, was reduced to 2.5 per cent between April and November 1999. Longer-term interest rates rose as the threat of deflation diminished (Graph 2 opposite).

- ★ The ECB then progressively tightened monetary policy for a year, bringing the refinancing rate up to 4.75 per cent by the autumn of 2000. This had only a modest impact on long-term borrowing rates, which began to stabilise in early 2001 – indicating that financial markets were little concerned about inflation.

- ★ Between the autumn of 2000 and May 2001, the ECB adopted a more steady approach, leaving the refinancing rate unchanged at 4.75 per cent. However, long-term rates fell below short-term rates (what economists call an inversion of the yield curve), which means that financial markets were betting on a long overdue easing of monetary policy.

- ★ The refinancing rate was cut slightly, to 4.5 per cent in May 2001, and to 4.25 per cent in August. A more substantial cut followed in September, in response to the heightened recessionary threats created by the terrorist attacks on the US. By the end of 2001 the refinancing rate was down to 3.25 per cent, where it has since remained (at least until the time of writing in September 2002). Long-term rates are now higher again than short-term rates, although one-year rates have remained at record low levels since late 2001. Markets are apparently still waiting for a further easing in interest rates.



Graph 2

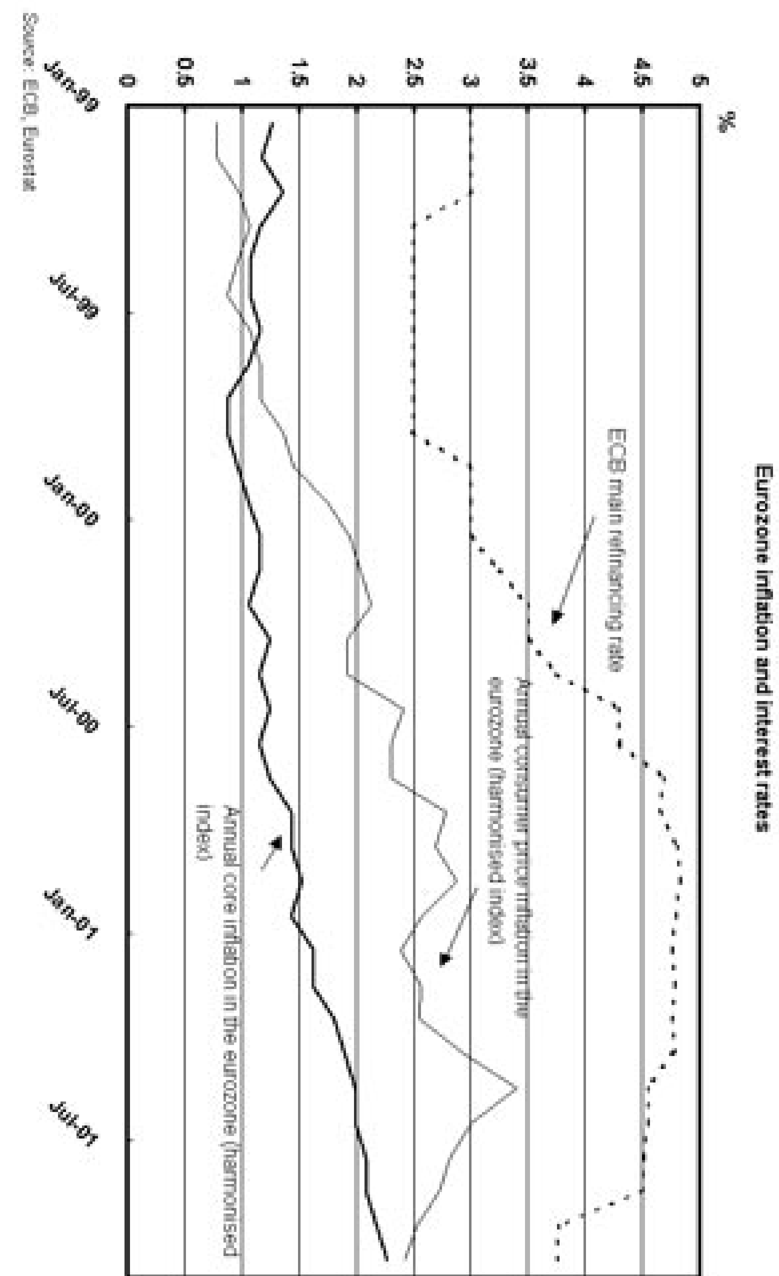
Graph 3 (opposite) shows the monthly progression of the ECB's refinancing rate and eurozone inflation (as measured by the year-on-year change in the standardised consumer price index). Data are also provided for underlying or 'core' inflation, which strips out the more volatile movements of prices for energy, foodstuffs, tobacco and alcohol. To provide an overview of developments in the real economy, Graph 4 (page 27) shows quarterly GDP growth rates in the eurozone and the contribution of internal eurozone demand and export demand. Following the Asian crisis, eurozone GDP growth peaked at the start of 2000 but then decelerated throughout the year, with the slowdown in domestic demand being the main drag on the economy in the second half of 2000.

The figures show that the ECB reacted swiftly to any acceleration of inflation. The ECB's first rate increase in November 1999 came after annual consumer price inflation had climbed from 1 per cent in the summer to 1.5 per cent in the autumn. Until late 2000, the ECB continued to react to rising inflation with further interest rate hikes. As these exceeded the rise in inflation, real interest rates (adjusted for inflation) increased. Nevertheless, consumer price inflation continued to accelerate, pushed up by soaring petrol and food prices. It peaked at almost 3.5 per cent in mid-2001 before descending again towards the ECB's medium term target of 2 per cent. Meanwhile, there was no accompanying rise in core inflation, which would have indicated a fresh build-up of inflationary pressures.

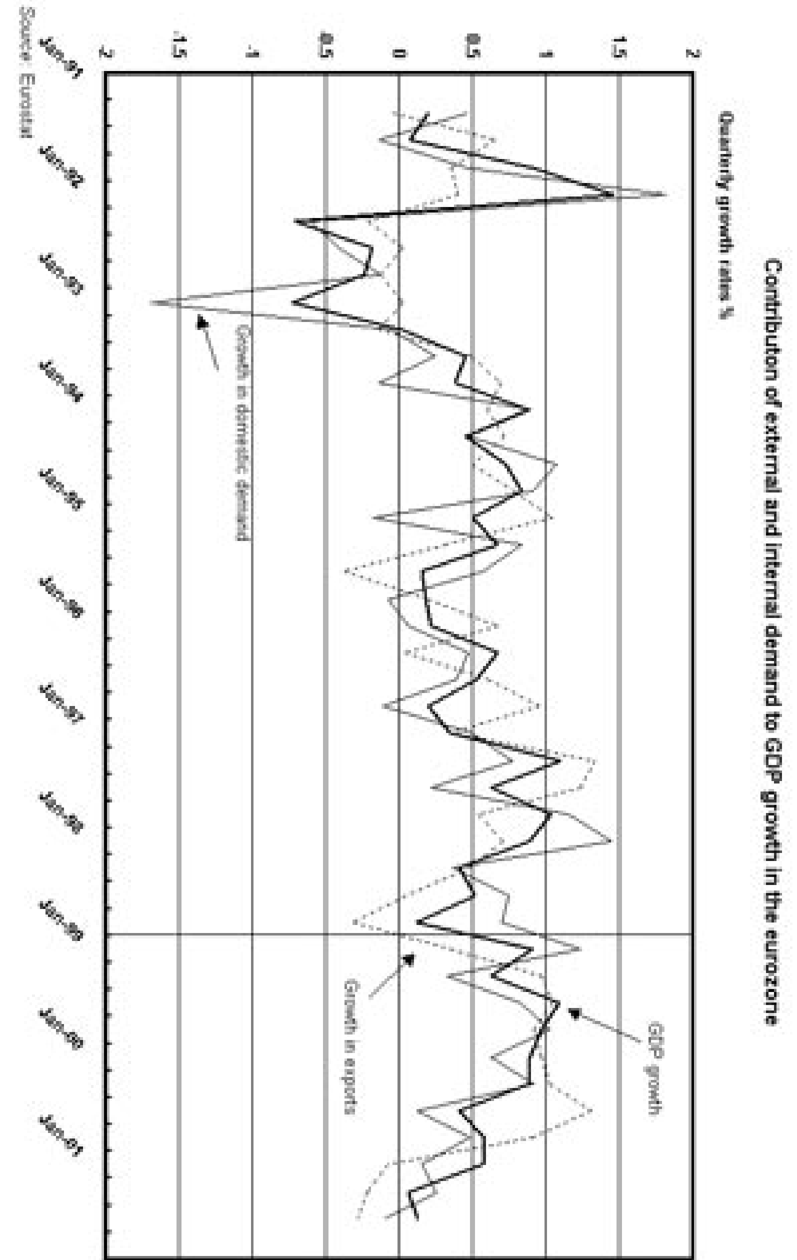
The ECB's continued interest rate hikes fuelled criticism that the Bank's policy was acting 'pro-cyclically' – in other words, that it was accentuating the economic slowdown that was already visible in 2000. Not only was the economic slowdown clearly visible, the expansion that had preceded it had been neither strong nor long enough for Europe to return to its normal medium-term growth rate.

However, these observations do not lead to firm conclusions about the quality and appropriateness of ECB policy making. Perhaps the

Graph 3

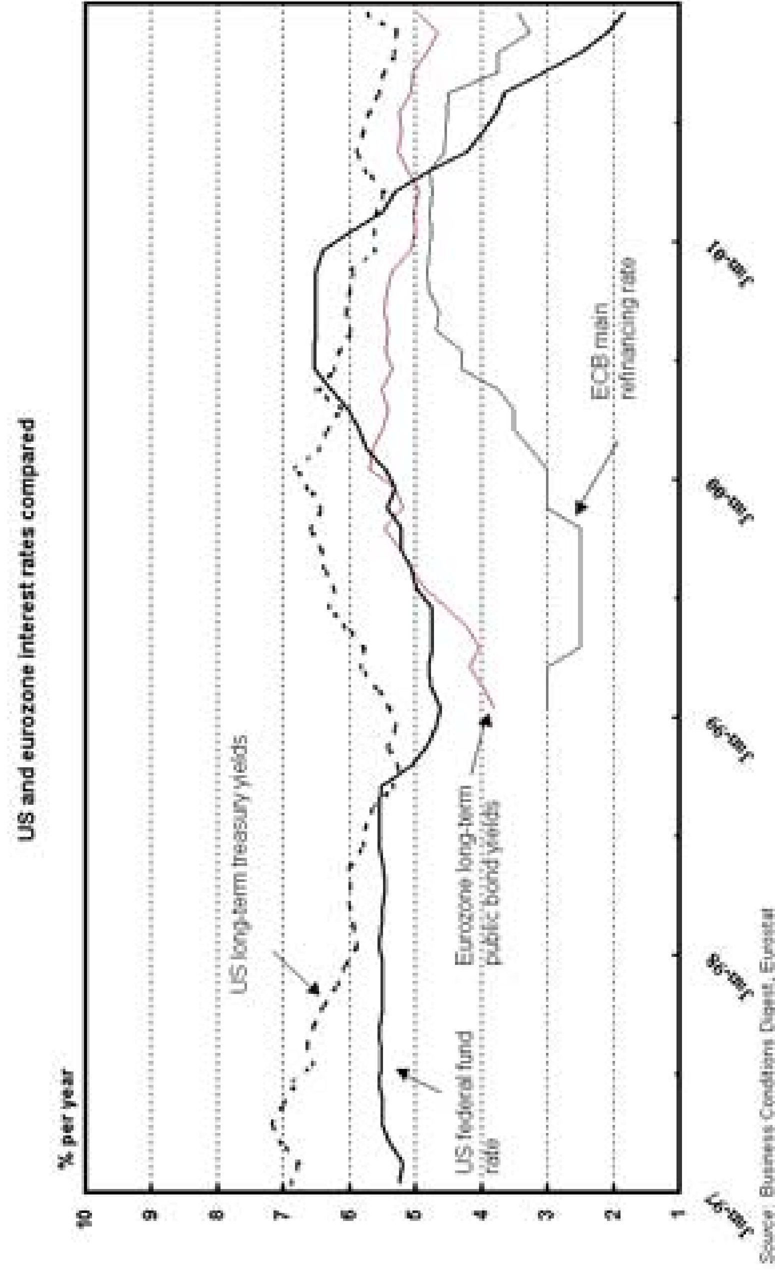


ECB did foresee the rise in core inflation that eventually took place in 2001. The ECB's pre-emptive tightening of monetary policy may have prevented a sharper increase in core inflation. An alternative interpretation would be that ECB policy is in fact quite powerless in the face of reviving inflation. Inflation did, after all, continue to accelerate despite the rate hikes. Of course, it takes time for interest rate changes to filter through into economic activities. But there may have been other factors at work as well. For example, the monetary tightening – and the deterioration in economic activity that it implied – may have exacerbated the weakness of the euro vis-à-vis the dollar. Since a weak currency pushes up the prices of imported goods, this may have contributed to higher EU inflation. To assess the policy of the ECB better, it may be helpful to compare it with the two most powerful central banks in post-war history, the US Federal Reserve and the German Bundesbank.



Graph 4

Graph 5



The ECB and the Federal Reserve

ECB interest rate decisions tend to follow those of the US Federal Reserve, albeit with a time lag of up to six months. They also tend to be less pronounced (see Graph 1 on page 21 and Graph 5 opposite). This parallel movement was partly due to the fact that until late 2000 both the US and the eurozone economy were in a period of expansion. The US expansion, however, was much stronger and longer. At the same time, the US had an inflation rate that was considerably higher than that in the eurozone (US headline inflation averaged 3-4 per cent in 2000, and core inflation 2.5 per cent). It was therefore perfectly normal for US (short-term) interest rates to exceed those in the eurozone. It was also normal for the euro to be weak against the dollar, be it as a result of interest rate or growth differentials.

This begs the question, however, of whether the ECB was right in following the US rate hikes, despite Europe's weaker economic performance. As indicated above, domestic inflationary pressures (especially core inflation) appeared contained. Instead, the ECB may have been worried about 'importing' inflation from the strongly growing world economy, powered by the US expansion. This may have happened through real channels, such as a growing imbalance between global supply and demand, for example in international oil markets, which would have pushed up energy prices in the EU; or through monetary ones and in particular the fall of the euro, as investors, including European investors, piled into the US market.

While short-term interest rates in the eurozone were much lower than in the US, long-term rates followed more closely the trends in international markets as represented by US long-term rates (Graph 5). US long-term rates fell considerably in the course of 2000, which indicated a fall in inflationary expectations in response to the Fed's determined monetary tightening. Long-term interest rates in the eurozone followed US rates downwards. Although eurozone rates tend to be weak indicators of inflation and growth expectations, this fall in long-term rates appeared premature given the immaturity of the eurozone expansion.

Thus both short-term and long-term eurozone interest rates appear more strongly influenced by international trends than by home-made factors. We should not exaggerate this lack of autonomy however. If we take into account both the level of interest rates and the weakness of the euro, monetary policy in the eurozone after 1999 was more relaxed than it had been in the run-up to EMU. This loosening of monetary policy supported Europe's economic recovery. But while the overall stance of monetary policy may have been appropriate, there were questions over whether the timing of ECB interest rate moves was right. Should the ECB have tightened monetary policy earlier, to prevent the spike in inflation that occurred in 2001? That might have given it more leeway to take a softer stance later on in 2001, when economic growth was slowing.

However, there were major differences between the US and the eurozone, which may help to explain and perhaps even justify the ECB's seeming inertia in the face of a changing economic picture. Commentators generally look at the changes in inflation and employment rates in the US and the eurozone, and conclude that the Fed has reacted much more vigorously to changes in the economic climate. But they fail to take into account that the levels of inflation and employment were very different. Between 1999 and 2001, inflation, in particular core inflation, remained much lower in the eurozone than in the US. Unemployment, on the other hand, was much higher. A pre-emptive tightening of monetary policy is much more difficult if unemployment is falling from a high level and inflation is accelerating from a very low base, than if the opposite is the case.

Any assessment of the ECB's monetary policy therefore has to take into account Europe's economic conditions at the time when the Bank was set up. Broadly speaking, in 1998-1999, unemployment was above and inflation below their long-term equilibrium levels. The ECB's reaction to rising inflation and falling unemployment was therefore naturally limited. A similar situation can arise at the other end of the economic cycle, when growth is strong, if the authorities think that actual levels of unemployment are close to their 'natural' rate.[4] The ECB's inertia may thus have been based on its assumption that Europe's 'natural' rate of unemployment is rather high – which itself has to do with Europe's reluctance to implement structural reforms.

Perhaps Europe finds it easier to live with high unemployment rates than the US. How else can one explain the co-existence of low employment levels and high interest rates? But this also means that the ECB has more limited room for manoeuvre for rate rises, even if there are dangers for macro-economic stability. Any attempt to widen this room for manoeuvre will require the action of various players – governments, labour unions and so on – in addition to the central bank. A pre-emptive monetary policy is attractive when the economy nears a state of full employment. But it cannot be the sole responsibility of the central bank.

[4] Economists assume that a certain amount of unemployment is 'natural' in each economy. If unemployment falls below this threshold, labour shortages will push up wages and thus inflation. The 'natural' rate of unemployment is usually lower in economies with flexible labour markets.

The ECB: the new Bundesbank?

The ECB's institutional design and monetary strategy were modelled on the German Bundesbank, which was the pivotal actor in European monetary policy-making until 1999. The legacy, however, has not always been an easy one. The ECB's monetary strategy, for example, highlights the unresolved tension between its strong historical ties to the Bundesbank, and the best practice followed by an increasing number of central banks, including the Bank of England, namely inflation targeting. The ECB thus ended up with a monetary strategy that rests on two 'pillars'. The first pillar is a money supply target similar to that used by the Bundesbank. The ECB's target is to keep growth in the money supply (M3, a broad measure of the money supply that includes certain financial assets) below 4.5 per cent a year in the medium term. The second pillar is

based on a close monitoring of actual inflationary developments and all factors that could contribute to future inflation. Although the ECB insists it does not follow an explicit inflation target, as the Bank of England does, it interprets its main objective of 'price stability' as keeping consumer price growth below 2 per cent a year over the medium term.

The ECB's two-pillar strategy tries to combine two different approaches to monetary policy-making. The money supply target rests on the assumption that the central bank cannot influence inflation directly, but that it can control the domestic supply of money, which – it is assumed – is the main factor driving future inflation. Inflation targeting, on the other hand, relies on the explicit choice of an 'optimal' inflation rate. If the central bank's forecast for actual inflation deviates from this target, it will adjust its policy accordingly. Inflation targeting is thought to have the advantage of being 'transparent' in the sense that the markets can easily ascertain whether the central bank is meeting its target and thus form expectations about future interest rate moves.

The ECB's first pillar has become increasingly shaky. Money supply growth has stayed consistently above its 4.5 per cent target (in 2002 it was running at more than 7 per cent). The ECB has cut interest rates regardless, which indicated that the Bank itself does not take its money supply target too seriously. This is justified, given that changes in eurozone M3 are poor indicators of future inflation anyway. It seems that the main purpose of the first pillar is to allow the ECB to dispense with a precise definition of the second pillar – which is the one that really matters. But this set-up has come at the expense of transparency. Since the ECB has to try and explain monetary policy decisions that are not based on its 'official' strategy, its communication with the public has often been opaque and highly confusing for the markets. Nevertheless, the ECB continues to defend its two-pillar strategy. However, it may become less defensible if and when the UK, which employs straight inflation targeting, decides to join the eurozone. Reciprocal concessions may be required. The UK

could reduce its inflation target from 2.5 per cent to 2 per cent while the ECB adopts a more explicit inflation target. Or the ECB could raise its target without altering it strategy for achieving it.

In practice, there is no doubt that the second pillar requires the ECB to engage in policies that are very close to inflation targeting. Financial markets, policy-makers and the public at large hold the ECB accountable for meeting or missing its 2 per cent target. They also expect the ECB to explain its interest rate decisions in the light of its judgement on whether future inflation will deviate from its target. An increasing number of economists have thus called on the ECB to dismantle the first pillar altogether and move to straight inflation targeting, just like the Bank of England.

Not everyone is convinced, however. Some argue that the disadvantages of a rigorous inflation target will quickly outweigh the benefits in terms of predictability and transparency.[5] The credibility and effectiveness of inflation targeting rests crucially on the accuracy of inflation forecasts that are provided by the central bank and private sector economists. If these do not match, the markets (and the public at large) do not know what to expect from future monetary policy. If the central bank's own forecasts are perceived as biased or inaccurate, the bank's credibility could suffer. Perhaps a less explicit target makes it easier for the central bank to preserve its credibility and flexibility. The Fed's monetary policy during the 1990s, for example, can be classified as 'covert inflation targeting': the target, set at around 3 per cent, remained implicit, allowing the bank to use discretion in its monetary policy to a degree that would not have been possible with an explicit target.[6]

[5] See for example E Solans, 'Monetary Policy under Inflation Targeting', Contribution à la Conferénce annuelle de la banque centrale du Chilli, Santiago du Chilli, December 2000.

[6] G Mankiw, 'US Monetary Policy during the 1990s', Working Paper n°8471, NBER, September 2001.

As strict as the Bundesbank?

Some commentators claim that the ECB has also inherited a hawkish attitude towards monetary policy from the famously strict Bundesbank. Officially, the prime objective of the ECB's monetary

strategy is to preserve price stability, as was the case with the Bundesbank, although officially the German central bank did not follow a two-pillarstrategy. Empirical studies have shown, however, that in practice the Bundesbank followed two objectives rather than one, namely low inflation plus production output that was close to the economy's capacity. In fact, the so-called output gap (the difference between actual GDP growth and its medium-term potential) was more important for influencing Bundesbank decisions than changes in inflation. Changes in inflation generally elicited a rather mild response from the Bundesbank (on average a 1 percentage point rise in inflation was met by an 0.85 percentage point increase in interest rates).[7]

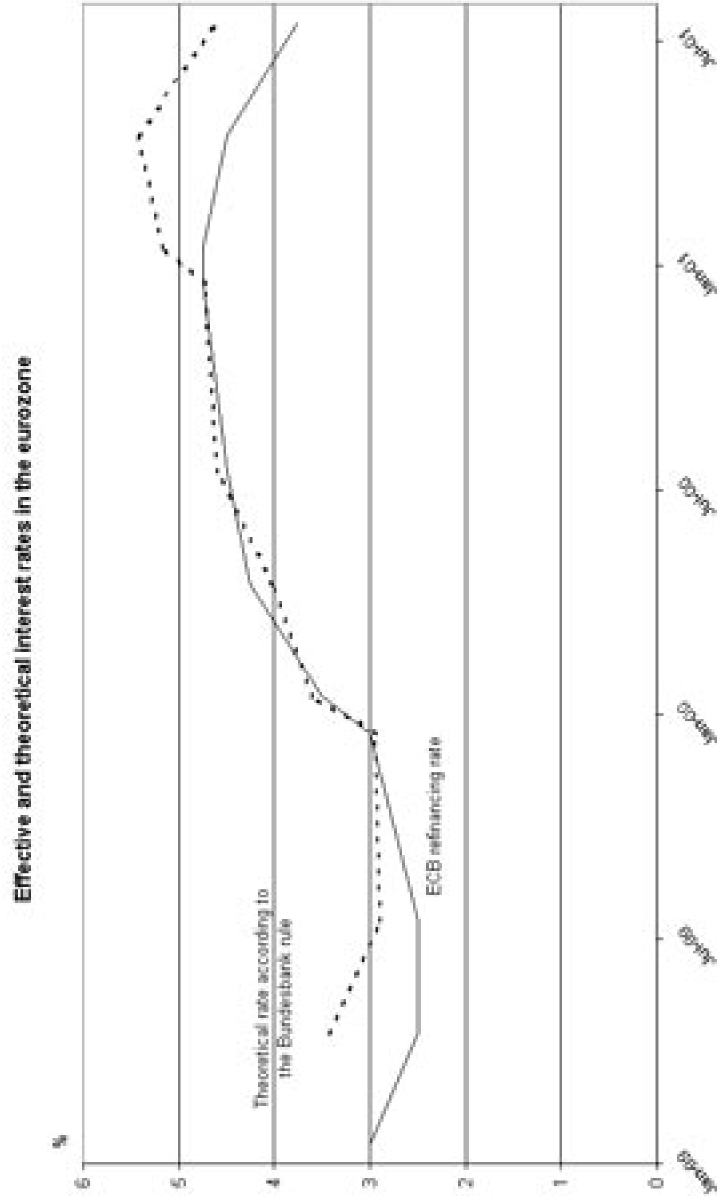
[7] *J Creel and J Fayolle, 'La BCE ou le Seigneur des euros', la Revue de l'OFCE, March 2002.*

This mild reaction was crucial for finding an optimal mix between monetary and budgetary policies. Take a situation in which a hike in international oil prices (or a fall in productivity) pushes up inflation while at the same time depressing growth, thus widening the gap between actual and potential output. The Bundesbank would react to the rise in inflation by increasing its interest rates, albeit by less than the rise in inflation, taking into account slowing growth. This means that real (inflation-adjusted) interest rates would actually fall. Since it is real rather than nominal interest rates that determine investment and credit growth, this would help to sustain economic activity. A fall in real interest rates would also help to contain the government's debt servicing costs, giving the government sufficient room to stimulate the economy through higher spending or tax cuts. Had the Bundesbank simply reacted to the rise in inflation without taking growth into account, this would have left the government little choice but to tighten fiscal policy, to compensate for the higher costs of servicing public debt. In the first case, monetary policy helped to stabilise output, albeit at a higher level of inflation. In the second case, inflation would have returned to its previous level, but at the expense of a lasting loss in economic output.

How does the ECB fare, compared with Bundesbank practice? Applying the Bundesbank's (estimated) monetary policy rule to the ECB indicates that ECB monetary policy was actually less restrictive than would have been the case for the Bundesbank, faced with the same economic realities (see Graph 6 on page 36). From 1999 to the first quarter of 2000, ECB interest rates were below the levels that would have been consistent with the Bundesbank's rule. From then until the end of 2000, ECB rates were in line with the hypothetical rates estimated according to the Bundesbank rule. And from the first quarter of 2001 onwards, the fall in eurozone rates was much more pronounced than could have been expected had the Bundesbank been in charge. Our tentative conclusion is that, like the Bundesbank or even more so, the ECB does not react to inflation only, but also takes into account the output gap and its indications for future inflation. This little exercise should put the general assumption that the ECB tends to err on the side of caution into perspective.

The ECB's first three years

Our analysis of the ECB's first three years paints a varied picture. Although most commentators would agree that the Bank has not done badly, some criticise it for not having formulated a convincing set of policy rules. After riding the storm of the first half of 1999 relatively well, the ECB has become apathetic. It appears to take its time to collect and analyse economic evidence, before it makes its rate decisions. Such inertia is not unusual in central banks, Germany before 1999 being a case in point. However, financial markets tend to get impatient with the ECB, especially since its approach appears overly cautious compared with the decisiveness of Alan Greenspan's Federal Reserve. Whereas the Fed regularly adjusts its rates by small amounts, which gives the markets the time and the opportunity to adjust their expectations, the ECB's decisions are based on long deliberations and thus appear much more final. If the markets misjudge the ECB's strategy the consequences can be serious, far more so than if it takes a more gradual approach.



Graph 6

We have already explained how ECB policy so far can be justified by the particular circumstances of the European economy at the point of its inception. We would also like to emphasise that it is much easier for a central bank to interact with a sole interlocutor, such as Wall Street in the US, than with a multiplicity of trading locations with vastly different traditions, as in Europe.

Credibility and transparency

The ECB's credibility, or the absence thereof, is a recurrent theme with economists and policy-makers. But what do they actually mean by this? The Oxford English Dictionary defines credibility as being 'capable of being believed' or 'worthy of belief or confidence; trustworthy'. But in the context of economic policy, credibility is somewhat more complex. If a central bank is not credible, the public will not believe that it can attain its inflation target. Expecting an inflation rate that is higher than that predicted by the central bank, the public will continue to bargain for higher pay-cheques to make up for any future erosion of their wages through 'surprise' inflation. This, in turn, will create exactly the kind of inflationary pressures that the public was expecting in the first place. In general, a central bank that lacks credibility will therefore have to follow a much tougher monetary stance than one that can simply announce a monetary target and influence the behaviour of private-sector actors without having to raise interest rates. But how does a central bank become credible? The economic literature identifies a number of channels, such as inflation aversion, pre-determined rules and contractual incentives. Let us look at each of these in turn.

In search of credibility

When the public forms expectations about future inflation, people look to the government and the central bank for guidance. There are two factors at work: the authorities' objective of economic growth (this is referred to as the 'inflation bias', since it is assumed that the authorities would like growth to exceed its long-term, non-inflationary equilibrium rate) and their dislike of inflation. In

general, if the authorities are seen to have a strong aversion to inflation, inflation tends to be lower and the central bank's credibility is stronger.

Another way to ensure credibility is to stick to pre-determined rules, rather than apply monetary policy pragmatically to respond to economic changes. If the private sector knows in advance how the central bank will react to changes in economic trends, it will adjust expectations accordingly. This makes it much harder for governments to disguise their intentions and engineer 'surprise' inflation in an attempt to boost growth. Tying the central bank's hands through pre-determined rules therefore helps to achieve an optimal policy mix.

A third way to enhance credibility is the use of contractual incentives. By providing central bankers with disincentives to go back on their words, such contracts can make policy statements sound more credible in the ears of the public. One way of doing this is to set fines for central bankers, which increase in relation to the difference between actual inflation and the pre-determined inflation target. However, the difficulties involved in predicting inflation correctly – which may depend on a plethora of 'external factors' such as international commodities prices, supply side shocks or exchange rate movements – make these contracts very difficult to use in practice.

Perhaps the most effective way for a central bank to demonstrate its determination to meet a set goal, such as price stability, is just to meet it. Blinder points out that the Bundesbank – although it repeatedly missed its money supply targets – was always seen as credible simply because it managed to control inflation.[8] In this case, credibility is synonymous with reputation, and hence it is hardly surprising that an institution as young as the ECB is not yet entirely 'credible'. It takes time to build a reputation.

[8] *A Blinder, 'Central Bank Credibility: Why do we care? How do we build it?', American Economic Review, December 2000.*

Generally speaking, a central bank becomes credible if it manages to create the conditions for low inflation in the long term. If the public

believes that the central bank will be effective, inflation expectations will converge with the inflation target, and long-term interest rates (which reflect inflation expectations) will fall. The ECB's persistent attempts to push inflation below an annual average of 2 per cent can be explained in these terms. As long as it is still in the process of building up its reputation, the ECB must stick to very strict rules and avoid any policy reversals. However, even the toughest policy can backfire in terms of credibility. The ECB – determined to bring inflation down – raised interest rates seven times between November 1999 and October 2000, before leaving them untouched for the following seven months. But although eurozone (short-term) rates were higher than US ones, the euro continued its slide against the dollar. The ECB's strict monetary policy itself may have been a factor contributing to the euro's weakness. Arguably, the ECB put the breaks on the European expansion too early, which further widened the gap between the US and Europe. This gap encouraged investors to move their money out of the euro and into more promising dollar assets, and thus undermined the external value of the new currency. The weak euro, in turn, created additional inflationary pressures through pushing up the prices of imported goods. In other words, the ECB's strict monetary policy undermined its own objective by strangling growth in Europe and depressing the value of the currency.

A credible central bank needs to be open

For a central bank to be credible, it must also be open about what it is trying to do and how. In other words, it needs transparency. Transparency has various elements: effective communication with the public; internal consistency and integrity (the central bank has to be seen to base its decisions on its own statistics, for example); and accuracy.[9] In an ideal world, transparency serves to remove all the ambiguities that may exist between the bank and the public, be it over economic information, monetary policy objectives or strategy. In this case, transparency enhances the central bank's credibility. However, in a not-so-ideal world transparency can reveal flaws in the central bank's decision-making. If the markets

[9] *B Winkler, 'Which Kind of Transparency? On the Need for Clarity in Monetary Policy-Making', Working Paper n°26, ECB, August 2000.*

and the public see the central bank's decision-making as inconsistent or flawed, credibility will be lost.

Transparency and a rule-based monetary policy go hand in hand. For a central bank, there is no point in trying to hide the fact that it follows an explicit rule in monetary policy decisions, such as an inflation target. The markets and the public at large can figure out the underlying rule anyway, simply by observing its application in practice. But what about central banks that follow a more discretionary approach? Academic economists have little to say about this, believing that the rule-versus-discretion debate has long been settled in favour of a rules-based monetary policy. In practice, however, this is not at all the case. US monetary policy, for example, is entirely discretionary – although the governor of the Federal Reserve subsequently has to account for the result in front of the nation and the government. The Fed's past actions can be reasonably well explained by the so-called Taylor rule, which computes the Fed's policy as a reaction to changes in inflation and the size of the output gap. No-one knows, however, whether the rule has any value in predicting future interest rate moves. In practice, no central bank can base its monetary policy entirely on a strict rule. Especially in today's uncertain economic environment, monetary policy will always have to fly by sight. Even with the best data and economists, central banks' forecasts about future economic developments will be tentative. Central banks thus need room for manoeuvre to react to unforeseen developments. A certain amount of secrecy may be needed, simply for monetary policy to be effective.

Faced with the conflicting demands of credibility and transparency, the ECB appears to have opted for minimal transparency. Although the ECB's objectives are well established and clear, its strategy is anything but. As shown above, the two-pillar system is not exactly a model of simplicity. And the ECB's communication with the public is more style than substance. In May 2001, for example, the ECB governor justified its decision to cut interest rates not in terms of gloomy growth predictions, which were at the time the focus of

media attention, but in terms of the past over-estimation of the broad money supply (M3). Preceding the long-awaited rate cut, the ECB had justified its seven-month inertia by pointing to the risks of a revival in inflation. The ECB's chief economist, Otmar Issing, however, had announced that inflation would peak in the second quarter of 2001. Given that the economic impact of monetary policy is always delayed, the reasons for the ECB's inertia were therefore hard to understand, unless, that is, the Bank does not trust its own in-house inflation forecasts.

Meanwhile, the debate continues over whether the ECB should follow the Federal Reserve and the Bank of England in publishing the minutes of its policy meetings. The ECB has agreed to publish its minutes with a 16 year lag, which may be of interest for economic historians, but will do little to help the markets understand how the Bank functions. Those against the timely publication of minutes argue that it could constrain policy-makers during the meeting and would therefore damage the freedom and the quality of the policy debate.[10] If this were the case, the minutes might not reveal much more than that a debate had taken place, which is what the public knew already. Those in favour think that the publication of minutes would help the general public, and private-sector economists in particular, to better understand the way in which the ECB reaches its decisions. This would allow the private sector to make more accurate predictions about future ECB behaviour, helping to clear up questions such as who carries the most weight in the debate, what role national sensitivities play and on which factors the Governing Council bases its decisions – such as economic data, forecasts, political events or others. The ECB's transparency may also be thrown into sharp relief if the UK – whose Central Bank is at the opposite end of the transparency scale – decides to join the eurozone. The Bank of England not only publishes the minutes of its meetings, but also the individual voting records of all the members of the Monetary Policy Committee.

[10] See W Buiter, 'Alice in Euroland', and O Issing, 'The Eurosystem: Transparent and Accountable or Willem in Euroland,' Journal of Common Market Studies, 37, September 1999.

Recent academic studies have reinforced doubts about the need for secrecy, instead emphasising the value of good communication with the public – 'open mouth operations' – over the direct intervention of central banks in financial markets – 'open market operations'.[11] Action is no longer enough. An effective monetary policy also requires continuous communication between the central bank and the public. Transparency has therefore become a key ingredient of an effective monetary policy.

[11] *G Gutherie and J Wright, 'Open Mouth Operations', Journal of Monetary Economics, October 2000.*

Nevertheless, it would be extremely difficult to draw up a clear set of recommendations for increasing the ECB's credibility. While credibility is crucial, there is no evidently wise way of attaining it. Transparency may add to it or diminish it. The publication of minutes works well in the US and the UK. But would it have the same effect in the eurozone, where the minutes would be subject to conflicting interpretations by various national authorities? For the time being, it appears that the best thing the ECB can do is to continue with current practices while paying close attention to constructive criticism with a view to future improvements.

There is, however, one recommendation that we are confident in making: the ECB would clearly enhance its credibility if it revised its definition of price stability, or what is in effect its inflation target. The current target of 2 per cent or lower is clearly too restrictive, probably because of the unusually low inflation that prevailed in 1998 when the ECB first set its policy goals. This not only implies the risk that the Bank could strangle a potential upturn in the eurozone economy. It also undermines the ECB's credibility and standing directly, because by the end of 2002 it will most probably have missed its target for the third year out of the four it has been in operation. If the ECB is reluctant to increase its target for now, it should at least add a margin of error of plus or minus 1 per cent. Whether this would be enough remains to be seen, as past experience has shown that central banks tend to miss their targets by margins closer to 3-4 per cent.

4 Reforming Europe's economic policy framework

The 12 current members of the eurozone differ greatly in terms of their economic competitiveness, degree of openness to foreign trade, structure of industrial production and, perhaps most importantly, levels of employment and unemployment. This diversity calls strongly for differentiated national economic policies – something that the current eurozone framework does not permit. Monetary policy is fully centralised in the hands of the ECB. And while fiscal policy remains decentralised, the Stability and Growth Pact sets real constraints. The co-existence of a single, independent and politically unaccountable central bank, and a plurality of fiscal authorities all constrained by the same rules, creates a major institutional imbalance. Until 2000, strong economic growth, leading to rapidly growing budget revenues, helped to disguise this imbalance by weakening the constraints of the SGP. The subsequent downturn, however, has fully revealed the problem. The SGP has effectively required European governments to tighten their budgets at a time when their economies are already slowing.

There may be two underlying reasons for this dilemma: an overly orthodox and single-minded conception of monetary policy and/or overly cautious assumptions about Europe's medium-term growth potential. The combination of the two first strangled Europe's recovery and then exacerbated the resulting slowdown. The eurozone's institutional set-up therefore prevents the implementation of an optimal policy mix. Reforms are necessary, not least because ten more countries are preparing to join the EU and its eurozone institutions in the near future. At the same time, it is important to measure all reform proposals by the standards of feasibility. Radical changes to the EU's institutional status quo may be desirable, but they are hardly realistic.

The future of European monetary policy

Our review of the ECB's first three years comes to broadly positive conclusions. 'If it ain't broke, don't fix it', some might argue. However, the ECB's monetary policy would have been much tighter during these years had the Bank followed a strict interpretation of its monetary targets. Consequently economic growth would have been much weaker, perhaps even negative, unemployment would have risen further and public deficits would have spiralled. And then? As outlined above, the ECB is in a strong position to resist all political pressures. Its primary objective is price stability. Supporting the economic policies of the member-states is a secondary objective, as Article 3A of the Maastricht treaty makes clear

The ECB and democracy in Europe

Europe's current set-up does not provide for the political accountability of the ECB. Political accountability in this context would mean that the Central Bank had to account for its actions in front of an institution that possessed the right – however carefully defined – to modify the central bank's statutes. Most national parliaments have this right. For example, the US Federal Reserve, like the ECB, is free to both set its inflation target and choose the means to achieve that goal. However, the US Fed has to justify its monetary policy actions in front of an elected body that has the power to modify its statutes and thus, ultimately, its independence. Similarly, the German Bundestag had, until 1998, the power to change the legal status of the Bundesbank. Although the ECB reports to the European Parliament, the latter has only the power of persuasion to attempt to influence the ECB.

The fact that national parliaments have hardly ever made use of the power to alter a central bank's statutes does not prove that it serves no purpose. Its very existence forces central banks to take into account the preoccupations of a country's elected representatives and make better use of the information available.

Democratic institutions work better than non-democratic ones, precisely because they make better use of information that is disseminated and discussed in the process of legislation.[12]

[12] *D Rodrik, 'Institutions for high growth: what they are and how to aquire them', Working Paper NBER, N° 7540, 2000.*

The EU, however, is suffering from a 'democratic deficit'. In theory, the deficit could turn into a crisis, if democratically elected representatives were subjugated to the powers of independent, unaccountable agents. The ECB has a very clear idea of what European governments should do in the name of 'sound' economic management: reduce the role of the state in the economy by cutting public expenditure; and increase the flexibility of labour markets by shrinking the welfare state. The ECB's vision would matter little if it did not have the power to 'punish' European governments by keeping interest rates high. The governments, on the other hand, have no power whatsoever to sanction the ECB. The Council of Ministers may well disagree with the ECB's monetary policy, but it has no way of forcing the ECB to change its behaviour.

Although the ECB's institutional legacy comes from the German Bundesbank, at least as far as its strategy is concerned, it lacks the kind of democratic foundations that gave the Bundesbank its legendary authority. The ECB is not embedded in an identifiable and unified social system, as was the case for the Bundesbank. This creates the danger that Europe's citizens regard the ECB as aloof and remote. For the average European in the street, the defence of price stability simply does not have the kind of significance and unifying force that it had for the Germans, whose nation had gone through economic turmoil and hyper-inflation.

The question of ECB accountability should obviously be approached with great caution. The issue at hand is not to rescind the ECB's institutional independence, but to acknowledge that in a democracy independence is a relative concept. The governments that signed the Treaty on European Union assigned the ECB responsibility for price stability, without elaborating further. It fell to the ECB to interpret

this objective freely. The ECB came up with an interpretation – the two-pillar system discussed above – but it may equally well have come up with a totally different one, without any political authority having the power to intervene. It then took a relatively pragmatic approach in implementing its choice. But again, it could have gone the other way. This is not a very satisfactory state of affairs, neither from the point of view of the Bank's credibility, nor its legitimacy.

Had the eurozone's political authorities taken part in translating the 'price stability' objective into numerical targets, perhaps in collaboration with the ECB Governing Board, this would have weakened the Bank's critics – many of whom are rather doctrinaire. Even if this had resulted in the same policy targets, the process alone would have increased the ECB's legitimacy and thus increased its freedom of action. Supranational institutions hardly gain if governments offload their responsibilities onto them. And it surely is the height of hypocrisy when governments then go on to criticise the ECB for an objective that they left it free to set. The way out of this institutional and policy dilemma is to improve the ECB's accountability as soon as possible.

One conceivable solution would be to give the European Parliament the right to define the meaning of 'price stability'. Enhancing the role of the Parliament in this context would have the added advantage of helping to achieve a better distribution of political power in the Union, which is currently skewed in favour of the Council of Ministers. In setting a target, the European Parliament could consult the ECB itself, as well as central bank officials from outside the eurozone and other experts. A constitutional majority – usually two-thirds of the votes – should be required for Parliament's vote on the monetary policy target. This is necessary not only to accord the decision the necessary political weight, but also to make sure that the target does not get altered with every slight change in economic circumstances.

Alternatively, the European Council could set the ECB's monetary policy targets, by a qualified majority and after consultation with the

ECB. Although this would be an improvement on the current situation, it would not bring the same gains in terms of legitimacy and transparency. The European Parliament's debates are characterised by real discussion. They are also public. The published records of its sessions and hearings would allow the public to better understand the rationale behind the ECB's policy targets. Furthermore, having the targets set by the European Parliament would be rich in democratic symbolism. The most important issue is not that the monetary policy target be changed, but that it be changed by a politically legitimate body, be it the Parliament or the Council. Would this require a revision of the Maastricht treaty? Since the treaty is silent on the definition of price stability, the answer is probably not. But it would probably require a new treaty and/or a unanimous decision by the Council. The current European Convention, and the inter-governmental conference that will follow it, provide an excellent opportunity for reviewing Europe's economic governance, and in particular, the respective roles that the Parliament, the Council and the Commission should play.

The ECB after enlargement

The Convention, whose brief is to reconsider the EU's institutions with a view to the upcoming eastward enlargement, should also have a thorough look at the future of European monetary policy. Enlargement will require at least two changes to ECB policy-making: a revamp of its management and a change in its inflation target. We shall look at the latter first, since it is the more straightforward of the two.

We have argued that the ECB's 2 per cent 'reference value' for medium-term inflation is too tight for the current EU. It will be even less realistic after the next round of enlargement, which will bring into the EU – and eventually the eurozone – a number of countries whose normal, long-run (or equilibrium) rates of growth and inflation are considerably higher than those of the current member-states. Per capita GDP in the central and eastern European candidates is much lower than that of the current EU-15. To catch up, the new members require both higher growth and higher

inflation, as the price levels of services and other non-traded goods adjust to western levels (economists refer to this process as the Balassa-Samuelson effect). Higher inflation in eastern Europe is thus a structural phenomenon, not necessarily a monetary one.

European monetary policy will therefore need additional room for manoeuvre. The new inflation target – set by the European Parliament in line with our suggestions – should be strictly positive (ruling out the possibility of deflation) and allow inflation to exceed the current ECB limit of 2 per cent over the medium term. The new target range could aim for inflation between 1 and 3 per cent, or better still between 1.5 and 3.5 per cent. Too low a target would needlessly limit the ECB's ability to reduce interest rates in the short term, to stimulate economic activity. Too high a target, on the other hand, could undermine the central bank's credibility and may weaken the economic discipline of the member-states.

EU enlargement will also require a revamp of the way the ECB makes policy decisions. At the moment, the Bank's Governing Council, the main decision-making body for monetary policy, has 18 members: the six members of the Executive Board and the 12 governors of the national central banks. Once the current round of enlargement is over and all 12 candidates have joined the eurozone, the ECB Governing Council will have 30 members or even 33 should Denmark, the UK and Sweden also decide to adopt the euro. This will create two kinds of problems. First, decision-making would become unwieldy and slow. Second, the Governing Council would become heavily dominated by small countries. A coalition of the smaller countries representing only 20 per cent of European GDP could control a majority of the votes.[13] The ECB is already criticised (probably unfairly) for its slow decision-making process with regard to interest-rate adjustments. And that is despite the fact that at present the ECB Council has only 18 members, and the Executive Board – presuming it agrees among itself – only has to persuade three of the national

[13] *R Baldwin, E Berglof, F Giavazzi and M Widgren, 'Preparing the ECB for Enlargement', CEPR Policy Paper N°6, October 2001.*

central bank governors to form a majority. After enlargement there are good reasons to fear that the ECB could become paralysed and that its monetary policy would be unable to adjust quickly enough to steer Europe's giant economy through the tricky waters of international shocks.

The fear among large countries that the ECB could become dominated by small countries is fuelled by the fact that the members of a possible small-country coalition have certain structural characteristics in common – characteristics that they do not share with the large countries, which represent 80 per cent of European GDP. Most of Europe's small countries belong to the group of fast-growing economies with (structurally) higher inflation. They may thus have objectives for monetary policy that differ from those of the large and economically well developed member-states. The result could be a monetary policy that is ill-suited for Europe's largest economies.

A smaller Governing Council would avoid both these problems. This, however, implies that not all the national central bank governors would have a vote in the Council at all times. There are a number of ways in which governors could be selected:

★ **Rotation**: The Nice summit considered the idea of rotating national representation in the European Commission, but without adopting it. Similar proposals are now being discussed for the ECB, although their political feasibility is still in doubt. Member-states may oppose rotation for fear of being excluded from decision-making for too long. Regular rotation among a large number of governors obviously does not make sense. But the lower the number of governors on the ECB Council and the longer the rotation period, the longer the other governors have to wait for their turn. Suppose that only 8 out of 24 governors have the right to vote and that their mandate is 5 years. Each governor would then have to wait 10 years for his next turn. Even if all the governors were allowed to attend Council meetings, this option would probably be considered politically unacceptable.

A compromise solution – 12 governors out of 24 with three-year mandates, for example – could make rotation more acceptable. After all, this is how the US Federal Reserve system works. It has the advantage of not creating permanent or semi-permanent 'second-class' members. But this is also its problem, since it does not sufficiently distinguish between large and small member-states and thus raises the spectre of a Governing Council in which the large economies are not represented. The Federal Reserve system, in which the New York Federal Reserve has a permanent seat for historic reasons, could be a model. On the ECB Governing Council, one or two seats could be permanently reserved for the four large countries – five if the UK joins. The Council could then have 19 members, only one more than at present. Six would be from the ECB Board, two would be governors from large countries while the other 11 governors would be chosen from the remaining 22 countries, each with a five-year mandate.

- **Representation**: This would involve the establishment of regional groups, each of which would send one representative to the Governing Council. There are number of drawbacks, however. Like rotation, it would exclude a number of governors from the decision-making process. Worse, in this case the exclusion would be permanent. Moreover, it would involve the difficulties of forming regional groupings and would add another layer to Europe's complex political geography (regions, nation-states, the EU as a whole, and now regional sub-groups).

- **Delegation**: What about basing the selection process on personal competence and merit, rather than political considerations? Baldwin argues that national central bank governors should only have a consultative role.[14] Instead, the Governing Council should include five external figures, chosen by the governments of Europe from among "the finest experts in the world". They do not specify the criteria to select these 'experts', except that they would not necessarily have to be European. They furthermore suggest that ECB reform should fall under the responsibility of the Commission since the ECB itself cannot be relied upon to generate sufficient ideas, not only because of its inherently conservative nature but also because any reform proposal requires a unanimous vote in the Governing Council.

[14] *R Baldwin, E Berglof, F Giavazzi and M Widgren, 'Preparing the ECB for Enlargement', CEPR Policy paper, N°6, October 2001.*

A technocratic solution like this will not help to reduce the EU's democratic deficit. The idea of a government of appointed experts may be appealing. But in a functioning democracy governments derive their legitimacy from being backed by the popular vote, not from having some kind of 'superior' knowledge. Moreover, experts disagree about the right course of action just as much as elected politicians. This is even truer in economic policy-making, where there is usually more than one 'right' answer to each socio-economic problem. The national central bank governors themselves may well be experts in the sense that they have ample economic and financial expertise. They have the added advantage of being accountable in their individual countries, which reinforces their incentive to make the 'right' decision. It is an illusion to believe that monetary policy is a purely technical affair. It is also, perhaps even primarily, a political affair – the Bundesbank's approach was a classic example. Here again we see how a disregard for democratic principles in the EU reform debate threatens to widen the gap between the European integration process and Europe's citizens, and thus undermine the legitimacy of the former in the eyes of the latter.

- **Direct nomination:** It is therefore preferable to ensure some form of direct political involvement if reform is to lead to enhanced efficiency, credibility and accountability – as we have argued all along. From our point of view, a more accountable central bank is also a more credible one. Politics should play a more prominent, but also better informed, role in the appointment of the ECB leadership. We would propose that the heads of government in the European Council directly

decide who sits on the ECB Governing Council. The Executive Board would remain unchanged with six members. The European Council would then select from among the national central bank governors a number it deems optimal for the Governing Council.

The appointment of Wim Duisenberg, the current ECB president, and his possible successor, may be instructive in this context. Many commentators considered the political horse-trading that preceded Duisenberg's nomination as damaging to the ECB's credibility. By implication, the direct appointment of the ECB Governing Council – based on the same horse-trading between large and small members-states, North and South etc – could be equally damaging. We disagree. The search for compromise is part and parcel of any democratic process. The idea behind democracy is that decisions are legitimate if they are supported by the largest possible share of eligible voters. However, for decisions that are subject to unanimity, any democratic assembly will have to make its choices by way of compromise. The European Council is no exception. It is not a fact-finding mission or a jury that somehow uncovers the 'right' decisions based on 'objective' criteria. And of course, even juries rely heavily on compromises in their verdict.

The political nature of the nomination process is therefore beyond doubt. But this does not mean that the process could not be improved, especially regarding the quality of the information on which it is based. Thus, the idea of direct nomination hinges on the quality of the selection and nomination process.

Let us assume that membership of the Governing Council is reduced to 15: six members of the Executive Board and nine national central bank governors. A pre-selection would be made under the aegis of two committees. The first – composed in equal numbers of members of the Council of Ministers (ideally deputy prime ministers responsible for European affairs) and MEPs – would present a shortlist for the six members of the Executive Board to the European Council. This

'search committee' would liaise extensively with other European institutions before putting forward two or three potential candidates for each position in the Executive Board. The second committee would comprise all the national central bank governors from the eurozone and would select the nine governors to sit on the Governing Council. If this selection proves difficult, the second committee might rely on suggestions from the first committee. The European Council would have the final word in the selection. As for the criteria for the pre-selection process, we do not think it is necessary to define them in advance. Very rigid criteria entail the risk of excluding some of the best candidates from the selection process. Very broad criteria, on the other hand, would simply complicate the process, without adding much value. We would, however, suggest softening the requirement that all members of the Executive Board be European nationals, and we would add the requirement that one Board member has to be a distinguished personality from the private sector.

To conclude, we think there are two possible solutions to the potential gridlock in the ECB's management. Our first choice would be the direct nomination of the Governing Board members in a political process. Alternatively, a rotation process could be instituted that permanently reserved two ECB Board seats for the larger member-states. We have a slight preference for the first solution because our enhanced rotation proposal would involve a partial 're-nationalisation' of the ECB Governing Council, through the permanent seats for certain member-states. We believe, however, that the ECB should shed some of its 'national' characteristics to become more 'European' in nature.

Europe's optimal policy mix

The ECB has shown itself deeply concerned about fiscal relaxation across Europe, which, it fears, could push up inflation. Nor has it always been happy with the way in which the large member-states, especially France and Germany, have interpreted the SGP. On the whole, however, the Stability and Growth Pact

suits the Bank perfectly well since it sets in stone the preponderance of monetary policy in the European policy mix.[15]

[15] *J-P Fitoussi and L Svensson, 'Rapport sur l'état de l'Union europeénne', Fayard et Presses de Sciences-Po, 1999.*

The Stability Pact: theoretical foundations and political credibility

Europe's budgetary rule-book, the Stability and Growth Pact, has two parts: the excessive deficit procedure, which threatens governments with sanctions if their budget deficits stay above 3 per cent of GDP; and the Stability Programmes, which oblige eurozone governments "to comply with the medium-term budgetary objective of positions close to balance or in surplus". These fiscal rules are the flipside of the EU's monetary policy objective of price stability. Profligate fiscal spending can, if it adds to existing strong demand in an economy, push up inflation. Also, governments which have run up large amounts of debt will be tempted to press for a lax monetary policy since lower interest rates (and higher inflation) will help them with their debt servicing costs.

There are many things to be said in favour of the SGP. By tying governments' hands, it can bolster the credibility of national budgetary policies. If the public does not suspect its government of succumbing to the temptation of fiscal profligacy (for example to win an election), it will also expect inflation to be lower. This, in turn, will make the ECB's work easier. Also, by improving the dialogue between the monetary and budgetary authorities, the SGP could help to avoid situations where fiscal and monetary policies are out of kilter, which usually results in great economic costs, and thus achieve a better European policy mix. If no dialogue takes place, the fiscal authorities might run up large budget deficits, forcing the Central Bank to tighten monetary policy. High interest rates, in turn, push up the costs of servicing the national public debt, which puts further strains on the national budgets.

Nevertheless, we believe that the SGP is flawed, not only because it is based on questionable theoretical assumptions, but also because

of its political implications: it falls to the (non-elected) European Commission to publicly reprimand elected governments for not implementing policies that they themselves have drawn up.

★ **Dubious theoretical foundations:** The rationale behind the SGP is to prevent irresponsible fiscal policies in one eurozone country from doing damage to the entire eurozone economy. Excessive government spending in one country, so the argument goes, will push up local inflation and may force the ECB to raise interest rates, which would then represent economic and social costs to the rest of the eurozone. The temptation to raise fiscal spending is even greater in a single-currency zone. Since the exchange rate is no longer available to smooth out economic fluctuations, governments may be tempted to react to any kind of disturbance by loosening the purse strings. The negative effects of this fiscal loosening, meanwhile, would be 'externalised'. In a national economy, a profligate government usually faces the immediate threat of a tighter monetary policy, or a collapsing currency. The ECB, however, has to take into account the fiscal policies of all member-states, which implies that even if it 'punishes' the profligate government with higher interest rates, the punishment would be much less severe. In theory, a government could thus reap the benefits of higher spending while the losses are collectivised. Other countries may even be forced to tighten their own budgets to make up for the overspending of a single eurozone member.

Even more worrying is the possibility that a eurozone government would pile up so much debt that it could eventually face default. To preserve macro-economic stability in the eurozone, the ECB could then find itself obliged to 'bail out' the government in question by buying up, or monetising, its debt. The resulting monetary loosening would be a serious blow to ECB credibility and would obliterate hard-won gains in the battle against inflation.

We are not convinced by these arguments. For one thing, the impact of an expansionary fiscal policy in one member-state on eurozone interest rates is likely to be minor, if not negligible. Even a marked increase in a national budget deficit, say 1 per cent of GDP, will increase the eurozone's overall fiscal deficit by no more than 0.1-0.2 per cent of eurozone GDP. This is unlikely to induce the ECB to tighten monetary policy. Moreover, the rationale commonly invoked in defence of the SGP is biased and therefore only tells half the story. We argue that a fiscal loosening in one of the eurozone countries may well be in its neighbours' interests, which is the exact opposite of the thinking behind the SGP.

Assume a member government follows an irresponsible fiscal policy, such as boosting fiscal spending at a time when growth is already strong, perhaps in an attempt to win an election or fulfil past promises. The result would be a rise in inflationary pressure and the threat of economic overheating, as output approached full capacity. The country's neighbours would benefit from this in two ways. First, they see demand for their exports increase, since output in the 'irresponsible' country would not be able to keep up with higher domestic demand. Second, since the 'irresponsible' country now has higher inflation, it loses competitiveness vis-à-vis its neighbours because the input costs for local industries rise disproportionately. The neighbouring countries may therefore experience higher growth, increased employment and, as a result, a rise in budget revenue and a smaller public deficit.

If the fiscal expansion occured in response to real economic trouble, such as a sudden rise in unemployment, the inflationary effect would be limited and the neighbouring countries would not reap the competitive gains described above. But they would still gain in terms of increased export demand and an improvement in their fiscal deficits. Take Germany as an example. Would it not be in the collective interest of the eurozone for Germany to reflate its sluggish economy rather than cutting spending in an attempt to stay within the limits of the SGP?

These examples illustrate that in a system with high trade integration and a single currency, the fiscal profligacy of one member-state leads, to a greater or lesser degree, to improved public finances in the fellow member-states. We therefore find the logic behind the SGP perplexing. Under the pretext of protecting all member-states from the potential consequences of irresponsible behaviour by one member-state, it forces them to renounce policies that might suit everyone.

Meanwhile, the danger of insolvency is overrated. A country that pursues a reckless fiscal policy would be the first to suffer the consequences. Financial markets would shy away from its national debt, which would push up long-term interest rates in relation to short-term eurozone ones. It is in any case hard to imagine why a European government would pursue such policies. They have never done so in the past, despite the absence of fiscal constraints at the European level. Fiscal positions are generally sound – with public debt below the Maastricht threshold of 60 per cent of GDP in most countries – and an increase in budget deficits of 1-2 per cent of GDP is unlikely to lead to a financial crisis. Numerous studies have shown that the eurozone countries have generally followed 'responsible' anti-cyclical fiscal policies in the past.

★ **Poor credibility:** Were it observed to the letter, the SGP would require the entire eurozone to pursue restrictive fiscal policies from 2002 to 2005, even if growth stayed below potential. In the current sluggish economic climate, the Pact encourages most European countries to follow a pro-cyclical fiscal policy, forcing them to cut public spending and/or raise revenue at a time when the economy faces a downturn. A budget usually includes what economists refer to as automatic fiscal stabilisers. These help to smooth out economic fluctuations. For example, when growth slows, the government automatically takes less tax from the private sector (because profits and consumption fall) while at the same time spending more, for example on unemployment benefits. Under the SGP, none of the large eurozone countries –

Germany, France and Italy – will have sufficient room for fiscal manoeuvre to allow these stabilisers to operate fully in coming years. Their room for manoeuvre is further restricted by high interest payments on public debt – amounting to 2.7 per cent of GDP in Germany in 2001, 2.9 per cent in France and 5.7 per cent in Italy. These costs, included in the fiscal deficit, limit the ability of fiscal policy to respond to even temporary economic trouble.

Having transferred monetary and exchange-rate policy to the ECB, eurozone governments now only have one macro-economic policy tool, namely their national budgets. The SGP, however, may not only restrict them in using this tool, it may even force them to use it in a way that goes directly against their wishes. To get out of this dilemma, EU governments are tweaking their budget plans, resorting to creative accounting and relying on overly optimistic growth forecasts, all under the watchful eyes of the Commission and the ECB. The SGP does, in fact, encourage deceit at the heart of European economic governance.

Every year, the member-states have to present their fiscal blueprints, the Stability Programmes, to the Commission. To some extent, the Commission has become the guardian of the budgetary orthodoxy. It is responsible for issuing warnings to countries whose public finances risk transgressing the SGP's rules. This is politically problematic, not least because the Commission's warnings are issued publicly, and widely discussed in the media. The final decision about whether a country has infringed the rules of the SGP lies with Ecofin. If Ecofin agrees with the Commission, the 'offending' country may face fines and penalties. If, on the other hand, the partner countries in Ecofin decide to let the 'offender' off, this may look like a political climb-down from previously-agreed budget precepts. Ecofin is quickly accused of undermining the credibility of the SGP. In fact, it is the Pact itself that has no credibility.

The implications of this procedure can be illustrated by three actual cases, those of Germany, Ireland and Portugal. The following table

gives an indication of these countries' macro-economic situation in recent years.

Table 1: macro-economic indicators in the eurozone

	Budget balance, % of GDP				Real GDP growth, %				Inflation, %			
	G	IR	P	€ zone	G	IR	P	€ zone	G	IR	P	€ zone
1999	-1.6	3.9	-2.1	-1.2	1.7	9.8	3.4	2.5	0.6	2.5	2.2	1.1
2000	-1.3	4.7	-1.8	-0.7	3.2	10.7	3.4	3.6	2.1	5.3	2.8	2.3
2001	-2.5	4.3	-4.1	-0.6	0.8	8.8	2.0	1.5	2.4	4.0	4.3	2.6

Sources: Stability Programmes for national data and the ECB for eurozone data.

In February 2001 the Council of Ministers agreed unanimously to address a 'recommendation' to the Irish government, advising it to revise its budget targets for 2001, which were seen as too expansionary for an economy faced with the threat of overheating (see Chapter 2). This first instance of the SGP in action was mainly triggered by worries about inflation, although the rules set out in the Maastricht treaty and the SGP define economic policy co-ordination in terms of the overall sustainability of budgetary positions. What is more, the EU's recommendations did not sufficiently take into account Ireland's specific situation. Ireland's demography does not imply impending problems with an unsustainable pension system (which would make it advisable to run budget surpluses now, to finance future pension liabilities). At the same time, Ireland needs more public investment in infrastructure to continue growing strongly and catch up with the richer member-states. Arguably, Ireland could thus justify higher fiscal spending. The fact that the country was running a fiscal surplus at the time made the EU's recommendations even more difficult to comprehend. This first episode of the SGP in action has only served to diminish the credibility of the procedures for drawing up Stability Programmes and assessing their validity.

The second episode diminished that credibility even more. In February 2002, Ecofin rejected the Commission's proposal to issue warnings to Germany and Portugal, although both had significantly overshot the fiscal targets enshrined in their Stability Programmes and were heading perilously close to the 3 per cent level (in fact Portugal's 2001 budget deficit subsequently turned out to be above 4 per cent). To avoid a public reprimand, both countries pledged a rapid reduction of their deficits. Nevertheless, many saw this compromise as breaching the SGP since it was clear at the time that Germany was highly unlikely to fulfil its promise to balance its budget by 2004. Indeed, the Commission itself was forced to accept in September 2002 that not just Germany but also France and Italy would not meet the 2004 target, which it extended until 2006. The impression was that Germany escaped a warning in February 2002 thanks to active lobbying and the support of the other large member-states. France and Italy were then able to benefit when the Commission retreated on the balanced budget target in September. Portugal also escaped censure, although the Council ruled that its failure to meet the target set in the previous Stability Programme derived more from a lack of control over public expenditure than from any economic slowdown.

The problem with the Commission's warnings is that they are triggered automatically and have a generic character, despite the fact that they address very different fiscal situations. What is the similarity between the situation in Germany, where a growing fiscal deficit is largely the result of the economic downturn while inflation remains subdued; in Ireland, which is enjoying catch-up rates of growth and thus higher rates of inflation, while running a budget surplus; and in Portugal, where deteriorating public finances are the result of rapidly rising public expenditure? It is clear that the SGP is not suited to achieve optimal fiscal policies in Europe. What is desirable in one country may be harmful in another. Germany needs to allow its automatic fiscal stabilisers to operate; Ireland needs a programme of public investment; and Portugal has to address the problems that have led to a continuous deterioration in

the budget, such as high public-sector employment and too many tax exemptions.

The Stability Pact and European monetary policy

The SGP is even more inadequate in the context of a single European monetary policy. The ECB's level of interest rates is highly unlikely to be suitable for all eurozone members. Those countries that grow fastest also tend to have the highest inflation. They would thus require higher interest rates. Instead, real interest rates – the ECB nominal interest rates minus the local inflation rate – in their economies are usually the lowest in the eurozone. Ireland, for example, had inflation well above the European average in 2001, which resulted in negative real interest rates. Low or negative real interest rates tend to stimulate borrowing and investment, which adds further fuel to economic growth and inflation. Those countries with low growth and inflation, on the other hand, have much higher real interest rates. In Germany, for example, inflation (and growth) remained below the eurozone average in 2001-02. The resulting tight monetary conditions stifled growth further.

Those eurozone countries for which the ECB's monetary policy is too lax should follow a more restrictive budgetary policy. Those for which monetary policy is too tight should be allowed to disregard the 3 per cent limit in their fiscal policies, if only temporarily.[16] Because the same monetary policy leads to different monetary conditions across the eurozone, there is no single appropriate fiscal stance for the entire area. Europe's optimal policy mix is therefore the optimal policy mix of each individual member-state. The Commission's warnings to Ireland and Portugal may still have been justified under this approach (their fast-growing economies called for a fiscal tightening). But it is hard to see the rationale behind the instructions for Germany, even if it escaped an official reprimand.

[16] The downside of such an approach is that it would increase public debt in those countries with the highest real interest rates, but this appears inevitable.

On a theoretical level, it is generally accepted that monetary policy, rather than fiscal policy, should fulfil the function of stabilising economic activity. Changes in interest rates are obviously quicker to implement – despite the fact that they impact on the economy with a lag – than changes to the budget. However, this only works if the automatic fiscal stabilisers smooth out economic fluctuations. If this is not the case, governments have to react to every economic upswing or downturn with discretionary budgetary measures, such as tax changes or cuts in spending programmes. This results in increased uncertainty for the private sector. It is also less effective, since the changes in taxes and expenditure caused by automatic stabilisers are not only greater but also work more quickly and predictably than those brought about by discretionary changes.

But what if monetary policy does not react sufficiently to changed economic circumstances? If the central bank is inert, discretionary budgetary policy must take over. This should also be the case in a situation where – like in the EU – budgetary policy is completely decentralised and fiscal transfers from the central budget to the sub-regions are severely limited. The same economic shock, such as an international oil price hike, can have different consequences for the sub-regions – and they should be free to respond accordingly.

The SGP, however, is based on the dubious idea that in a monetary union national fiscal deficits should converge. Both intuition and most research into the topic suggest the opposite. Differences between national deficits should increase in the aftermath of an economic shock, to help the stabilisation of the entire eurozone economy. However, a look at national Stability Programmes implies that this divergence should decrease in the years ahead, even if all countries had very different fiscal conditions to start with. Those that try to diverge will soon face the unifying discipline of the SGP. This is economically dangerous. It also creates political antagonism towards the ECB, since governments have no discretion to counterbalance an unsuitable eurozone monetary policy. The SGP does not encourage a constructive dialogue between the budgetary

and monetary authorities – of the sort which would help to achieve an optimal European policy mix.

Reforming the Stability Pact

Economists generally agree that the SGP's focus on headline (overall) fiscal deficits is misguided. Most think that it would be preferable to focus on 'structural' deficits[17] – a definition of the deficit that strips out the impact of economic fluctuations on revenue and expenditure. Using headline deficits as a benchmark has a number of disadvantages. It can force governments to tighten fiscal policy just when growth is weak. It can limit or even suspend the functioning of automatic fiscal stabilisers. Moreover, it may harm public investment. Since current expenditure, such as public-sector wages or unemployment benefits, tends to be fixed in advance, governments are often forced to slash public investment – the most flexible part of the budget – to cut the deficit. This is undesirable, especially during an economic downturn, since public investment can be a good way of boosting an ailing economy and it generally increases an economy's future growth potential. This also implies that the SGP may be particularly harmful for the EU's less developed member-states, which require high public investment to support their economic catch-up.

[17]See for example J Creel, T Latreille and J Le Cacheux, 'Le Pacte de stabilité et les politiques budgétaires dans l'Union européenne', Revue de l'OFCE, March 2002.

A focus on structural deficits, on the other hand, would allow current spending to go up if growth slows – and not just in a recession, as stipulated by the SGP. The EU appeared to warm to this idea in 2001, when it agreed that the medium-term Stability Programmes should also take into account unforeseen risks and other possible sources of fluctuations and uncertainty in public finances. Moreover, in September 2002, the Commission said it would in future focus on the structural measure of the deficit in its review of the SGP. However, clearer rules are needed if a modified SGP is to reinforce the credibility of budgetary policy and reassure the ECB about inflationary risks. Buiter and others have long proposed to set a limit of 3 per cent for *structural* deficits, based on

the fact that public investment spending typically represents around 3 per cent of a country's GDP, and that it is normal for this to be funded by borrowing.[18]

[18] W Buiter, G Corsetti and N Roubini, *'Excessive Deficits: Sense and Nonsense in the Treaty of Maastricht', Economic Policy, N°16, 1993.*

Given the importance of public investment for growth, Europe's fiscal framework could be based on the 'golden rule' of public finances, which stipulates that over the course of the economic cycle current public spending – excluding investment – should not exceed revenue. Borrowing for investment purposes is allowed under this rule. Although this would be a better solution than the current SGP, this rule may still prevent the automatic fiscal stabilisers (which are not necessarily related to investment) from operating. The best fiscal rule would be a mix of the two. It would require European governments to balance their structural deficits but allow borrowing for investment spending. In other words, they should follow a 'golden rule' that has been amended to allow for cyclical fluctuations in public finances, and thus for the stabilising impact of the budget on the economy.

However, the golden rule is tricky to implement in practice. Both governments and economists have struggled to come up with a clear distinction between current spending and public investment. For example, building a school can easily be classified as an investment. But what about teachers' salaries, which are generally classified as current spending? The French government ran into heavy criticism in the summer of 2002 when it suggested that its planned increase in defence spending should be treated as an 'investment'. In the European context, it would best be left to the European Council to clarify the distinction. By defining what counts as investment spending, the European Council could even encourage governments to orientate their spending towards policy areas that have been highlighted as European priorities, such as trans-European transport links, research and development, higher education and new technologies. Unlike current attempts at economic policy co-ordination, which are cumbersome and controversial, this modified rule could help the emergence of a genuine set of European policies in those crucial areas.

This modified rule would impose enough restrictions on national budgetary policies to calm ECB fears, while giving European governments enough room for manoeuvre to react to unforeseen events and to pursue policies suitable for national circumstances. It would give European countries a degree of autonomy in deciding what share of their national revenue they wished to devote to public investment. There is no economic reason why this share should be the same for all countries. The European Council, by defining what constituted public investment, would gain new powers to instil priority policy areas with momentum. Although the new rule would not guarantee the stabilisation of public debt, it would ensure that any increase was due to a rise in public investment, which in turn improves the economy's growth potential and thus the government's future ability to repay the debt. The EU should move the SGP from a zero headline deficit to a zero structural deficit, excluding public investment, thereby allowing the eurozone governments to invest in future growth, without fearing the wrath of the European Commission.

5 Conclusion

As our pamphlet went to press, Europe was once again fearing recession. But despite the gloomy economic data, the ECB appears to be wavering. Although it acknowledges the risk of recession, it highlights the fact that inflation is still above its 2 per cent medium-term target. We strongly suggest that the target itself be put under review. As we have argued in this pamphlet, the ECB has largely done a commendable job in steering the European economy. Its monetary policy stance has been more conducive to economic growth than those of the national central banks – led by the powerful Bundesbank – before it. However, the ECB has done a poor job presenting itself and its policies. Intent on establishing a 'tough' reputation with the markets, it has neglected to explain to the European public that it does indeed care about growth. In its communication with the public, the ECB consistently highlights its 'reference value' for inflation and – often in a confusing way – its monetary policy target. This may well have undermined the ECB's credibility, rather than added to it.

Like most economists writing on the subject, we would like the ECB to become more credible and more transparent. But unlike most other economists, we do not claim to have a clear-cut solution to the ECB's credibility problem – the exception being our conviction that a rapid change to the inflation target is necessary. We believe that a measure of discretion, perhaps even secrecy, may be necessary for an effective monetary policy. A better use of existing channels of communication could go a long way in the meantime. As for the ECB's political accountability, the European Parliament should be involved in setting the overall inflation target – but the ECB needs to maintain its operational independence. ECB reform should be put on the agenda of the

European Convention. This fact alone could help to ameliorate the ECB's democratic deficit.

Meanwhile, the Growth and Stability Pact is in crisis. While the European economy is grinding to a halt, eurozone governments are less and less willing to comply with the strict fiscal limits of the Pact. Their attempts to evade its rules have undermined the Pact's credibility. There can now be no doubt that a thorough overhaul is necessary, as suggested in these pages. For the European policy mix, this 'liberation' of fiscal policy would be a breath of fresh air. It would ease the constant pressure on the ECB to adopt a more active style of macro-economic management, and remove many of the constraints that are currently inhibiting economic policy co-ordination in the EU.

★

- ★ **New designs for Europe**
  Katinka Barysch, Steven Everts, Heather Grabbe, Charles Grant, Ben Hall, Daniel Keohane and Alasdair Murray
  With an introduction by the Right Hon Peter Hain MP
  (October 2002)

- ★ **What future for federalism?**
  Gilles Andréani (September 2002)

- ★ **Business in the Balkans: The case for cross-border co-operation**
  Liz Barrett (July 2002)

- ★ **The Barcelona Scorecard: The status of economic reform in the enlarging EU**
  Edward Bannerman (May 2002)

- ★ **Learning from Europe: Lessons in education**
  Nick Clegg MEP and Dr Richard Grayson (May 2002)

- ★ **The future of EU competition policy**
  Edward Bannerman (February 2002)

- ★ **Germany and Britain: An alliance of necessity**
  Heather Grabbe and Wolfgang Münchau (February 2002)

- ★ **Shaping a credible EU foreign policy**
  Steven Everts (February 2002)

- ★ **Constructive duplication: Reducing EU reliance on US military assets**
  Kori Schake (January 2002)

- ★ **Europe after September 11th**
  Edward Bannerman, Steven Everts, Heather Grabbe, Charles Grant and Alasdair Murray (December 2001)

Available from the Centre for European Reform (CER), 29 Tufton Street, London, SW1P 3QL
Telephone + 44 20 7233 1199, Facsimile + 44 20 7233 1117, kate@cer.org.uk, www.cer.org.uk

CENTRE FOR EUROPEAN REFORM
NEW IDEAS FOR A NEW EUROPE

HOW TO REFORM THE EUROPEAN CENTRAL BANK

Jean-Paul Fitoussi and Jérôme Creel

The European Central Bank has by and large applied the right monetary policy, according to Jean-Paul Fitoussi and Jérôme Creel. Nevertheless the authors argue for a range of reforms that would make the ECB more effective and accountable. They suggest a role for the European Parliament in setting monetary policy targets. And with EU enlargement around the corner, they propose reforms to the composition of the ECB's policy-making council. Finally, they make the case for a thorough revamp of the Stability and Growth Pact, which threatens to strangle Europe's economic recovery.

Jean-Paul Fitoussi is a Professor at the Paris Institut d'Études Politiques, and President of the OFCE (Observatoire français des conjonctures économiques). Jérôme Creel is a research officer at the OFCE.

ODEY
Asset Management

ISBN 1 901 229 34 3★ £10/€16